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Financial Industry Group

Client Alert

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Dodd-Frank Implementation: What's Happened?

Introduction

It has now been eight months since the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173, 111th Congress) ("Dodd-Frank") became law July 21, 2010. As we opined in our overview presentation of July 27, 2010, much needed to be done by the regulators before we could better understand the implications of Dodd-Frank. Since that time, the federal bank regulatory agencies ("Agencies")[1] have been putting out proposed rulemakings for comment, studies, reports and final rules. This alert will cover the steps that have been taken to date, primarily by the Financial Stability Oversight Council ("FSOC"), the Board, and the FDIC in implementing Titles I, II, III and VI.

The Agencies have approached the implementation of Dodd-Frank in a fairly methodical and triaged manner. They appear to be working their way through the statutory implementation requirements, first doing those with the most current deadline to those furthest out on the timeline.

Titles I and II are intended to address the overriding concerns of Too Big To Fail and "moral hazard," and which financial services companies will be wearing the dubious crown of a Systemically Important Financial Institution ("SIFI"). Title III focuses on a restructuring of the regulatory world by (i) the absorption by the OCC of the OTS, (ii) the parent thrift holding companies becoming supervised by the Board, and (iii) the FDIC being afforded the means to replenish the Deposit Insurance Fund ("DIF"). Title VI's focus is on the Volcker Rule and the statutorily mandated "improvements" to the regulation of banks and their parent holding companies.

Title I

- Under Title I, most of the future rulemakings are to be undertaken by the Board and completed by January 2012.
- The rulemakings are to focus on setting standards for risk-based capital requirements, leverage limits, use of contingent capital, creation of acceptable resolution plans or living wills (the latter along with the FDIC), credit exposure limits, limits on debt, early remediation, intermediate holding companies, and limits thereon (Section 165).
- The Board has recently proposed criteria for determining when a company is "predominantly engaged" in financial activities, as well as the questions of what a "significant bank holding company" ("BHC") is and what a "significant nonbank financial company" is. Comments are due by March 30, 2011 (Sections 102(a)(7), 112 and 113). [2]
- The proposed principal test for "predominantly engaged" in financial activities is whether 85 percent or more of a company's consolidated annual gross revenues or consolidated total assets during either of its two most recently completed fiscal years (under the accounting standard the company uses in the ordinary course of its business) are in financial activities as defined under the Bank Holding Company Act (i.e., financial in nature or incidental to such financial activity, or complementary to a financial activity).
- A significant nonbank financial company is one supervised by the Board and any other bank holding company that had $50 billion or more in assets as of its last completed fiscal year.
- FSOC has put out an Advanced Notice of Proposed Rulemaking ("ANPR") for comment on the criteria that it should consider in designating what organization should be identified as a SIFI (Section 102(a)(7), 113).[3]
- Comments were received from 50 persons by November 5, and as a result, FSOC has now put out a Notice of Proposed Rulemaking ("NPR") describing the criteria that it will use and the process it will follow in designating nonbanks as SIFIs. The NPR indicates that determinations should be based on a combination of quantitative and qualitative factors with significant weight given to size, leverage and the type of leverage (secured versus unsecured, long-term versus

short-term, and operational versus financial), liquidity risk, interconnectedness, degree of primary regulation, and substitutability. The criteria track the considerations set out in Section 113 of Dodd-Frank.[4]

- FSOC's determinations will be based on whether the firm's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness or mix of its activities, could pose a threat to the financial stability of the United States. The standards will be adjusted for a particular industry sector and business model.
- To date, no specific firm has been identified by FSOC. There has been a Bloomberg report that an 80-page memo is circulating at Treasury that suggests some large hedge funds, private equity firms and insurers pose a systemic risk under certain scenarios. I am certain that report was intended only for internal Treasury Department circulation.
- With respect to the requirement in Section 171 (Collins Amendment) for a minimum risk-based capital floor for large banking organizations that is at least the same as the banks, on December 15 the Agencies requested comments on a proposed rule that would amend the advanced-approaches capital-adequacy framework, to meet on an ongoing basis, the higher of the generally applicable and the advanced-approaches minimum risk-based capital standards.[5]
- Section 616 of Dodd-Frank states that a countercyclical capital component is to be added.
- On March 18, 2011, the Board issued a report on its comprehensive supervisory review of the capital planning process of 19 large complex BHCs and their planned capital actions under stress scenarios. The scenarios include Basel III's capital requirements. While the institution-specific results will not be made public, those BHCs that proposed increased capital distributions in 2011 (whether dividends or share buy-backs) will be advised of the Board's non-objection position no later than March 21, 2011.[6]
- FSOC issued an ANPR December 21, 2010 as to the framework to be applied for designating Financial Market Utilities ("FMUs"). On March 17, 2011, FSOC issued an NPR describing the criteria and analytical framework that it will apply in designating FMUs. Comments are due 60 days after publication in the *Federal Register* (Sections 112, 804, 809 and 810).[7]
- In November 2010, the Board and the FDIC held a roundtable with industry executives to discuss the purpose, goals, key elements, and potential effects of the resolution plan or living will requirements of Section 165. There has been no further action on this issue to date, since the Agencies have until January 21, 2012, for a final rule.
- This will be one of the most difficult rules to implement. This provision imposes an extra burden on an SIFI acquirer who must court its target and almost simultaneously have discussions on how it will divest of the target in the event of "material financial distress or failure." Both the Board and the FDIC must agree on how the acquirer will implement the living will requirements.

