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Financial Regulatory Reform: The Dodd-Frank Wall Street Reform and Consumer Protection Act

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The Dodd-Frank Act will enact significant financial reform legislation that will have a major and lasting impact on the operations of banks, financial institutions and other financial services organizations doing business in the United States.

On July 15, 2010, the United States Senate approved the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act was approved by the United States House of Representatives on June 30, 2010 and is now expected to be signed into law by President Obama. The act will significantly reform the structure of federal financial regulation and enact new substantive requirements and regulations that will apply to a broad range of financial market participants, affecting every segment of the financial services industry. The Dodd-Frank Act strengthens oversight and regulation of banks and nonbank financial institutions, enhances regulation of over-the-counter derivatives and asset-backed securities, includes corporate governance and executive compensation reforms applicable to all public companies, creates new requirements for hedge fund and private equity fund advisers and establishes new rules for credit rating agencies. In this alert we highlight certain significant aspects of the Dodd-Frank Act. We are concurrently issuing alerts addressing in detail various provisions of this sweeping and comprehensive legislation.

Systemic Risk and Regulation

The Dodd-Frank Act creates a new framework intended to promote the financial stability of the United States financial services system. The act creates a new inter-agency regulatory authority, the Financial Stability Oversight Council, that is responsible for monitoring the activities of the financial system and recommending a framework for substantially increased regulation of financial companies and large bank holding companies.

The Financial Stability Oversight Council

The Financial Stability Oversight Council (FSOC) is charged with identifying and managing systemic risk in the financial system. The FSOC, chaired by the Secretary of the Treasury, will consist of ten voting members who are heads of federal financial regulatory agencies, and will also include five nonvoting members, who are heads of a new Office of Financial Research and a new Federal Insurance Office, and representatives of state insurance, banking and securities regulators.

The FSOC will have authority to designate a nonbank financial company (including a foreign company) as being subject to Federal Reserve supervision and regulation if it determines that material financial distress at the company, 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 FSOC's authority to subject nonbank financial companies to regulation by the Federal Reserve is limited to nonbank financial companies that are "predominantly engaged in financial activities." A company is considered "predominantly engaged in financial activities" if at least 85 percent of its consolidated annual gross revenues are derived from, or 85 percent of its consolidated assets are related to, activities that are financial in nature.

The FSOC will have the authority to recommend that the Federal Reserve implement stricter prudential standards and reporting and disclosure requirements for nonbank financial companies supervised by the Federal Reserve and "large interconnected bank holding companies" (those with total consolidated assets of $50 billion or more). These standards may be increased in stringency depending on a variety of factors, including the company's size and total liabilities. The Dodd-Frank Act also authorizes the FSOC to make recommendations to the Federal Reserve on various other matters, including requiring such companies to submit resolution plans, mandating credit exposure reports, establishing concentration limits, and limiting short-term debt. The FSOC may also recommend that other federal financial regulatory agencies apply new or more stringent standards on financial activities.

Minimum Leverage and Risk-Based Capital Requirements

Under the Dodd-Frank Act, federal banking regulatory agencies are required to establish minimum leverage and risk-based capital requirements on a consolidated basis for all insured depository institutions, bank holding companies and nonbank financial companies supervised by the Federal Reserve. The minimum requirements can be no less than the currently applicable total leverage and capital requirements in effect for depository institutions, requiring bank holding companies and nonbank financial companies supervised by the Federal Reserve to maintain the same capital standards that apply to banks.

Liquidation Authority

The Dodd-Frank Act creates a new liquidation authority and establishes a process for the orderly liquidation of systemically important "financial companies" that pose a significant risk to the financial stability of the United States, administered by the Federal Deposit Insurance Corporation (FDIC) as receiver. This authority is modeled on the FDIC's resolution authority for insured depository institutions under the Federal Deposit Insurance Act. Financial companies that may be subject to this liquidation authority include bank holding companies, nonbank financial companies supervised by the Federal Reserve, and companies that are predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental thereto.

