

DEVELOPMENTS IN BANKING AND FINANCIAL LAW:  
2010

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***I. Staff Introduction***

The financial crisis substantially changed the way that many Americans live their lives, and led to numerous company failures, widespread job-loss and housing foreclosures. Congress responded to these problems by enacting in-depth legislation that changed the landscape of financial regulation. The “Dodd-Frank Act” revamped swap markets, the insurance industry, consumer protections, banking regulation and many other areas of financial law. The financial industry is still in the process of implementing these changes and the long-term impact of this broad-reaching legislation remains uncertain.

This series of articles focuses on key portions of the Dodd-Frank Act, detailing the specific changes that it requires. The articles also analyze how the new laws could potentially impact financial institutions on a broader level.

## **II. Orderly Liquidation Authority**

### **A. Introduction**

In response to the bailouts of financial institutions deemed “too big to fail” during the financial crisis in 2008, Title II of the Dodd-Frank Act creates a new resolution authority for large financial institutions whose failure could threaten the United States economy. This Orderly Liquidation Authority (“OLA”) replaces bankruptcies for affected financial institutions, vesting federal receivership powers in the FDIC similar to the FDIC’s existing powers to take over insured depository institutions.

The OLA, however, raises significant issues. The OLA will replace a predictable, transparent judicial bankruptcy process with an unpredictable, untested agency process. The OLA also alters shareholder and creditor rights, particularly unsecured creditor rights, from those in traditional bankruptcy proceedings. Consequently, rather than mitigating future financial crises, OLA and its uncertain impact on creditor rights could bring about the very financial instability that Dodd-Frank was intended to resolve.

### **B. Bailouts, Bankruptcies and the Financial Crisis**

In the wake of the 2008 financial crisis, a general consensus emerged that the failure of financial institutions that were “too big to fail” and the costly bailouts they required resulted from the failure of the U.S. Bankruptcy Code (“Code”) to provide for their orderly resolution.<sup>1</sup> Experts often cite the Lehman Brothers bankruptcy, which caused the largest drop on Wall Street since the September 11, 2001 terrorist attacks, as proof that traditional bankruptcies are inadequate in the case of large financial firms.<sup>2</sup> This line of argument

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<sup>1</sup> See Donna Borak, *FCIC: Will Dodd-Frank Stop Future Bailouts?* AMERICAN BANKER, September 3, 2010, at 3 (indicating that if Dodd-Frank had been in place the government would have “had a detailed resolution plan” and “seized and unwound [Bear Stearns, Lehman, and AIG.]”); see Chann, *infra* note 3.

<sup>2</sup> Alex Berenson, *Wall St.’s Turmoil Sends Stock Reeling*, N. Y. TIMES Sep. 16, 2008, at C7; See Michelle Harner, *Dodd-Frank Forum: Who Benefits from the New Resolution Authority*, THE CONGLOMERATE (Sept. 28, 2010, 8:31 AM) available at: <http://www.theconglomerate.org/2010/07/doddfrank-forum-who-benefits-from-the-new-resolution-authority.html>.

holds that in the case of Lehman, bankruptcy courts were too cumbersome and lacked the expertise to efficiently grapple with the firm's complex financial structure.<sup>3</sup>

As a result of the Code's perceived shortcomings and the continued threat to the US financial system posed by failing financial firms, Title II of the Dodd-Frank Act creates the OLA, a new resolution authority for large and complex financial institutions whose failure could destabilize the foundations of United States economy.<sup>4</sup> Functionally, the OLA may replace bankruptcies for affected financial institutions, vesting federal receivership powers in the FDIC similar to the FDIC's existing powers to take over insured depository institutions.<sup>5</sup> But the OLA's greater purpose is to ensure that financial institutions are not "too big to fail," thereby stabilizing and restoring market discipline to the US financial system.<sup>6</sup>

### C. OLA Resolution Authority

#### 1. Determination of Entities Subject to OLA

A "financial company" is subject to Title II's alternative resolution authority.<sup>7</sup> The OLA defines a "financial company" as any company incorporated or organized under any provision of federal or state law and is: (i) a bank holding company as defined in section 2(a) of the Bank Holding Company Act of 1956 ("BHCA");<sup>8</sup> (ii) a non-bank financial company supervised by the U.S. Federal Reserve Board of Governors ("FRB");<sup>9</sup>; (iii) any company that is predominantly engaged in activities that the FRB has determined are

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<sup>3</sup> Sewell Chann & Binyamin Appelbaum, *They've Got It: Fixes for the Financial System*, N.Y. TIMES, Apr. 24, 2010, at WK3, available at <http://www.nytimes.com/2010/04/25/weekinreview/25chan.html>.

<sup>4</sup> See *2010 U.S. bank failures now 125*. UNITED PRESS INTERNATIONAL, Sep. 18, 2010, [http://www.upi.com/Business\\_News/2010/09/18/2010-US-bank-failures-now-125/UPI-41181284826535/](http://www.upi.com/Business_News/2010/09/18/2010-US-bank-failures-now-125/UPI-41181284826535/).

<sup>5</sup> Joseph Gabai, *Dodd-Frank, Title: Where the FDIC and the "Orderly Liquidation Authority" Meet the Bankruptcy Code*, p. 1, August 31, 2010, available at <http://www.mofo.com/files/Uploads/Images/100831TitleII.pdf>.

<sup>6</sup> *Id.*

<sup>7</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 201(a)(11), 124 Stat 1376 (2010) (to be codified at 12 U.S.C. § 5381).

<sup>8</sup> *Id.* at § 201(a)(11)(B)(i) (to be codified at 12 U.S.C. § 5381).

<sup>9</sup> *Id.* at § 201(a)(11)(B)(ii) (to be codified at 12 U.S.C. § 5381).

financial in nature or incidental thereto (i.e., 85 percent of their annual gross revenues are derived from activities that are “financial in nature”);<sup>10</sup> or (iv) any subsidiary of the above that is predominately engaged in activities that the FRB has determined are financial in nature or incidental thereto (not including subsidiaries that are insured depository institutions or insurance companies).<sup>11</sup>

## 2. Systemic Risk Determination

To initiate an alternative liquidation under the OLA, a covered financial company must pose a “systemic risk.”<sup>12</sup> In order to make this determination, the FDIC and FRB must recommend, either on their own initiative or at the request of the Secretary of the Treasury (“Secretary”), the appointment of the FDIC as a receiver for a covered financial company.<sup>13</sup> At least two-thirds of the FRB members and FDIC board of directors must approve this recommendation. The recommendation must address the following criteria: (i) whether a company is in default or in danger of default; (ii) the effect that the default of the financial company would have on financial stability in the United States; (iii) the effect that the default of the financial company would have on economic conditions or financial stability for low income, minority, or underserved communities; (iv) a recommendation regarding the nature and the extent of actions to be taken; (v) whether a private sector alternative to prevent the default of the financial company exists; (vi) why a case under the Bankruptcy Code is not appropriate for the financial company; (vii) the effects on creditors, counterparties and shareholders of the financial company; and (viii) whether the company satisfies the definition of a financial company under section 201.<sup>14</sup>

Based on the FRB and FDIC recommendation, the Secretary in consultation with the President of the United States must then determine whether to appoint the FDIC as receiver for the covered

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<sup>10</sup> *Id.* at § 201(a)(11)(B)(iii) (to be codified at 12 U.S.C. § 5381); Mark A. McDermott, *Orderly Liquidation Authority*, p. 1, available at: [http://skadden.com/newsletters/FSR\\_Orderly\\_Liquidation\\_Authority.pdf](http://skadden.com/newsletters/FSR_Orderly_Liquidation_Authority.pdf)

<sup>11</sup> *Id.* at § 201(a)(11)(B)(iv) (to be codified at 12 U.S.C. § 5381).

<sup>12</sup> *Id.* at § 203(a) (to be codified at 12 U.S.C. § 5383).

<sup>13</sup> *Id.* at § 203(a)(1)(A) (to be codified at 12 U.S.C. § 5383).

<sup>14</sup> *Id.* at § 203(a)(2) (to be codified at 12 U.S.C. § 5383).

financial company in danger of default.<sup>15</sup> The OLA stipulates that a financial company is in default or in danger of default if (i) a bankruptcy case has been, or likely will promptly be, commenced with respect to the covered financial company; (ii) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; (iii) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or (iv) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.<sup>16</sup>

### 3. Appointment of FDIC as Receiver

The OLA is designed to swiftly appoint the FDIC as a receiver for a covered financial company.<sup>17</sup> Once the Secretary determines that a financial company poses a systemic risk, the Secretary must notify the financial company and the FDIC.<sup>18</sup> If the financial company's board of directors consents or acquiesces to the appointment of the FDIC as receiver, the FDIC becomes the receiver.<sup>19</sup> Board members cannot be liable to shareholders or creditors for acquiescing in or consenting in good faith to the FDIC's appointment as receiver.<sup>20</sup>

If the defaulting financial company's board does not consent to the appointment of FDIC as receiver, "the Secretary shall petition the United States District Court for the District of Columbia ("Court") for an order authorizing the Secretary to appoint the Corporation as receiver."<sup>21</sup> The covered financial company must receive notice of the Secretary's filing and will have an opportunity to oppose the petition.<sup>22</sup>

When reviewing the Secretary's petition, the Court must determine whether the Secretary's findings that the covered financial

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<sup>15</sup> *Id.* at § 202(b) (to be codified at 12 U.S.C. § 5382).