Title II

- FDIC has filed an NPR on what its initial rules should be for the orderly liquidation of an SIFI (in implementing Sections 204(a), 206, 209 and 210). The proposal outlined how the FDIC will carry out its role as liquidator of a nonbank SIFI.[8]
- Shareholders and creditors will bear much of the losses, and management and other involved parties will be held accountable. The FDIC also will have the ability to create a bridge financial company to guard against a disorderly collapse.
- After having received 27 comments and having held two meetings with industry representatives and trade associations, the FDIC decided to issue an interim final rule (effective January 25, 2011) that took from both the Bankruptcy Code and the FDIC Act.[9]
- Because many of the comments related to matters beyond the scope of the original October 19, 2010 NPR, and the FDIC wanted to provide additional time for comments, the comment period was extended to March 28, 2011.
- A key point in the revised rule was to make it clear that all collateral will be valued at Fair Market Value as of the date the FDIC was made receiver. A number of other technical provisions are covered by this rulemaking, including (i) the payment of similarly situated creditors, (ii) the honoring of personal service contracts, (iii) the treatment of any remaining shareholder value in the case of a covered financial company that is a subsidiary of an insurance company, and (iv) limitations on liens the FDIC may take on the assets of a covered financial company that is an insurance company or covered subsidiary.

- On March 15, 2011, the FDIC issued a new proposed rule (with a 60-day comment period commencing after publication in the *Federal Register*) further amplifying on its orderly liquidation process while focusing on the rights of creditors in Title II receiverships. For example: (i) defining the priorities of payment for creditors, (ii) detailing the priority of setoff claims, (iii) specifying how post-insolvency interest will be paid, (iv) specifying the process for initial determination of claims, and (v) outlining the steps necessary to seek a judicial decision on any disallowed claims.[10]
- The proposed rule also (i) helps define what "financial company" is subject to this resolution process, (ii) helps define how compensation can be clawed back up to two years from covered senior executives and directors, and (iii) clarifies the application of the receiver's powers to avoid fraudulent and preferential transfers (Sections 201 and 210).

Title III

- Title III grants the FDIC much greater discretion to manage the DIF through economic cycles, to achieve moderate, steady assessment rates, and to maintain a positive fund balance.
- It includes changing the assessment base from the traditional bank deposits to the new average consolidated total assets minus tangible equity (Tier 1 capital). The new base may also be adjusted for bankers' banks and custodial banks (Section 331).[11]
- FDIC is afforded much more flexibility in deciding when and how to raise DIF funding. A new rule also changes the assessment rate for large banks (those with at least $10 billion in assets) using a scorecard based on institution performance and financial measures, with a separate and more complex scorecard for "highly complex" institutions that have more than $50 billion in assets and are controlled by a parent to intermediate holding company with more than $500 billion in total assets. FDIC also established a Designated Reserve Ratio at 2 percent (Section 334).[12]
- Early on, the FDIC issued a final rule raising its deposit insurance coverage to $250,000 per account (Section 335).[13]
- FDIC also issued a final rule implementing until December 31, 2012, unlimited deposit insurance coverage for non-interest-bearing transaction accounts (Section 343).[14]
- Agencies have submitted a joint implementation plan to the House Financial Services Committee, the Senate Banking Committee, and the Agencies' Inspector Generals describing actions taken to date for implementation of Title III's consolidation of the OTS into the OCC, and about the thrifts' parent holding companies becoming subject to Board supervision (Section 327).[15]
- This integration process actually started with a February 3, 2011, interagency change to the current OTS reporting requirements for savings associations and Savings and Loan Holding Companies ("SLHCs") by requiring thrifts to file bank Call Reports beginning with the March 31, 2012, reporting period in lieu of Thrift Call Reports, and for SLHCs to start making bank holding company form filings starting with their First Quarter March 31, 2012, reporting period.[16]
- It will be interesting to see what the Board will do with the thrifts that have subsidiaries engaged in real estate development activities, an impermissible activity as far as the Board is concerned.