The appointment of the FDIC as receiver requires that the Secretary of the Treasury, upon recommendation by a 2/3 vote of each of the board of governors of the Federal Reserve and the board of directors of the FDIC (or the commissioners of the Securities and Exchange Commission (SEC), in the case of a broker or dealer or a company whose largest United States subsidiary is a broker or dealer, or

the director of the newly created Federal Insurance Office, in the case of an insurance company or a company whose largest United States subsidiary is an insurance company), make a determination that, among other things, the financial company is in default or danger of default, the failure of the financial company and its resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability in the United States and no viable private sector alternative is available to prevent the financial company's default. Upon such determination and recommendation of receivership, the Secretary of the Treasury would either obtain the consent of the financial company's board of directors or an order from the United States District Court for the District of Columbia that the company is a "financial company" and in default or danger of default.

The Dodd-Frank Act allows the FDIC to exercise many of the same kinds of receivership powers that it has under the Federal Deposit Insurance Act. However, the liquidation authority granted to it under the act also includes a number of provisions that are based on the United States Bankruptcy Code to compensate for the fact that the liquidation authority may be used for a broader range of businesses, including nonbank institutions. The act expressly prohibits the use of taxpayer funds to bail out failing financial companies. The FDIC may fund a liquidation by borrowing from the Department of the Treasury, but must repay any such borrowings by reclaiming funds paid to shareholders and unsecured creditors, and, if such funds are insufficient, levying risk-based assessments on large bank holding companies and nonbank financial companies.

Payment Clearing and Settlement Supervision

The Dodd-Frank Act also authorizes the Federal Reserve, in consultation with the FSOC and other federal regulators, to prescribe standards regulating the risk management of systemically important financial market utilities and systemically important payment, clearing and settlement activities conducted by financial institutions.

Banking Reform

The Dodd-Frank Act includes a broad range of legislation intended to reform the regulatory framework for depository institutions, bank and thrift holding companies, and other financial institutions in the United States.

Elimination of the Office of Thrift Supervision and Changes to Bank Regulatory Structure

The act abolishes the Office of Thrift Supervision, transferring its authority with respect to savings associations, their holding companies and their affiliates to the Office of the Comptroller of the Currency (OCC), the FDIC and the Federal Reserve. The OCC will assume the supervision of federal savings and loan associations (thrifts), while the FDIC will assume the responsibility for supervising state-chartered thrifts. The Federal Reserve will supervise thrift holding companies.

Deposit Insurance

The Dodd-Frank Act modifies the FDIC's assessment base upon which deposit insurance premiums are calculated, by shifting from an assessment base defined by deposit liabilities to a risk-based system based on total assets. Generally speaking, the new assessment base will equal the average total consolidated assets of an insured depository institution minus the sum of the average tangible equity of the insured depository institution during the assessment. The act also makes permanent the increase in standard maximum federal deposit and share insurance limits from $100,000 to $250,000.

The Volcker Rule

The Volcker Rule, named after the provision's main advocate, former Federal Reserve Chairman Paul Volcker, broadly restricts banking entities from engaging in proprietary trading, private fund sponsorship, management activities and investment activities, including investing in a hedge fund or private equity fund. These prohibitions, and their exceptions and limits, will need to be clarified and refined through the regulatory process. While the Volcker Rule does not apply to nonbank financial companies, the Federal Reserve is required to adopt rules that impose additional capital requirements and quantitative limits on nonbank financial companies it supervises that engage in proprietary trading or sponsoring or investing in hedge funds or private equity funds. None of the Volcker Rule prohibitions take effect before the earlier of two years after enactment or twelve months after the issuance of final rules, and there are additional phase-in periods for certain restrictions.

Concentration Limits

The Dodd-Frank Act imposes a general concentration limit on all financial companies, prohibiting any acquisition that would result in a financial company having more than ten percent of the aggregate consolidated liabilities of all financial companies.