<sup>16</sup> *Id.* at § 203(c)(4) (to be codified at 12 U.S.C. § 5383).

<sup>17</sup> Gabai, *supra* note 5, at 4.

<sup>18</sup> Dodd-Frank, *supra* note 7, at § 202(a)(1)(A)(i) (to be codified at 12 U.S.C. § 5382).

<sup>19</sup> *Id.* at § 202(a)(1)(A)(i) (to be codified at 12 U.S.C. § 5382).

<sup>20</sup> *Id.* at § 207 (to be codified at 12 U.S.C. § 5387).

<sup>21</sup> *Id.* at § 202(a)(1)(A)(i) (to be codified at 12 U.S.C. § 5382).

<sup>22</sup> *Id.* at § 202(a)(1)(A)(iii) (to be codified at 12 U.S.C. § 5382).

company 1) is in danger of default; and 2) satisfies the definition of a financial company were arbitrary and capricious.<sup>23</sup> If the Court determines that the Secretary's findings were arbitrary and capricious, the Court must provide the Secretary a written statement supporting its reasoning and allow the Secretary the opportunity to amend and re-file.<sup>24</sup> If the Court rules that the Secretary's findings were not arbitrary and capricious, or the Court does not make a determination within twenty four hours of receipt of Secretary's petition, the petition will be granted.<sup>25</sup>

Both the Secretary and a covered financial company have thirty days to appeal the Court's decision on an expedited basis.<sup>26</sup> However, the Court's decision is not subject to stay or injunction pending appeal.<sup>27</sup> Once the FDIC becomes the receiver, the Code no longer applies and the covered financial company's liquidation is administered exclusively under Title II.<sup>28</sup> Given the abbreviated period allowed for review of a Secretary's petition and the fact that the FDIC's appointment cannot be enjoined, the practical opportunity to review the FDIC's appointment as receiver is extremely limited.

## **D. Liquidation Process**

### **1. FDIC Powers**

The OLA grants the FDIC broad powers. As one commentator states, "once the FDIC is appointed receiver of a covered financial company, it assumes virtually complete control over the liquidation process, the role of the courts in the core receivership process ends and only limited avenues exist for challenging the various ancillary decisions that the FDIC may make. . . ."<sup>29</sup> Many of the FDIC's receivership powers mirror those available

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<sup>23</sup> *Id.* at § 202(a)(1)(A)(iv) (to be codified at 12 U.S.C. § 5382).

<sup>24</sup> *Id.* at § 202(a)(1)(A)(iv)(II) (to be codified at 12 U.S.C. § 5382).

<sup>25</sup> *Id.* at § 202(a)(1)(A)(v)(I) (to be codified at 12 U.S.C. § 5382).

<sup>26</sup> *Id.* at § 202(a)(2)(A) (to be codified at 12 U.S.C. § 5382).

<sup>27</sup> *Id.* at § 202(a)(1)(B) (to be codified at 12 U.S.C. § 5382).

<sup>28</sup> James H.M. Sprayregen & Stephen E. Hessler, "Orderly Liquidation Authority" Under the Dodd-Frank Act: The United States Congress's Misdirected Attempted to Ban Wall Street Bailouts, *INSOL WORLD*, at 21, (Third Quarter 2010), available at: [http://www.kirkland.com/siteFiles/Publications/ARTICLES%20-%20PRINTING%20ALLOWED%20-%20INSOL%20World%20-%20Sprayregen\\_Hessler.pdf](http://www.kirkland.com/siteFiles/Publications/ARTICLES%20-%20PRINTING%20ALLOWED%20-%20INSOL%20World%20-%20Sprayregen_Hessler.pdf).

<sup>29</sup> McDermott *supra* note 10, at 3.

in a traditional bankruptcy and include the authority to succeed to all rights, titles, powers and privileges of the covered financial company and its assets;<sup>30</sup> take over the assets of and operate the covered financial company;<sup>31</sup> collect all obligations and money owed to the covered financial company;<sup>32</sup> resolve claims to creditors,<sup>33</sup> and repudiate or assign contracts entered into by a financial company.<sup>34</sup>

The OLA, however, also invests the FDIC with new powers without analogs in traditional bankruptcy. For example, the FDIC can create a “bridge financial company” (“BFC”) to acquire the assets and liabilities of the covered financial company as receiver or in anticipation of its appointment as receiver.<sup>35</sup> The FDIC requires no court, creditor, or shareholder approval to create a BFC.<sup>36</sup> A board of directors appointed by the FDIC manages a BFC.<sup>37</sup> A BFC is not a permanent entity.<sup>38</sup> The FDIC grants a BFC a charter for two-years that can be extended for up to three additional years.<sup>39</sup>

In addition, whereas the Code requires creditors with similar claims to be treated equally, the OLA empowers the FDIC to treat similarly situated creditors differently.<sup>40</sup> The FDIC may treat similar creditors dissimilarly for a number of reasons, including to maximize the value of the company’s assets, or to minimize the amount of any loss realized upon the sale or disposition of the company.<sup>41</sup> Thus, while the FDIC may not pay similarly situated unsecured creditors less than they would in a liquidation under Chapter 7, the FDIC can favor certain unsecured creditors over others.<sup>42</sup>

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<sup>30</sup> Dodd-Frank, *supra* note 7, at § 210(a)(1)(A)(i) (to be codified at 12 U.S.C. § 5390).

<sup>31</sup> *Id.* at § 210(a)(1)(B)(i) (to be codified at 12 U.S.C. § 5390).

<sup>32</sup> *Id.* at § 210(a)(1)(B)(ii) (to be codified at 12 U.S.C. § 5390).

<sup>33</sup> *Id.* at § 210(a)(2) (to be codified at 12 U.S.C. § 5390).

<sup>34</sup> *Id.* at § 210(c)(1) (to be codified at 12 U.S.C. § 5390).

<sup>35</sup> *Id.* at § 210(h)(1)(A) (to be codified at 12 U.S.C. § 5390).

<sup>36</sup> *Id.* at § 210(h)(2)(E)(ii) (to be codified at 12 U.S.C. § 5390).

<sup>37</sup> *Id.* at § 210(h)(2)(B) (to be codified at 12 U.S.C. § 5390).

<sup>38</sup> Gabai *supra* note 5, at 7.

<sup>39</sup> *Id.*

<sup>40</sup> Spraygen & Hessler, *supra* note 28, at 22; Dodd-Frank, *supra* note 7, at § 210(b)(4) (to be codified at 12 U.S.C. § 5390).

<sup>41</sup> Dodd-Frank, *supra* note 7, at § 210(b)(4)(A) (to be codified at 12 U.S.C. § 5390).

<sup>42</sup> Spraygen & Hessler, *supra* note 28, at 22.



## 2. Orderly Liquidation Fund

Still smarting from the costly bailouts of 2008, Congress expressly required that “taxpayers shall bear no losses from the exercise of any authority under” Title II of the Dodd-Frank Act.<sup>43</sup> Consequently, the OLA ultimately requires the financial sector to subsidize the FDIC’s new resolution powers. The OLA establishes in the Treasury Department a separate fund called the Orderly Liquidation Fund (“Fund”) available to the FDIC.<sup>44</sup> If a covered financial company’s assets are not sufficient to fund its liquidation, the FDIC may borrow from the Fund after reaching an agreement with the Secretary about a specific plan for repayment.<sup>45</sup> The Fund will be largely supported through assessments on financial companies with more than \$50 billion in total assets and nonbank financial companies supervised by the FRB.<sup>46</sup>

## 3. Unsecured Creditor Claim Priorities

The OLA’s prioritization of unsecured creditor claims deviates from the Code. First, the FDIC will reimburse its own administrative expenses before addressing any unsecured creditor claims.<sup>47</sup> The OLA also changes the priority scheme between unsecured creditors. The Code gives priority to 502(f) claims, which arise in the ordinary course of the debtor’s business or financial affairs (i.e. a company’s unsecured debts to other businesses), over all other unsecured claims.<sup>48</sup> Under the OLA, however, 502(f) claims are subordinated to two unsecured claim classifications: 1) unpaid wages and benefits up to \$11,725 non-executives earned 180 days prior to the FDIC appointment of receiver; and 2) contributions owed to employee benefit plans.<sup>49</sup>

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<sup>43</sup> Dodd-Frank, *supra* note 7, at § 214(c) (to be codified at 12 U.S.C. § 5394).

<sup>44</sup> *Id.* at § 210(n) (to be codified at 12 U.S.C. § 5390).

<sup>45</sup> *Id.* at § 210(n)(9)(A) (to be codified at 12 U.S.C. § 5390).