Title VI

- On January 18, FSOC issued its 79-page Study and Recommendations on Section 619's Volcker Rule. The Volcker Rule prohibits banking entities from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds, subject to certain exceptions.[17]
- These exceptions are, in a very general sense, certain types of market making related activities, risk-mitigating hedging activities, asset management, underwriting, transactions in government securities, and other transactions on behalf of customers.
- Permitted activities are subject to a prudential "backstop" that prohibits an activity if it would result in (i) a material conflict of interest, (ii) material exposure to high-risk assets or high-risk trading strategies, (iii) a threat to the safety and soundness of the banking entity, or (iv) a threat to the financial stability of the United States.
- Many of these activities often evidence outwardly similar characteristics to proprietary trading. It will be difficult for the Agencies, the SEC and the CFTC to not come out with a very prescriptive rule.
- The Study has 10 upfront recommendations (at page 3), and sets out a four-part implementation and supervisory framework built around: (i) strong internal controls and a programmatic compliance regime with extensive monitoring, recordkeeping, reporting and testing, (ii) a detailed set of metrics, (iii) extensive supervisory review and oversight, and (iv) strong enforcement

procedures for violations, which includes termination of the impermissible activities, reductions in risk limits, increased capital charges or monetary penalties.

- The next required step is for the Board to come out with proposed rules as to how it will implement Section 619 of Dodd-Frank that are to be finalized within nine months of the FSOC study, or by October 18, 2011.
- The Board has issued a final rule (effective April 1, 2011) establishing the conformance period for banking entities and nonbank financial companies supervised by the Board; in effect, when BHCs with more than $50 billion in assets and nonbank financial companies deemed to be SIFIs must bring their proprietary trading, hedge fund and private equity fund activities, and investments into compliance with the Volcker Rule.[18]
- The prohibitions in the Volcker Rule become effective on the earlier of July 21, 2012 (two years after Dodd-Frank) or one year after the adoption of final Agency rules. That can be extended an additional three years (one year at a time) if the extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest.
- In the case of illiquid funds, they could have an additional five years or maybe less (up to the Board's discretion).
- The final rule clarifies a fund as illiquid only if at least 75 percent of its consolidated total assets are, or are expected to be, comprised of illiquid assets.
- The conformance period can be two years after a nonbank financial company is designated by FSOC for Board supervision. Requests for extension can be made as late as 180 days before the conformance deadline.
- There is no final Volcker Rule, as it requires interagency action by the Agencies and the SEC and CFTC. Also, the Board will likely need to issue its own rulemaking before it will issue a final rule, and will likely set out definitions such as "hedge funds," "private equity funds," and investments and activities. The Board will review this conformance rule after completion of the interagency rulemaking.
- Under Section 622, the FSOC completed its study and made recommendations on how to implement the new concentration limits on large financial companies, which need not be BHCs.[19]
- It was anticipated the concentration limit will help deal with Too Big To Fail and moral hazard, and the Study makes recommendations consistent with the statutory limit of 10 percent of aggregate consolidated liabilities (or total risk-weighted assets less total regulatory capital for risk-based capital rules, i.e., Basel III). It was felt that this aggregate limit would be more comprehensive than the 10 percent of nationwide deposit limit in Riegle-Neal.
- Note that U.S.-based firms are treated differently from foreign-based firms because the concentration limit for U.S.-headquartered firms is based on global liabilities. In the case of foreign firms, only their U.S. operations are considered.

Future Regulatory Actions

- The Board has a very large number of anticipated rulemakings. Among those it has indicated it may issue by mid-year 2011 are the following proposed rules under Title I:
  - Propose the reporting forms and information requirements for nonbank SIFIs that must register with the Board (Sections 114 and 604);
  - A rule to implement the requirement that it must consider whether the foreign bank's home country has a financial regulatory system that mitigates risk the foreign bank may present to the United States, before it acts on a foreign bank application to establish a U.S. office or whether to terminate its U.S. office (Section 173(a) and (b));
  - Final rules defining "predominantly engaged," "significant nonbank financial company," and "significant BHC";
  - Prior notice requirement for SIFIs to acquire a nonbank with $10 billion or more in assets (Section 163(b));
  - Final rule that will make Regulation L applicable to nonbank SIFIs (Section 164); and
  - Board is to issue a series of proposed stricter prudential rules applicable to BHCs with total consolidated assets of $50 billion or greater in the following areas:

- Risk-based capital and leverage requirements (Section 165(b)(i)(A)(i));
- Liquidity requirements (Section 165(b)(i)(A)(ii));
- Risk-management requirements (Section 165(b)(i)(A)(iii));
- Credit exposure limits (Section 165(e));
- Risk committee requirements (for all BHCs with $10 billion or more in assets) (Section 165(h));
- Stress tests, both internal and examiner conducted (Section 165(i)); and
- New preemptive Prompt Corrective Action measures (Section 166).