Derivatives Regulation

The Dodd-Frank Act creates a new framework for the regulation of over-the-counter (OTC) derivatives. The act requires the centralized clearing of OTC derivatives, under which any OTC derivative that is accepted for clearing by a clearing organization generally must be cleared by that organization. In addition, the act creates a new regulatory scheme for the oversight and supervision of swap dealers and major swap participants, and provides new regulatory authority to the Commodity Futures Trading Commission (CFTC) and the SEC.

Exchange Trading and Clearing

The Dodd-Frank Act requires the clearing of swaps and security-based swaps that have been accepted to be cleared by a clearinghouse and approved by the federal regulators. Swaps and security-based swaps that are currently listed for clearing by a derivatives clearing organization will be reviewed to determine whether the swap or security-based swap should be required to be cleared. New swaps and security-based swaps will have to be approved before the swap or security-based swap will be required to be cleared. If a swap or security-based swap cannot be cleared, then it must be reported to a swap data repository or security-based swap data repository, or, if there is no such repository, to federal regulators.

If a swap or security-based swap is required to be cleared, it must be exchange traded if a designated contract market, swap execution facility, national securities exchange or security-based swap execution facility will accept it for trading. The act also requires public reporting of swap and security-based swap transaction and pricing data. The act gives the CFTC, the SEC and banking regulators the authority to impose capital, initial and variation margin requirements on dealers and major participants with respect to uncleared swaps and security-based swaps. The act also authorizes regulators to establish position limits on certain contracts and prohibits market manipulation.

End-User Exemption

The Dodd-Frank Act includes an exemption from the central clearing and exchange trading requirements for certain end-users that are not financial entities, are using the swap or security-based swap to hedge or mitigate commercial risk and notify the applicable regulatory agency how they generally meet their

financial obligations associated with entering into non-cleared swaps or security-based swaps. "Financial entity" is a term that includes many dealers and participants in the swap and security-based swap markets, commodity pools, private funds, employee benefit plans and other persons predominately engaged in banking and financial activities.

Lincoln Provision

Depository institutions are permitted to continue to act as swap dealers with respect to hedges of their own activities and to enter into rate swaps and swaps referencing assets permitted for investment by a national bank, but are not permitted to act as swap dealers with respect to credit default swaps unless such swaps are cleared. The Dodd-Frank Act specifically authorizes the spin-off by depository institutions of impermissible swap dealer activities to affiliates controlled by the same bank holding company. Insured depository institutions will have up to twenty-four months to divest themselves of prohibited swap dealer activities.

Registration and Reporting Requirements for Investment Advisers

The Dodd-Frank Act effects registration requirements for advisers to hedge funds, private equity funds, and certain other types of private investment vehicles. These advisers will, among other things, be required to provide information to the SEC and other federal regulators.

Private Fund Adviser Registration and Regulation

The Dodd-Frank Act significantly changes registration requirements for advisers to private funds by, among other things, eliminating the current "private adviser" exemption from registration for any United States resident adviser that has fewer than 15 clients, creating new registration exceptions and exemptions, and raising the minimum asset threshold for federal registration for most United States resident advisers from $25 million to $100 million (those below the threshold will be subject to state regulation). Registered advisers will be subject to reporting and recordkeeping requirements and periodic examination by the SEC. Information provided by registered advisers can be shared by the SEC with the FSOC to assess systemic risk.

Exemptions from Registration

The act provides exemptions from registration for advisers who solely advise venture capital funds (to be later defined by the SEC) and for advisers that solely advise private funds and have assets under management in the United States of less than $150 million. Certain advisers to family offices, foreign private advisers and advisers to smaller business investment companies are also exempt from registration. Many exempted advisers will nevertheless be subject to such recordkeeping and reporting obligations as the SEC determines are necessary and appropriate in the public interest or for the protection of investors.

Investor Protection and Regulatory Enforcement

The Dodd-Frank Act increases the regulatory oversight of securities and capital markets activities by strengthening protections to investors, expanding the SEC's regulatory authority, and broadening the application and enforcement of existing provisions of the federal securities laws. Comments from SEC Chairman Mary Schapiro suggest that the SEC will swiftly promulgate rules implementing the act.