<sup>46</sup> *Id.* at §§ 210(n)(2) (to be codified at 12 U.S.C. § 5390) and §210(o)(1) (to be codified at 12 U.S.C. § 5390).

<sup>47</sup> *Id.* at § 210(b)(1) (to be codified at 12 U.S.C. § 5390).

<sup>48</sup> 11 USCA § 507(a)(3) (West 2010).

<sup>49</sup> Dodd-Frank, *supra* note 7, at § 210(b)(1) (to be codified at 12 U.S.C. § 5390).

#### 4. Management Liability

Motivated by public dissatisfaction with Wall Street, Congress included several provisions in the OLA that create significant potential liability for management of covered financial companies.<sup>50</sup> First, “management responsible for the financial company will not be retained” by the company.<sup>51</sup> The OLA mandates the FDIC to “take all steps necessary and appropriate to assure that all . . . management . . . having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution and recoupment of compensation and other gains not compatible with such responsibility.”<sup>52</sup> Perhaps most interesting, the FDIC may seek to ban a senior executive or director from the financial services industry for more than two years if such a person (i) violates a law or regulation; (ii) participates in “any unsafe or unsound practice”; or (iii) breaches their fiduciary duty.<sup>53</sup>

##### E. The OLA: Resolution at Creditors’ Expense?

The new resolution authority established by the OLA significantly alters liquidation proceedings for covered financial companies. Like any major change to an established system, the OLA’s departure from traditional bankruptcy has engendered criticisms. For example, some commentators question the wisdom of replacing a predictable and transparent judicial bankruptcy process with an untested agency process.<sup>54</sup> Other concerns, however, focus on the OLA’s substance, particularly the OLA’s treatment of unsecured creditors.

Unsecured creditors face uncertainty about whether a defaulting financial institution will be liquidated under Chapter 7 or the OLA.<sup>55</sup> Compounding this uncertainty is the fact that financial

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<sup>50</sup> See Spraygen & Hessler, *supra* note 28, at p. 22.

<sup>51</sup> Dodd-Frank, *supra* note 7, at § 204(a)(2) (to be codified at 12 U.S.C. § 5384).

<sup>52</sup> *Id.* at §204(a)(3) (to be codified at 12 U.S.C. § 5384).

<sup>53</sup> *Id.* at § 213(b)(1) (to be codified at 12 U.S.C. § 5393).

<sup>54</sup> See Chann & Applebaum *supra* note 3.

<sup>55</sup> Interview with Randall Guynn, *Ending Too Big to Fail*, WALL ST. J., Aug. 27, 2010, available at <http://online.wsj.com/video/ending-too-big-to-fail/9F800511-CD66-4CF8-AED0-D663490D78CC.html>.

companies that have already commenced bankruptcy proceedings can be removed from bankruptcy proceedings and placed into the OLA process.<sup>56</sup> Thus, even creditors pressing claims under a current Chapter 7 proceeding cannot be sure that the OLA will not be invoked at a later date, thereby subjecting their claims to FDIC scrutiny.

Another concern for creditors involves judicial review of disallowed claims. While the OLA allows creditors to file suit on disallowed claims, the OLA does not specify how the FDIC's disallowance of the claim will be subject to judicial review.<sup>57</sup> The OLA also deviates from judicial review under bankruptcy by requiring creditors to file suit in the district where a covered financial company's principal place of business is located.<sup>58</sup> By requiring creditors to challenge disallowed claims in the district court where the defaulting financial company's principal place of business is located, creditors may be forced to pursue litigation in an unfamiliar and inconvenient jurisdiction.<sup>59</sup>

Unsecured creditors must also be wary of the many provisions that are inconsistent between the OLA and Chapter 7. For example, the OLA maintains a flat prohibition on oral contracts, which are applicable under Chapter 7 if enforceable under state law.<sup>60</sup> The OLA also contains special provisions involving the enforceability of written contracts.<sup>61</sup> Such discrepancies between Chapter 7 and the OLA could significantly impact unsecured creditors' claims.

## F. Conclusion

The ultimate impact of the OLA will largely depend on judicial interpretation and agency rule-making.<sup>62</sup> The OLA may be

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<sup>56</sup> See Gabai *supra* note 5, at 3-5.

<sup>57</sup> Dodd-Frank, *supra* note 7, at § 210(a)(4)(A) (to be codified at 12 U.S.C. § 5390).

<sup>58</sup> Spraygen & Hessler, *supra* note 28, at p. 22.

<sup>59</sup> Dodd-Frank, *supra* note 7, at § 210(a)(4)(A) (to be codified at 12 U.S.C. § 5390); Harner *supra* note 2.

<sup>60</sup> Interview with Randall Guynn, *supra* note 55.

<sup>61</sup> *Id.*

<sup>62</sup> See Joe Adler, *FDIC Plots Large-Firm Resolutions: Agency must develop new system, identify targets, hire staff*, AMERICAN BANKER, July 7, 2010 (“[T]he agency is required to issue several rules to ensure a new structure is up and running soon.”).

the ideal mechanism for handling the liquidation of financial firms that would otherwise be “too big to fail.” But given the uncertainties surrounding Title II, its limited opportunity for judicial review and its treatment of creditors, some commentators believe the OLA could create as many problems as it solves. For example, one can imagine a situation where unsecured creditors, fearing lack of creditor protection under the OLA, abandon a covered financial company at the first hint of default, thereby creating the financial instability that the new resolution authority was designed to prevent.<sup>63</sup> Whether or not this disaster scenario comes to pass, regulators and financial companies alike should be vigilant about the OLA.

Adam Mayle<sup>64</sup>

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<sup>63</sup> *Financial reform in America: The hand of Dodd*, THE ECONOMIST, March 20, 2010 (“The threat of being wiped out in bankruptcy could cause creditors to flee both the troubled firm and any firms like it, precisely the sort of panic the resolution regime is meant to avoid.”).

<sup>64</sup> Student, Boston University School of Law (J.D. 2012).

### **III. *The Dodd-Frank Act Regulation of Proprietary Trading— The Volcker Rule***

#### **A. Introduction**

On July 21, 2010, President Obama signed into law the much-anticipated Dodd-Frank Wall Street Reform and Consumer Protection Act (“Act”).<sup>1</sup> One of the more controversial parts of the Act is Section 619, which codifies the infamous “Volcker Rule.”<sup>2</sup> Section 619 amends the Bank Holding Company Act of 1956 to restrict proprietary trading within banking entities.<sup>3</sup> Congress included the restriction in response to what proponents of the Volcker Rule describe as reckless risk-taking on the part of banking institutions using taxpayer guaranteed depositor funds, resulting in institutional and systemic risk.<sup>4</sup>

Proprietary trading is essentially the investing of institutional funds, including depository funds, to augment profit.<sup>5</sup> The practice became popular among larger banks after the effective repeal of the Glass-Steagall Act in 1999 by the Gramm-Leach-Bliley Act.<sup>6</sup> In response to Section 619, many banks have begun restructuring their

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<sup>1</sup> Press Release, Office of the Press Secretary, Background on the President’s Bill Signing Ceremony Today (July 21, 2010), *available at* <http://www.whitehouse.gov/the-press-office/background-presidents-bill-signing-ceremony-today>.

<sup>2</sup> See John Kemp, *Volcker Rule Unexpectedly Revived by Dodd Bill*, REUTERS, Mar. 16, 2010, <http://blogs.reuters.com/great-debate/2010/03/16/volcker-rule-unexpectedly-revived-by-dodd-bill/> (“The Volcker Rule’s surprise survival comes despite fierce opposition from the banking industry and after many commentators had written it off as a short-term political gimmick . . .”).

<sup>3</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620-31 (2010).

<sup>4</sup> See also John Cassidy, *Scandals*, NEW YORKER, May 3, 2010, at 21

<sup>5</sup> See *Proprietary Trading*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/proprietarytrading.asp> (last visited Oct. 6, 2010) (defining proprietary trading as “when a firm trades for direct gain instead of commission dollars”).

<sup>6</sup> Jeff Merkley & Carl Levin, *Making the Dodd-Frank Act Restrictions on Proprietary Trading & Conflicts of Interest Work*, ROOSEVELT INSTITUTE, Oct. 6, 2010, [http://www.rooseveltinstitute.org/sites/all/files/Will\\_It\\_Work\\_Proprietary\\_Trading.pdf](http://www.rooseveltinstitute.org/sites/all/files/Will_It_Work_Proprietary_Trading.pdf) (“[S]ince 2004, trading revenues have sky-rocketed at the largest banks, and by the end of 2009, accounted for all of their net operating revenues.”)

proprietary trading operations or divesting themselves of proprietary trading desks altogether.<sup>7</sup> Part II of this article will evaluate the need for a ban on proprietary trading. Part III will detail the provisions of Section 619 as signed into law and will describe how Section 619 will be implemented by the agencies so tasked. Part IV will examine reaction to the legislation by affected institutions and commentators.