- The proposed rules under Title VI are the following:
  - limits on asset purchases or sales with insiders (Section 615);
  - Requirement that the parent bank holding company, in addition to its depository subsidiaries, be well-capitalized and well-managed in order for the parent holding company to qualify as a financial holding company (Section 606);
  - Agencies will seek comments on Volcker Rule's 10 percent of liabilities concentration limit, which is in lieu of Riegle-Neal's 10 percent of countrywide deposit cap (Section 622(b)); and
  - Board will issue a final rule indicating that among the factors it must consider in passing on bank acquisitions or mergers is the impact on the stability of the U.S. banking or financial system (Section 604(d) and (f)).
- Board is to undertake joint or coordinated rulemakings with the Agencies in the following areas:
  - Resolution Plan or Living Will requirements with the FDIC (Section 165(d));
  - For nonbanks supervised by the Board and BHCs with $50 billion or more in assets, a new reporting requirement to the Board, FSOC and FDIC on credit exposures between these several companies and other "significant" nonbanks and BHCs (Section 165(d));
  - For banks, thrifts and their holding companies with total consolidated assets of more than $10 billion, a rule regarding requirements for self-administered stress tests – to be done in a coordinated manner along with the Federal Insurance Office (Section 165(i)(2)); and
  - Final joint rulemakings by the Board and other Agencies implementing the Volcker Rule's proprietary trading restrictions.
- As the above suggests, the rulemaking process for Dodd-Frank is quite extensive and it will be quite a while before the true impact of Dodd-Frank can be ascertained. There is also the need to be mindful of Congressional action that might delay, modify, or nullify not just the various provisions in Dodd-Frank, but also implementing actions by the financial services regulators.

Michael Bleier is a partner in Reed Smith's Financial Industry Group and a member of the firm's internal task force following the Dodd-Frank Act. The task force includes partners from various practice groups across the firm, including Mark Oesterle (former Chief Counsel to the Senate Banking Committee and a key drafter of Dodd-Frank) and Bill Mutterperl (former Vice Chairman of The PNC Financial Services Group and General Counsel of Fleet Financial Company). These partners, along with others on our task force, have extensive backgrounds and unique insights when it comes to financial services and the ever-changing regulatory environment.

The lawyers at Reed Smith have been closely following the developments of Dodd-Frank since its inception and have been holding a series of webinars on Dodd-Frank and populating a dedicated website focused on all things Dodd-Frank. The site (www.reedsmith.com/doddfrank) includes articles and client alerts related to Dodd-Frank and its impact on the financial services industry. In addition, the site houses recordings and materials related to our teleseminars focusing on Dodd-Frank.

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1 Federal Deposit Insurance Corporation (“FDIC”), Federal Reserve Board (“Board”), Office of the Comptroller of the Currency (“OCC”) and Office of Thrift Supervision (“OTS”).

2 76 *Federal Register* 7731.

3 75 *Federal Register* 61653.

4 76 *Federal Register* 4555.

5 75 *Federal Register* 82317.

6 Board of Governors of the Federal Reserve System, *Comprehensive Capital Analysis and Review: Objectives and Overview* (March 18, 2011), http:/www/federalreserve.gov/newsevents/press/bcreg/20110318a.htm.

7 75 *Federal Register* 79922 and http://www.treasury.gov/initiatives/Pages/FSOC-index.aspx.

8 75 *Federal Register* 64173.

9 76 *Federal Register* 4207.

10 http://www.fdic.gov/news/news/press/2011/pr11056.html.

11 75 *Federal Register* 66272, 75 *Federal Register* 72582 and 75 *Federal Register* 72612.

12 75 *Federal Register* 79286.

13 75 *Federal Register* 49363.

14 76 *Federal Register* 4813.

15 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, J*oint Implementation Plan, 301-326 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 2011).

16 76 *Federal Register* 7082.

17 Financial Stability Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds, Completed Pursuant to Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 2011).

18 76 *Federal Register* 8265.

19 Financial Stability Oversight Council, *Study & Recommendations Regarding Concentration Limits on Large Financial Companies, Completed Pursuant to Section 622 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 2011).

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