Fiduciary Duty for Broker-Dealers

The Dodd-Frank Act requires the SEC to conduct a six-month study on the need to impose a fiduciary duty on brokers, dealers and investment advisers providing personalized investment advice to retail customers. The study will examine the effectiveness of enforcement and compliance mechanisms and consider alternative means of imposing a fiduciary duty on broker-dealers. When the study is complete, the SEC is authorized to issue rules imposing a fiduciary-like duty on broker-dealers in providing advice to retail customers. The act also gives the SEC the power to limit the use of mandatory predispute arbitration agreements between brokers, dealers and investment advisers with their customers and clients.

Enforcement of Securities Laws

The Dodd-Frank Act includes several provisions intended to increase regulatory enforcement and remedies under the federal securities laws. Among other provisions meant to improve the SEC's ability to enforce securities laws, the act provides incentives and protections to whistleblowers by creating a whistleblower fund to create financial incentives for the public to provide information to the SEC that leads to successful enforcement proceedings, and by prohibiting retaliation by an employer against a whistleblower employee who provides information to the SEC. The act also permits the SEC to impose expanded collateral bars, prohibiting violators from associating with a broad range of SEC regulated firms rather than only those entities regulated under the particular federal securities law under which the violation occurred.

Other significant provisions of the Dodd-Frank Act give the SEC the authority to bring aiding and abetting charges under federal securities laws, allow the SEC to impose civil penalties in cease and desist proceedings, and broaden the standards for extraterritorial application of the anti-fraud provisions of federal securities laws.

Investor Standards

The Dodd-Frank Act revises the net worth standard in the definition of "accredited investor," to provide that the value of a person's primary residence is excluded from the calculation of the $1 million net worth requirement. This provision is immediately effective upon enactment of the act and affects all private offerings under Regulation D of the Securities Act of 1933. The Dodd-Frank Act requires subsequent reviews by the SEC of this definition and adjustments to the financial threshold as appropriate. The act also requires the SEC to index for inflation the dollar amount measures in any test it establishes to determine who is a "qualified client" for purposes of permitting the assessment of a performance fee by a registered investment adviser.

Credit Rating Agency Regulation

The Dodd-Frank Act reforms the regulation of credit rating agencies, including the imposition of new liability standards, potentially increasing the liability exposure of credit rating agencies. The act establishes a new Office of Credit Ratings to oversee and examine credit rating agencies and promulgate new rules for internal controls, independence, transparency and penalties for poor performance. Nationally recognized credit rating agencies will be required to establish, maintain, enforce and document an effective internal control structure and submit an annual internal controls report to the SEC. Credit rating agencies will be subject to new disclosure requirements that mandate public disclosure of ratings methodologies, use of third parties' due diligence and ratings track records, as well as material changes made to, or material errors identified in, ratings procedures or methodologies. The act authorizes the SEC to deregister credit rating agencies for failing to consistently produce accurate ratings and establishes a new private right of

action against rating agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.

Corporate Governance and Executive Compensation

The Dodd-Frank Act includes several provisions that impact companies' corporate governance and executive compensation practices. These provisions include non-binding shareholder say on pay votes, increased independence of compensation committees and their advisers, clawback of current and former executive officers' compensation upon restatement of company's financials, SEC authority to adopt proxy access, and enhanced disclosure requirements. While, in most instances, SEC rulemaking will determine their final implementation, requirements of most of the corporate governance and executive compensation provisions will likely be clarified and could be in effect as early as the 2011 proxy season.

Say On Pay

"Say on pay" refers to mandated non-binding shareholder votes to approve named executive officers' compensation and to approve so-called golden parachutes (merger-related compensation agreements or understandings with executives). The Dodd-Frank Act requires that, at the company's first shareholder meeting occurring six months after passage of the act, shareholders be given a non-binding vote on executive compensation. Further, at that same meeting, companies must provide shareholders a non-binding vote on the frequency of future executive compensation say on pay votes. The act requires that an executive compensation say on pay vote take place no fewer than once every three years, and that a vote on the frequency of say on pay votes take place no fewer than once every six years.