### **B. The Lead-Up to Dodd-Frank: Proprietary Trading and the Perceived Risk**

In Washington, D.C., the last-minute inclusion and passage of Section 619 was heralded as a way to “reduce systemic risk to our financial system and protect American taxpayers and businesses from Wall Street’s risky bets.”<sup>8</sup> When President Obama first promoted the idea of a ban on proprietary trading in January 2009, he said proprietary trading “can create enormous and costly risks . . . .”<sup>9</sup> Some critics of Wall Street claimed proprietary trading was the “key driving force” behind the crisis.<sup>10</sup> Such statements, while probably effective at driving support for a ban, are misleading. Even prominent proponents of the rule admit uncertainty as to whether an earlier ban on proprietary trading would have prevented the 2008 financial crisis.<sup>11</sup> Only a handful of banking institutions participate in the types of activities halted by Section 619.<sup>12</sup> Even Paul Volcker, a former Federal Reserve chairman and namesake of the rule, said that proprietary trading, while a contributing factor, was “not central” to

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<sup>7</sup> See Charles Wallace, *Is Wall Street Reshaping Itself in Response to Dodd-Frank?*, DAILY FINANCE, Aug. 4, 2010, <http://www.dailyfinance.com/story/investing/wall-street-reshaping-after-dodd-frank/19579716/>

<sup>8</sup> Meredith Shiner, *Volker Rule Backers Praise Bill*, POLITICO, June 25, 2010, <http://www.politico.com/news/stories/0610/39035.html>.

<sup>9</sup> President Barack Obama, Remarks by the President on Financial Reform (Jan. 21, 2010), available at <http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform>.

<sup>10</sup> Stephen Gandel, *Is Proprietary Trading Too Wild for Wall Street?*, TIME, Feb. 5, 2010, <http://www.time.com/time/business/article/0,8599,1960565,00.html>

<sup>11</sup> Editorial, *Volcker Rules: The Obama Administration’s New-Old Approach to Bank Regulation*, WASH. POST, Jan. 24, 2010, at A12 (“It is not clear that the Volcker Rule would have prevented the current financial crisis . . . .”).

<sup>12</sup> Paul Volcker, *How to Reform Our Financial System*, N.Y. TIMES, Jan. 31, 2010, at WK11.

the crisis.<sup>13</sup> Most experts, including those in the current administration, seem to agree that most of the activities that led to a market crash in 2008 did not take place in depository institutions.<sup>14</sup> Treasury Secretary Timothy Geithner stated that proprietary trading was not at the root of the crisis and expressed doubt as to whether a trading ban would help prevent future crises.<sup>15</sup> The major failures contributing to the crisis—Fannie Mae, Freddie Mac, AIG, Bear Stearns or Lehman Brothers—did not involve deposit-taking institutions and would not have been subject to any ban on proprietary trading.<sup>16</sup>

Another concern forwarded by proponents of the Volcker Rule was the apparent conflicts of interest that are presented between a financial institution and its customers when the institution is trading on its own account.<sup>17</sup> Proponents rarely cite specific examples.<sup>18</sup> Most likely, the conflict of interest proponents have in mind occurs when a bank is tempted to sell financial products to a client, only to short the same securities on its account, essentially betting against its client.<sup>19</sup> The practice received a lot of attention (and infamy) during the run up to the Dodd-Frank Act as the SEC launched an investigation into a Goldman Sachs deal, alleging that the company defrauded clients by engaging in a similar scheme.<sup>20</sup> Given that such practices are already illegal, as illustrated by the SEC enforcement action, it is unclear why the Volcker Rule was necessary to put an end to such activity.

Though it may be generally accepted that proprietary trading played a minimal, if any, role in the recent crisis, and that the effect of the Volcker Rule on conflict of interest concerns is likely to be

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<sup>13</sup> Kim Dixon & Karey Wutkowski, *Volcker: Proprietary Trading Not Central to Crisis*, REUTERS, Mar. 30, 2010, <http://www.reuters.com/article/idUSTRE62T56420100330>.

<sup>14</sup> Karey Wutowski, *Proprietary Trading Ban Positive: FDIC's Blair*, REUTERS, Jan. 29, 2010, <http://www.reuters.com/article/idUSTRE60S4F820100129>.

<sup>15</sup> *Id.*

<sup>16</sup> Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System*, 33 Harv. J.L. & Pub. Pol'y 671, 677 (2010).

<sup>17</sup> Obama, *supra* note 9.

<sup>18</sup> See Volker, *supra* note 12.

<sup>19</sup> See Gretchen Morgenson & Louise Story, *Banks Bundled Bad Debt, Bet Against It and Won*, N.Y. TIMES, Dec. 24, 2009, at A1.

<sup>20</sup> Gretchen Morgenson & Louise Story, *S.E.C. Accuses Goldman of Fraud in Housing Deal*, N.Y. TIMES, Apr. 17, 2010, at A1.

minimal, there is a more compelling argument for the adoption of the Volcker Rule. Proprietary trading amounts to government-subsidized risk-taking when engaged in by deposit-taking institutions, giving those institutions an unfair advantage in the market place.<sup>21</sup> Because banking functions are essential to the national economy, institutions that provide them are provided a governmental “safety net” comprised of federal insurance and the availability of Federal Reserve lending.<sup>22</sup> These government safety nets and the ability for large banking institutions to rely on the government to bail them out result in government-subsidized risk-taking on behalf of banks trading on their own account.<sup>23</sup> While it probably did not play a large role in the financial crisis of 2008, and does not significantly contribute to overall systemic risk in the financial system, proprietary trading arguably does not comport with a free and fair market.

### C. The Volker Rule in Action: The Prohibitions and Implementation of Section 619

The Dodd-Frank Act amends the Bank Holding Company Act of 1956 by adding an additional section devoted to proprietary trading.<sup>24</sup> Section 619(a)(1)’s general prohibitions at first glance appear to be simple. They prohibit activities that can be easily identified: banking entities are prohibited from engaging in proprietary trading, defined as “engaging as a principal for the trading account . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract . . . .”<sup>25</sup> Such entities are also prohibited from acquiring or retaining any ownership interest in a private equity or hedge fund,<sup>26</sup> though a later exception allows three percent of capital to be invested in such funds.<sup>27</sup> Section 619(d)(1) allows exceptions to the prohibitions that range from simple to enigmatic. Simple exceptions allow banking entities to invest in various government-related securities such as Treasury and

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<sup>21</sup> Obama, *supra* note 9.

<sup>22</sup> *Id.*

<sup>23</sup> Cassidy, *supra* note 4.

<sup>24</sup> § 619, 124 Stat. at 1620.

<sup>25</sup> *Id.* at 1630

<sup>26</sup> *Id.* at 1620

<sup>27</sup> *Id.* at 1627



FNMA bonds, small businesses as defined by the Small Business Investment Act of 1956, certain investments to promote the public welfare and investments that are qualified rehabilitation expenses under the U.S. Tax Code.<sup>28</sup> The harder-to-define exceptions allow trading undertaken for the purpose of hedging risk related to other holdings, market-making activities that are not designed to exceed “reasonably expected” client demand, trades on behalf of customers and certain foreign activities.<sup>29</sup>

Finally, Section 619(d)(4) allows a banking entity to invest in a hedge fund or private equity fund that the entity organizes and offers, so long as the investment does not constitute more than three percent total ownership of the fund, and the aggregate of all such investments does not exceed more than three percent of the banking entity’s Tier 1 capital.<sup>30</sup> Of course, if any of these exceptions result in or involve a “material conflict of interest,” “material exposure . . . to . . . high-risk assets . . . or strategies,” or a threat to the “safety and soundness of such banking entity” or the “financial stability of the United States,” it is prohibited by 619(d)(2)(A).<sup>31</sup>

Banking entities are not the only ones affected by the Volcker Rule. Under Section 619(a)(B)(2), non-bank financial companies that are under the supervision of the Federal Reserve Board ( “Board”) and engage in proprietary trading or retain ownership in private equity funds or hedge funds may be subject to increased capital requirements at the agency’s discretion.<sup>32</sup> Thus, if a company such as Goldman Sachs, in order to avoid divesting itself of proprietary trading units, decides to declare itself a non-bank or denounce its status as a bank holding company, it can still be subjected to extra capital requirements. Exactly what those capital requirements would entail is uncertain, and their determination is subject to the same rulemaking as the rest of Section 619.

It will be left up to the agencies to define the vague prohibitions, exemptions and potential capital requirements outlined above. Section 619(b)(1) tasks the newly-formed Financial Stability Oversight Council (“FSOC”) with studying and making recommendations on how to implement Section 619 so as to promote the safety and soundness of the banking industry, minimize unsafe

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<sup>28</sup> *Id.* at 1623—24.

<sup>29</sup> *Id.* at 1624—25.

<sup>30</sup> *Id.* at 1627.

<sup>31</sup> *Id.* at 1626.

<sup>32</sup> *Id.*

and unsound activities, reduce conflicts of interest and limit activities that create undue risk.<sup>33</sup> No later than nine months after the completion of the study, the appropriate federal banking agencies, the Securities and Exchange Commission (“SEC”) and the Commodities Future Trading Commission (“CFTC”) are directed to issue rules and regulations to implement Section 619. Thus, what defines “risk-mitigating hedging activities,” “reasonably expected near-term demand,” “high-risk trading strategies” and the other less-than-clear contours of Section 619 are largely a matter of agency discretion.

The FSOC has already begun the process of gathering public comment in order to begin its study pursuant to Section 619(b).<sup>34</sup> The public Notice and Request for Public Information filed by the FSOC solicits comments regarding virtually every paragraph of Section 619, looking for input on definitions, ways to minimize risk, which activities are historically the riskiest, and relationships with private equity and hedge funds.<sup>35</sup> According to a study conducted by the U.S. Chamber of Commerce, the entire act will require regulators to complete approximately 520 rulemakings, eighty-one studies, and ninety-three reports.<sup>36</sup>

#### D. Reaction

Section 619 allows banks a total of four years to divest themselves of their proprietary trading activities, and they can apply for up to three one-year extensions to that requirement.<sup>37</sup> However, compliance efforts have already begun at some of the nation’s largest banks.<sup>38</sup> Most banks were able to begin reducing proprietary operations without making significant structural changes. Shortly after the bill’s passing, reports surfaced that Morgan Stanley would be spinning off its subsidiary FrontPoint Partners, a hedge fund

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<sup>33</sup> *Id.*

<sup>34</sup> Public Input for the Study Regarding the Implementation of Prohibitions on Proprietary Trading, 75 Fed. Reg. 61758-02, 61758 (2010).

<sup>35</sup> *Id.* at 61759-60

<sup>36</sup> Tom Quaadman, *Financial Regulatory Reform—Uncertainty Grows*, CHAMBERPOST, July 13, 2010, <http://www.chamberpost.com/2010/07/financial-regulatory-reform-uncertainty-grows.html>.

<sup>37</sup> § 619, 124 Stat. at 1622--23.

<sup>38</sup> Wallace, *supra* at note 7.

sponsor.<sup>39</sup> Goldman Sachs, widely regarded as having one of the largest and most aggressive proprietary trading groups among the large banks, moved about half of its proprietary traders into its asset management group, where they will advise and place trades for clients.<sup>40</sup> Citigroup is rumored to be considering several options to comply with the new law, including moving proprietary traders to its hedge fund unit, where they will manage hedge funds whose shares are owned by clients.<sup>41</sup> Bank of America has announced plans to terminate just under one-third of their proprietary trading jobs.<sup>42</sup>

While banks seem to be taking the new regulation in stride, many commentators are not pleased with the final draft of Section 619. Most of the criticism aimed at Dodd-Frank's codified version of the Volcker Rule argues that the statute does not go far enough to mitigate risk in the nation's banks. Receiving the most criticism is the section's exemption allowing banks to invest up to three percent of their Tier 1 capital in hedge funds and private equity funds.<sup>43</sup> The allowance was the result of last-minute legislative deal-making to garner a few Republican votes in the Senate. The allowance originally included a strict dollar limit and allowed for three percent of tangible common equity.<sup>44</sup> As negotiations went forward, the dollar limit was removed and "tangible common equity" was changed to "Tier 1 capital," allowing banks to invest approximately forty percent more capital in funds than did the original compromise.<sup>45</sup> Paul Volcker himself recalls being "disappointed" in

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<sup>39</sup> Courtney Comstock, *FrontPoint is Going to Completely Spin Off From Morgan Stanley and Everyone Wants a Piece*, BUSINESSINSIDER, Aug. 2, 2010, <http://www.businessinsider.com/morgan-stanley-frontpoint-spin-off-2010-8>.

<sup>40</sup> Charlie Gasparino, *Goldman Already a Step Ahead of FinReg*, FOX BUSINESS, July 27, 2010, <http://www.foxbusiness.com/markets/2010/07/27/goldman-step-ahead-finreg/>.

<sup>41</sup> Bradley Keoun, *Citigroup May Move Prop Traders to Hedge Funds for Volcker Rule*, BLOOMBERG BUSINESSWEEK, July 28, 2010, <http://www.businessweek.com/news/2010-07-28/citigroup-may-move-prop-traders-to-hedge-funds-for-volcker-rule.html>.

<sup>42</sup> Christine Harper, *Bank of America Said to Cut More Than 20 Prop Trading Jobs*, BLOOMBERG, Sept. 29, 2010, <http://www.bloomberg.com/news/2010-09-29/bank-of-america-is-said-to-eliminate-more-than-20-proprietary-trading-jobs.html>.

<sup>43</sup> § 619, 124 Stat. at 1624.

<sup>44</sup> John Cassidy, *The Volcker Rule*, NEW YORKER, July 26, 2010, at 25.

<sup>45</sup> *Id.*

the final version of his namesake rule after learning about the removal of these limitations.<sup>46</sup>

Critics are quick to point out that the three percent allowance will permit banks to continue almost the same amount of proprietary trading that they were engaged in before the bill was passed, as long as it is done through a private equity or hedge fund instead of pure proprietary trading.<sup>47</sup> Despite the bank actions listed above, those critics are, for the most part, correct. Banks do not report how much of their capital is tied up in pure proprietary trading and hedge and private equity funds, and it may be because they do not track the figure.<sup>48</sup> But there is some sense of how much revenue is generated by proprietary trading. Citigroup's proprietary trading activities, including those placed in hedge fund or private equity investments, account for less than three percent of the bank's total revenue, according to sources there.<sup>49</sup> Citigroup therefore, aside from divesting itself of its pure proprietary trading operations, will be mostly unaffected. Bank of America finds itself in a similar situation.<sup>50</sup> Estimates place JP Morgan's proprietary trading revenues at under one percent of total revenue, though the bank also manages the world's largest hedge fund and may have to sell some of its hedge fund interest.<sup>51</sup> The only bank that will be materially impacted by Section 619 is Goldman Sachs.<sup>52</sup> The bank generates about ten percent of its revenue via proprietary trading, both pure and fund related, and so will have to restructure much more than the other banks.<sup>53</sup>

Another concern with the three percent allowance is that it may, perversely, increase the amount of risk banks are willing to take with hedge funds they sell to clients. Often, banks will be heavily invested in their own funds to convince outside investors that they

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<sup>46</sup> *Id.*

<sup>47</sup> See Daniel Indiviglio, *Dodd-Frank Bill's Volcker Rule a Win for Big Banks*, ATLANTIC, June 25, 2010, <http://www.theatlantic.com/business/archive/2010/06/dodd-frank-bills-volcker-rule-a-win-for-big-banks/58747/>.

<sup>48</sup> John Carney & Cadie Thompson, *Senators Prepare a Citigroup-Sized Hole in Volcker Rule*, CNBC.COM, June 23, 2010, [http://www.cnbc.com/id/37879514/Senators\\_Prep\\_A\\_Citigroup\\_Sized\\_Hole\\_In\\_Volcker\\_Rule](http://www.cnbc.com/id/37879514/Senators_Prep_A_Citigroup_Sized_Hole_In_Volcker_Rule)

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

are confident in the fund's portfolio.<sup>54</sup> Competition between funds encouraged banks to put more and more "skin in the game."<sup>55</sup> However, with the Volcker rule's three percent allowance in place, the banks have a good excuse not to have much at stake in the funds they market to clients.<sup>56</sup>

Any risk mitigation accomplished by Section 619 is further hampered by the difficulty of determining what constitutes proprietary trading versus trading at the behest of a customer, also known as market making. Neither Section 619 nor any other part of the Dodd-Frank Act restricts risky trades, just those done on the bank's own account. Much non-proprietary trading activity done at the behest of clients exposes the bank to the same type of market risk the bank would face were it making the trade on its own account.<sup>57</sup> Traditionally, banks were intermediaries who matched up buyers and sellers to take either side of a trade.<sup>58</sup> More frequently, they now place their own capital at risk, and can either hedge to remain neutral, or hold the position if the investment aligns with the bank's market outlook.<sup>59</sup> Earlier this year, Goldman Sachs lost \$250 million taking the other side of a trade when several institutional clients approached the bank looking to bet that the market would not stay quiet.<sup>60</sup> In a similar trade, JP Morgan's commodities unit lost \$130 million taking the other side of trades initiated by clients expecting coal prices to rise, which they did.<sup>61</sup> The risk involved in both trades was not what would be considered by most to be proprietary, and is expressly allowed under the market making exception of 619(d)(B).<sup>62</sup> Any hedge taken against such position would also be allowed under 619(d)(C).<sup>63</sup> These examples show how a bank can essentially place trades using their own capital, for their own gain, but in the process of making markets, which is allowed under 619(d)(B).

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<sup>54</sup> John Carney, *Why Wall Street Will Love the 3% Solution in Reform Bill*, CNBC.COM, June 25, 2010, <http://www.cnbc.com/id/37921692>.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> See Nelson D. Schwartz & Eric Dash, *Despite Reform, Banks Have Room for Risky Deals*, N.Y. TIMES, Aug. 25, 2010, at A1.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> § 619, 124 Stat. at 1624.