Additionally, the act mandates that companies provide shareholders a non-binding advisory vote on golden parachutes at a meeting of the shareholders to approve any merger-related transaction occurring six months after the passage of the act.

Broker Discretionary Voting

The Dodd-Frank Act restricts the ability of brokers to vote shares in the absence of direction from shareholders with respect to election of board members, executive compensation or "any other significant matter," as determined by the SEC. In light of the act prohibiting broker discretionary voting in connection with executive compensation, the say on pay provisions will likely impact how companies approach named executive officer compensation.

Compensation Committee and Adviser Independence

The Dodd-Frank Act will require exchange-listed companies to comply, through new rules to be adopted by exchanges, with enhanced independence requirements (similar to the Sarbanes-Oxley Act's independence requirements for audit committee members) for compensation committee members. Compensation committees will also be required to take into account independence factors identified by the SEC in their selection of advisers, and disclose in the company's proxy statement any conflict of interest related to the adviser.

Compensation Clawbacks

The Dodd-Frank Act directs the SEC to adopt rules requiring national securities exchanges and associations to adopt listing standards mandating that listed companies implement clawback policies for executive compensation in the event of a financial restatement due to material noncompliance with any

financial reporting requirement. These rules would apply to current or former executive officers who received incentive-based compensation in excess of the amount that should have been received under the restated financials within three years preceding such restatement.

Enhanced Proxy Disclosure

The Dodd-Frank Act will require companies to disclose in the compensation section of their annual meeting proxy statement the relationship between executive compensation actually paid and the company's financial performance, taking into account any change in stock value, dividends and any other distributions. In addition, companies will be required to disclose the ratio between the CEO's compensation and the median compensation of all other employees. The SEC is also directed to require companies to disclose whether they prohibit employees and directors from hedging against a decrease in the value of the company's equity securities.

Sarbanes-Oxley Section 404(b) Exemption

The Dodd-Frank Act permanently exempts issuers that are neither a "large accelerated filer" nor an "accelerated filer" from compliance with the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002.

Consumer Financial Protection

Bureau of Consumer Financial Protection

The Dodd-Frank Act establishes a new consumer financial services regulating agency, the Bureau of Consumer Financial Protection (Bureau). The Bureau is within the Federal Reserve, but the act includes provisions to preserve the Bureau's independence from the Federal Reserve, including prohibiting the Federal Reserve from intervening in Bureau matters and from appointing or removing any Bureau officers or employees.

The Bureau's purposes include investigating consumer complaints, conducting market research, rulemaking, supervising and examining covered persons, promoting financial education, and enforcing rules related to consumer financial products and services. To that end, the act creates offices in the agency, such as the Office of Fair Lending and Equal Opportunity and the Office of Financial Education. The Bureau has authority to issue regulations, orders and guidance implementing consumer financial law, and, subject to explicit carve-outs, may issue rules applicable to all financial institutions offering consumer financial services or products, including both non-depository and depository institutions. The Bureau also has the authority to exempt classes of covered persons, providers, and financial products or services.

The extent of the Bureau's supervision and enforcement powers depends on the covered persons. If the covered person is a "very large" insured depository institution or credit union (having assets over $10 billion) or an affiliate or service provider of such depository institution or credit union, the Bureau has exclusive rulemaking and examination power and primary enforcement authority concerning federal consumer financial laws. For smaller insured depository institutions and credit unions and their service providers, the Bureau has exclusive rulemaking authority only to the extent authorized by a federal consumer financial law and no enforcement authority. As to non-depository institutions, the Bureau has exclusive rulemaking and enforcement powers for only those non-depository institutions engaged in specific activities defined in the act and their service providers.