<sup>63</sup> *Id.* at 1624

### **E. Conclusion**

If the purpose of the Volcker rule was to reduce the magnitude of risk undertaken by banks, it falls short; while pure proprietary trading is expressly prohibited, the risk will most likely remain, albeit under a different name. This type of scenario is best avoided by a Glass-Steagall type ban on investment banking activities by depository institutions, the stricter version of the Volcker Rule many proponents were hoping for.<sup>64</sup> The ability for banks to invest three percent of their capital in hedge or private equity funds and the difficulty in drawing a line between proprietary trading and market-making activities essentially takes the effectiveness out of the Volcker Rule.

Richard C. Burson<sup>65</sup>

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<sup>64</sup> See Terry Smith, *Volcker Rule is Necessary to Prevent Bank Failures Turning into a Crisis*, TELEGRAPH, Jan. 24, 2010, at 5

<sup>65</sup> Student, Boston University School of Law (J.D. 2012).

#### **IV. Hedge Fund Adviser Regulation**

##### **A. Introduction**

The Private Fund Investment Advisers Registration Act of 2010 (“PFIARA” or “Act”) was signed into law, as contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, on July 21, 2010 by President Barack Obama.<sup>1</sup> The Act aims to protect consumers and financial markets from future meltdowns by requiring certain funds to register and disclose information to the Securities and Exchange Commission (“SEC”) and other regulatory agencies.<sup>2</sup> Hedge funds and private equity funds have traditionally been exempt from laws that regulate investment companies’ operations and management.<sup>3</sup> Hedge funds, primarily dealing in investing or trading securities, would ordinarily be required to register under section 3(a)(1)(A) of the Investment Companies Act of 1940 (“ICA”), except that many qualify for certain exemptions.<sup>4</sup> Most hedge funds avoid registration by making the fund available only to qualified investors.<sup>5</sup> Similarly, hedge fund advisers avoid registration with the SEC under the Investment Advisers Act of 1940 (“IAA”) by limiting the number of clients to less than fifteen over the preceding twelve months and neither holding themselves out generally to the public, nor acting as investment advisers to any investment company registered under the ICA.<sup>6</sup>

Registration with the SEC subjects advisers to examinations of their activities, books and records, including review of the firm’s internal compliance policies and procedures.<sup>7</sup> The SEC designates the types of books and records to be maintained, and the duration and

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<sup>1</sup> Press Release, Office of the Press Secretary, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010).

<sup>2</sup> S. Rep. No. 111-176, at 53 (2010).

<sup>3</sup> Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 Am. J. Comp. L. 295 (2010).

<sup>4</sup> *Id.* at 300.

<sup>5</sup> *Id.*

<sup>6</sup> Client Alerts, *Regulation of Private Fund Managers Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, COOLEY LLP, Aug. 20, 2010.

<sup>7</sup> Nathan J. Greene & John M. Adams, *Private Fund Manager Regulation: US and European Initiatives Compared*, 3 J. Sec. L., Regulation and Compliance, no. 3, at 243 (July 2, 2010).

manner for which they must be maintained.<sup>8</sup> In addition, registered advisers with custody of their clients' assets must also maintain those assets with a qualified custodian, such as a bank or registered broker-dealer.<sup>9</sup> Furthermore, the ICA prohibits investment companies from selling short or utilizing substantial leverage, two activities characteristically taken by hedge funds.<sup>10</sup>

Previously, the SEC targeted hedge funds for increased regulation to protect consumers from fraud and systemic risk.<sup>11</sup> In 2004, the SEC adopted rule amendments under the ICA to require advisers to "look through" a pooled investment vehicle.<sup>12</sup> The rule closed a loophole allowing hedge fund advisers to avoid registration in situations where the assets of hedge fund investors are managed similarly to the manner in which a registered adviser manages the assets of clients who directly open accounts with the adviser.<sup>13</sup> While recognizing the SEC's desire to increase regulation of hedge funds as understandable,<sup>14</sup> the D.C. Circuit Court in *Goldstein v. SEC* found the SEC's rule to be "arbitrary"<sup>15</sup> and that interpreting "client" to include investors was "close to violating the plain language of the statute."<sup>16</sup> Following the court's decision, former SEC Chairman Christopher Cox argued that the "lack of public disclosure about the way hedge funds operate, the lack of standards . . . , the possibility for undisclosed conflicts of interest, the unusually high fees and indeed the higher risk that accompanies a hedge fund's expected higher returns, . . . [make hedge funds] risky ventures."<sup>17</sup> However,

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<sup>8</sup> *Id.* at 244.

<sup>9</sup> *Id.*

<sup>10</sup> Ordower, *supra* note 3, at 297.

<sup>11</sup> *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873, 877 (D.C. Cir. 2005).

<sup>12</sup> Rachel McTague, *D.C. Cir. Strikes Down SEC Regulation Requiring Hedge Fund Advisers to Register*, 38 Sec. Reg. & L. Rep. (BNA) 1105, 1105 (June 26, 2006).

<sup>13</sup> Jeffrey M. Sneeringer, *Note: The Lesson of Goldstein v. SEC: If At First You Do Not Succeed, Regulate Again?*, 36 Cap. U.L. Rev. 1173, 1174 (2008).

<sup>14</sup> *Goldstein*, 451 F.3d, at 882.

<sup>15</sup> *Id.* at 884.

<sup>16</sup> *Id.* at 881.

<sup>17</sup> *Testimony Concerning the Regulation of Hedge Funds Before the S. Comm. on Banking, Hous. and Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Chairman of SEC) available at <http://www.sec.gov/news/testimony/2006/ts072506cc.htm>.



hedge funds contribute substantially to capital formation, market efficiency, price discovery and liquidity, help counterparties hedge their own risks by participating in derivatives markets and provide a way for institutional investors to reduce their exposure to downside risk.<sup>18</sup>

### **B. Systemic Risk and the Financial Crisis**

One significant task the Dodd-Frank Act seeks to undertake is to define and monitor systemic risk. Systemic risk is generally defined as the risk of a “broad-based breakdown in the financial system, often realized by a series of correlated defaults among financial institutions, typically banks.”<sup>19</sup> Like banks, hedge funds and private funds expose the financial system to systemic risks.<sup>20</sup> Since the collapse of Long-Term Capital Management (“LTCM”) in 1998, it has been apparent that hedge funds have the potential to impose significant systemic risk on the financial system, and have continually been the target for increased regulation and supervision.<sup>21</sup> The federal government was forced to step in and rescue the fund or risk collapse of major financial institutions and commercial banks due to their overexposure in LTCM.<sup>22</sup> The use of substantial borrowing and financial leverage by hedge funds creates economic risk to lenders and counterparties.<sup>23</sup> A default by a particularly large hedge fund or several funds might jeopardize the stability of the lending financial institutions.<sup>24</sup> A highly-leveraged fund’s default may cause its lenders or derivative counterparties to default on their own obligations<sup>25</sup> and those defaults may lead to further defaults of other counterparties and lenders.<sup>26</sup> A default in a large credit

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<sup>18</sup> *Id.*

<sup>19</sup> *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Hearing on Hedge Funds Before the H. Comm. on Oversight and Government Reform*, 111<sup>th</sup> Cong. 3 (2010) [hereinafter *Hearings*] (written testimony of Andrew W. Lo, Massachusetts Institute of Technology).

<sup>20</sup> *Id.* at 4.

<sup>21</sup> Scott V. Wagner, *Comment, Hedge Funds: The Final Frontier of Securities Regulation and A Last Hope for Economic Revival*, 6 J.L., Econ. & Pol’y 1, at 17 (Fall 2009).

<sup>22</sup> *Id.*

<sup>23</sup> Ordower, *supra* note 3, at 315.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 316.

<sup>26</sup> *Id.*

institution has the potential to cause a domino effect reaching minute corners of the economy.<sup>27</sup> Hedge funds have increasingly taken on the role traditionally filled by banks, taking a significant position in the shadow banking system.<sup>28</sup> However, unlike banks, hedge funds are outside the jurisdiction of the Federal Reserve, the Office of the Comptroller of the Currency, the SEC, the CFTC and the Treasury.<sup>29</sup> Without registration and oversight, it is impossible to determine conclusively how hedge funds contribute to systemic risk.<sup>30</sup> While hedge funds were not the cause of the financial crisis, they are rightfully subject to increased regulatory requirements to monitor systemic risk given their increased role in financial markets.<sup>31</sup>

### C. Private Fund Investment Advisers Registration Act

The PFIARA heightens the registration and reporting requirements of hedge funds and private funds to the SEC under the IAA by narrowing the exemptions used by hedge funds to avoid registration.<sup>32</sup> The Act eliminates one of the most commonly used exemptions to the Investment Advisers Act.<sup>33</sup> The section exempted advisers with fewer than 15 clients who did not “hold themselves out to the public as investment advisers,” and did not provide advice to investment companies registered under the ICA.<sup>34</sup> The PFIARA also revises the exemption for commodity trading advisers registered with the Commodity Futures Trading Commission (“CFTC”).<sup>35</sup> Those registered with the CFTC may also be required to register with the SEC if their business becomes “predominantly” securities-related

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<sup>27</sup> *Id.*

<sup>28</sup> Preliminary Staff Report, *Shadow Banking and the Financial Crisis*, Fin. Crisis Inquiry Comm’n 4 (May 4, 2010).

<sup>29</sup> *Hearings*, *supra* note 19, at 8.

<sup>30</sup> *Id.*

<sup>31</sup> Stephen Taub, *AIMA’s Todde Groome Advocates Practical Regulation, AR (Absolute Return & Alpha)* (February 1, 2010).

<sup>32</sup> *See generally* Clients & Friends Memo, *Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, CADWALADER, WICKERSHAM & TAFT, July 20, 2010.

<sup>33</sup> *Dodd-Frank: What It Means To You*, *Futures Magazine* (October 2010).

<sup>34</sup> *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 203, § 403, 124 Stat. 1376 (2010).

<sup>35</sup> *Id.*

advice.<sup>36</sup> Those not registered with the CFTC and not “predominantly” engaged in securities-related advice are considered well-monitored for purposes of systemic risk and consumer protection.<sup>37</sup> The Act also provides exemptions for foreign private advisers, venture capital advisers, small- and mid-sized private fund advisers, small investment company advisers and family office advisers.<sup>38</sup> PFIARA raises the threshold for SEC registration from \$25 million to \$100 million assets under management (“AUM”); advisers with less than \$100 million AUM may be forced to deregister from the SEC.<sup>39</sup> The Accredited Investor Standard, required for exemptions under Regulation D, was amended to exclude the value of the investor’s primary residence in calculation of whether such person’s net worth exceeds \$1 million at the time of purchase into the fund.<sup>40</sup>

SEC registration may require strict maintenance of records and reporting.<sup>41</sup> The SEC may require registered investment advisers to maintain any records necessary and appropriate for the protection of investors or for the assessment of systemic risk.<sup>42</sup> Registered advisers will be required to maintain records and reports including the amount of AUM, the use of leverage (including off-balance sheet leverage), counterparty credit risk exposure, trading and investment positions, valuation policies and practices of the fund, types of assets held and trading practices.<sup>43</sup> Along with recordkeeping and reporting, the Act also directs the SEC to conduct periodic inspections of all records of private funds managed by registered advisers.<sup>44</sup> The Act exempted the SEC from disclosing records and information resulting from “surveillance, risk assessments, or other regulatory and

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<sup>36</sup> KATHLEEN ANN RUANE & MICHAEL V. SEITZINGER, CONG. RESEARCH SERV., R40783, HEDGE FUNDS: LEGAL HISTORY AND THE DODD-FRANK ACT, at 6 (2010).

<sup>37</sup> *House-Senate Conference Committee Holds A Meeting On The Wall Street Reform And Consumer Protection Act*, 111th Cong. (June 15, 2010)[hereinafter *House-Senate Conference*] (describing funds that trade predominantly in commodities as “well-regulated” by the CFTC).

<sup>38</sup> CADWALADER, *supra* note 32, at 4.

<sup>39</sup> *Id.* at 3.

<sup>40</sup> *Id.* at 17.

<sup>41</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 203, § 408, 124 Stat. 1376 (2010).

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Dodd-Frank: What It Means To You*, *supra* note 33.

oversight activities.”<sup>45</sup> To further protect consumers from fraud and safeguard consumer assets, the Act requires registered investment advisers with custody over clients’ assets to have such assets verified by an independent public accountant.<sup>46</sup>

Within a year of the passage of the Act, the SEC will propose and adopt rules implementing the reporting obligations on investment advisers, the transition of mid-sized advisers from SEC to state regulation and the exemptions from registration for advisers to venture capital firms and certain private funds.<sup>47</sup> Additionally, the Commission will define “family office,” adjust the threshold for “qualified client,” and revise the “accredited investor” standard.<sup>48</sup>

#### D. Analysis of Legislation

The PFIARA focuses regulation and oversight to those funds that are systemically significant. This is made apparent by the exemptions for venture capital advisers, family offices, small and mid-sized funds and small business advisers, while imposing greater registration and reporting requirements for larger funds with more systemically significant trading activities.<sup>49</sup> Congress identified these types of funds as producing less systemic risk than hedge funds, thus requiring less oversight.<sup>50</sup> The registration and reporting requirements for larger funds will bring further transparency into the activities of these funds, allowing the SEC and Financial Stability Oversight Council (“FSOC”) access to the information that may be needed to avoid another crisis by identifying systemic risk.<sup>51</sup> Although hedge funds and venture capital funds are similar, in that they are unregulated investment pools and highly leveraged, venture capital funds may require mandatory capital contributions, their investments are typically maintained for the fund’s lifetime and the

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<sup>45</sup> *Rep. Towns’ Testimony on Legislation to Eliminate SEC FOIA Exemptions in Wall Street Reform Act*, US Fed News, HT Media Ltd. (Sept. 18, 2010).

<sup>46</sup> CADWALADER, *supra* note 32, at 11.

<sup>47</sup> Securities and Exchange Commission Home Page, [www.sec.gov](http://www.sec.gov) (follow “Implementation of Dodd-Frank Act”; then follow “Advisers to Hedge Funds and Other Private Funds”).

<sup>48</sup> *Id.*

<sup>49</sup> *House-Senate Conference*, *supra* note 37.

<sup>50</sup> S. Rep No. 111-176, at 53 (2010).

<sup>51</sup> RUANE & MICHAEL V. SEITZINGER, *supra* note 36, at 4.

fund's managers are usually interested in the management of the companies in which they invest.<sup>52</sup> While increased regulation and transparency into systemically risky funds is generally regarded as needed and beneficial, a number of issues must be considered when implementing the Act.

The first major concern of increasing oversight of hedge funds is decreasing the liquidity in financial markets. Particularly, hedge funds, motivated by profit-sharing incentive fees, take on a broad array of risks that many other market participants are less willing to take.<sup>53</sup> In short, the increased risk-sharing capacity and liquidity provided by hedge funds has contributed significantly to the growth and prosperity enjoyed in the economy.<sup>54</sup> Hedge funds contribute significantly to efficient pricing across markets with their ability to pursue arbitrage trading activities in all markets.<sup>55</sup> Furthermore, by actively trading in credit derivatives, hedge funds contribute to accurate and efficient management of counterparties' risk.<sup>56</sup>

Additionally, hedge funds develop unique, highly-complex investment strategies that allow investors to diversify their investment portfolios.<sup>57</sup> Institutional investors worry that registration and transparency will hold back innovation by managers because their proprietary strategies will be open to review by the SEC and competitors.<sup>58</sup> While increased transparency is essential to monitor systemic risk, it must be balanced with the importance of preserving the intellectual property of hedge funds.<sup>59</sup> Because financial innovations are primarily protected through trade secrecy and not patents, hedge funds are some of the most secretive of financial institutions.<sup>60</sup> Hedge funds receive their value almost entirely through the performance of their investment strategies, and thus have an obligation to their investors to protect the confidentiality of such

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<sup>52</sup> Wagner, *supra* note 21, at 5.

<sup>53</sup> *Hearings*, *supra* note 19, at 8.

<sup>54</sup> *Id.*

<sup>55</sup> Charles Gottlieb, *Hedge Funds: Heading For a Regulatory Hard Landing?*, ECMI Policy Brief, No. 5 at 4 (April 2007).

<sup>56</sup> *Id.* at 4-5.

<sup>57</sup> *Hearings*, *supra* note 19, at 10.

<sup>58</sup> Arleen Jacobius, *Changes In Store For Alternative-Investment Firms, Investors Worry Financial-Reform Bill Will Hurt Innovation*, Investment News, Crane Communications Inc. v.4; iss. 34 (September 6, 2010).

<sup>59</sup> *Hearings*, *supra* note 19, at 7.

<sup>60</sup> *Id.* at 8.

strategies.<sup>61</sup> If required to disclose their investment strategies, many funds will “cease to exist or move to less intrusive regulatory jurisdictions”—a major loss to the financial system.<sup>62</sup>

Concerned that the Freedom of Information Act (“FOIA”) exemption given to the SEC in the Act was too broad and would undermine the goal of restoring transparency and accountability in the financial system, Congress promptly repealed the FOIA exemption unanimously on September 23, 2010.<sup>63</sup> In testimony against repealing the exemption, SEC Chairman Mary Shapiro warned that the SEC needs the broad authority to effectively examine registered advisers and that if Congress limits such authority, registrants will be “reluctant to cooperate with the agency for fear that any information provided in the course of examinations could eventually be leaked to the public as a result of a FOIA request.”<sup>64</sup> The repeal further clarified that the SEC can protect sensitive records derived from its regulatory activities by using an existing FOIA exemption covering records of financial institutions.<sup>65</sup> Because of concerns that advisers and funds newly falling under SEC regulation would not be covered under the repeal as “financial institutions,” the new legislation broadly defines the term “as any entity the SEC examines, regulates or supervises.”<sup>66</sup>

Accordingly, the challenge of addressing systemic risk and consumer protection is to set transparency standards that balance the need for information with hedge funds’ needs to protect their proprietary strategies.<sup>67</sup> A key distinction that must stay intact under the PFIARA is that between registration and regulation. Registration requires advisers to provide information regarding their experience, staff, systems, infrastructure, accountants, lawyers, prime-brokers and other broad-based information at the manager level, not at the

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<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> Dunstan Prial, *Obama Repeals SEC FOIA Exemption*, Fox Business (October 5, 2010) available at <http://www.foxbusiness.com/markets/2010/10/05/obama-repeals-sec-foia-exemption>.