Despite the Bureau's broad authority, the Dodd-Frank Act excludes from supervision and enforcement numerous financial service providers. These include merchants, retailers and sellers of nonfinancial goods or services; real estate brokerage activities; manufactured home retailers and modular home retailers; accountants and tax preparers; persons regulated by state insurance regulators; employee benefit and compensation plans; persons regulated by state securities commissions, the SEC or the CFTC; activities related to charitable contributions; and auto dealers. In addition, the FSOC may stay a Bureau regulation upon petition by a member agency of the FSOC, and the FSOC may permanently set aside a Bureau regulation upon a 2/3 vote of the FSOC.

Regulatory Improvements

The Dodd-Frank Act includes several provisions intended to promote consumer protection, including provisions restricting card issuers' interchange transaction fees and expanding application of the Truth in Lending Act to consumer credit transactions and consumer leases in an amount up to $50,000 (increased from $25,000).

Securitization

The Dodd-Frank Act requires securitizers to retain an economic interest in the credit risk for any asset that securitizers transfer, sell, or convey to a third party. Under these requirements, securitizers must retain not less than five percent of the credit risk for any asset that is not a "qualified residential mortgage" (to be defined by regulations promulgated under the act) that is transferred, sold, or conveyed through the issuance of an asset-backed security. The risk retained may be less than five percent if the originator of the asset meets certain underwriting standards, as established by the OCC, Federal Reserve and FDIC. The regulations may provide for total or partial exemptions of any securitization that may be in the public interest and for the protection of investors, including an asset issued or guaranteed by the federal government or subdivision thereof.

The act also prohibits underwriters, placement agents, initial purchasers and sponsors of asset-backed securities from engaging in any transaction during the one-year period following the date of the first closing of the sale of the securities that would involve or result in any material conflict of interest with respect to any investor in the transaction, other than certain risk-mitigating hedging activities and purchases or sales made pursuant to and consistent with liquidity commitments or bona fide market-making activities.

Insurance Regulation

Federal Insurance Office

The Dodd-Frank Act establishes the Federal Insurance Office (FIO) within the Department of the Treasury. Headed by a director appointed by the Secretary of the Treasury, the FIO is charged with the duty to monitor all lines of the insurance industry except health insurance, certain long-term care insurance and crop insurance and to recommend and promote improvements in the insurance industry. The FIO is authorized to monitor the insurance industry, including identifying gaps in insurance regulation that could contribute to a systemic crisis in the insurance industry or United States financial system, monitor the extent to which underserved consumers and communities have access to affordable insurance products, recommend to the FSOC any insurers that should be treated as systemically important, assist in administering the Terrorism Insurance Program, develop and coordinate a federal policy on international insurance matters, and determine whether state insurance measures are preempted by international

agreements on prudential measures. Despite the FIO increasing federal involvement in the insurance industry, state regulators remain the primary regulatory authority over the industry.

Nonadmitted Insurers and Reinsurance Provisions

The Dodd-Frank Act includes provisions intended to streamline and promote uniformity in the nonadmitted insurance market and reinsurance by limiting interstate application of regulation and encouraging implementation of uniform standards.

Mortgage Reform and Anti-Predatory Lending Act

The Dodd-Frank Act enacts various consumer protections for residential mortgages and strengthens underwriting by prohibiting creditors generally from extending residential mortgages to borrowers who cannot demonstrate through documentary evidence a reasonable ability to repay the loan. The act also bans a variety of residential mortgage lending practices, and imposes further restrictions on mortgages that are not deemed "qualified," defined as meeting certain pro-consumer requirements concerning interest rates, fees, and terms. The act bans certain practices in mortgage origination, imposes new requirements on mortgage servicers, establishes standards for property appraisals, and places conditions on certain high-cost and higher-risk mortgages.

Implementation of the Dodd-Frank Act

While generally effective the day after its enactment, many of the significant provisions of the Dodd-Frank Act have extended implementation periods and delayed effective dates, and will require regulatory action and rulemaking by federal regulatory authorities to either implement the standards set out in the legislation or to adopt new standards, as well as numerous separate studies by different agencies. As a result, the full scope and effect of this profound legislation on the United States financial system may not be known for several years.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the attorneys below.

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