<sup>64</sup> *Regulatory Reform: Congress Moves Quickly to Repeal Dodd-Frank’s SEC Confidentiality Provision*, Securities Law Daily (Sept. 24, 2010).

<sup>65</sup> *Rep. Towns’ Testimony supra* note 45.

<sup>66</sup> James Hamilton, *Congress Clears Legislation on SEC Dodd-Frank FOIA Exemptions for President’s Signature*, Jim Hamilton’s World of Securities Regulation, Newstex Web Blogs (September 23, 2010).

<sup>67</sup> *Gottlieb, supra* note 55, at 5.

fund level.<sup>68</sup> Periodic reporting of systemically relevant information to the SEC, CFTC, or FSOC would also be consistent with registration requirements.<sup>69</sup> Given the complexity of the financial market and its ability to adapt, any requirements of disclosure should identify leverage, liquidity, correlation, concentration, sensitivities and connectedness.<sup>70</sup> The SEC must cautiously determine reporting requirements concerning the fund's trading and investment positions, valuation policies and practices and trading positions.<sup>71</sup> Requiring too much disclosure under these categories, while highly relevant to monitor systemic risk, will highlight concerns over the protection of funds' proprietary information.

In addition to concerns regarding the substance of information to be reported, the SEC will need to carefully consider the costs of implementing and maintaining compliance with reporting and registration requirements. Compliance costs will disproportionately impact smaller hedge funds and, if the costs are too great, funds will either be forced out of the market by shifting investment strategies or will be forced to increase in size to gain economies of scale.<sup>72</sup> Because many funds' strategies seek to exploit market inefficiencies, which becomes more difficult as fund size increases, consolidation of the industry could hurt the performance of hedge funds.<sup>73</sup>

### E. Conclusion

The Dodd-Frank Act provides for significant rulemaking and studies to be conducted by the SEC, Government Accountability Office and the Comptroller General. While the scope of the Act's coverage is still uncertain, the rulemaking will focus on increasing transparency to hedge fund trading activities that may contribute to systemic risk in an effort to ensure against another financial crisis. The reporting and registration requirements defined by the SEC will

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<sup>68</sup> Taub, *supra* note 28.

<sup>69</sup> *Id.*

<sup>70</sup> *Hearings, supra* note 19, at 4.

<sup>71</sup> *Id.* at 8.

<sup>72</sup> See generally, Allison Bisbey Colter, *Does M&A Wave Loom for Smaller Hedgies? Investor Preference for the Biggest Hedge Funds Leaves Others Struggling to Stay Afloat as Compliance Costs Climb*, Investment Dealers' Digest (Aug. 20, 2010).

<sup>73</sup> *Id.*

need to be reasonable to implement, or the SEC risks consolidation in the hedge fund industry. In sum, agencies designated to regulate and monitor systemic risk must carefully balance the hedge fund industry's ability to provide liquidity and innovation to financial markets with the need for increased transparency to carry out their regulatory and oversight functions.

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V. *A New Cop on the Beat: The Bureau of Consumer Financial Protection*

A. **Introduction**

The “Consumer Protection” centerpiece in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Act”) is Title X, which creates a new independent agency called the Bureau of Consumer Financial Protection (“Bureau”).<sup>1</sup> In response to the Great Recession, President Obama vowed to create greater consumer protections in the financial products and services markets. This would serve to act as a partial remedy for the recent failures of the U.S. financial services sector. Lauded as President Obama’s most impressive legislative accomplishment behind comprehensive healthcare reform, it may still be years before the public, Wall Street, or even Beltway insiders know what Title X actually does. This article will explore the underlying need, if any, for an agency geared solely towards consumer financial protection, the form and function of the Bureau as created by Title X and some of the effects the Bureau may have on consumers, covered persons and the health and wellness of the consumer financial products and services sector.

B. **Why do we need a consumer financial protection agency?**

Will greater disclosure of products, education for consumers and regulations for providers combine to equal a healthier financial services industry? According to a recent Rasmussen Reports survey, twenty-nine percent of adults in the U.S. believe that more government regulation is the best way to protect borrowers from unfair lending practices, while fifty-one percent would prefer increased competition in the financial sector.<sup>2</sup> While there is a split amongst consumers, the Bureau’s interim leader, Elizabeth Warren, believes that increased government regulation, when effectively

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<sup>1</sup>Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1011(a) (2010).

<sup>2</sup> Scott Rasmussen, Rasmussen Reports, *Most Say Competition Protects Borrowers More Than Regulation* (September 22, 2010), available at [http://www.rasmussenreports.com/public\\_content/business/general\\_business/september\\_2010/most\\_say\\_competition\\_protects\\_borrowers\\_more\\_than\\_regulation](http://www.rasmussenreports.com/public_content/business/general_business/september_2010/most_say_competition_protects_borrowers_more_than_regulation).

implemented, should lead to increased innovation and competition.<sup>3</sup> Congress must have shared this view when developing the Bureau's purpose and objectives, which are to "implement and . . . enforce Federal Consumer Financial law consistently" in order to ensure equal access to financial products and services and to ensure that these products and services are fair, transparent and competitive.<sup>4</sup>

While there is only tepid support for the creation of the Bureau amongst consumers themselves, Professor Warren says that "without a watchdog in place, the big banks just keep slinging out uglier and uglier products."<sup>5</sup> Her top priority is making credit card and mortgage agreements shorter and simpler,<sup>6</sup> but certain provisions in the Credit CARD Act of 2009 have already made significant changes to card agreements.<sup>7</sup> Warren has also spoken out against exorbitant fees being charged by banks, but cries to cap them may ring hollow if consumers continue to opt-in for "overdraft protection" and other fee-generating schemes.<sup>8</sup> Given the positive gains already from the CARD Act and consumer support for some of the "abusive" bank fee schemes, it is puzzling that Warren has fixated on credit card and mortgage agreements—especially since the Bureau has power over the whole consumer financial products and

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<sup>3</sup> Jeff Gelles, *Warren in the Lion's Den*, Philly.com (October 1, 2010), available at [http://www.philly.com/philly/business/Elizabeth\\_Warren\\_in\\_the\\_lions\\_den.html](http://www.philly.com/philly/business/Elizabeth_Warren_in_the_lions_den.html) (contending that expanded government regulations could lead to a better functioning market when implemented properly).

<sup>4</sup>Dodd-Frank, *supra* note 1 at § 1021(a).

<sup>5</sup> Elizabeth Warren, *Wall Street's Race to the Bottom*, WALL ST. J. Feb. 8, 2010, at A19, available at <http://online.wsj.com/article/SB10001424052748703630404575053514188773400.html> (explaining that without government regulation, consumers will continue to lose trust in the financial sector due to the fact that banks and other similarly situated financial companies have been providing risky sub-par products).

<sup>6</sup> *Id.* (stating that credit card and mortgage agreements have become complicated to the point where consumers have difficulty comparing products).

<sup>7</sup> 15 U.S.C.A. § 1601 (some noteworthy changes are improved mandatory disclosures, fee restrictions and restrictions on interest rate hikes for late payments).

<sup>8</sup>Am. Banker's Ass'n, News Release, *Half of Bank Consumers Choose Overdraft Coverage: ABA survey shows customers value overdraft service*, Aug. 31, 2010, available at <http://www.aba.com/Press+Room/083110OverdraftProtection.htm> ("[M]any bank customers value debit card overdraft protection and are willing to pay for the service.").

services industry. Although populist politics may be at work here,<sup>9</sup> informed consumer advocates hope that the Bureau will go much further than merely trimming verbiage from credit card agreements.

### C. Form and Function

To address concerns in the financial markets, the Bureau will have a broad mandate to enforce consumer financial protection laws, which include rules written by the Bureau. The following subsections discuss the form and function of the Bureau.

#### 1. Form

In response to pressure from consumer advocates, the Bureau was made an independent agency and is only nominally part of the Federal Reserve System. It operates under independent budget<sup>10</sup> and direction and is largely insulated from outside pressures. Of course, the Director may want to temper action with substantial input from the financial services sector, unless in the coming years Congress chooses to backpedal with respect to Title X. Indeed, certain Republican senators targeted Title X for repeal not long after the Act was passed.<sup>11</sup> And for some of the newly elected Republican congressmen, repeal was even a campaign promise.<sup>12</sup>

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<sup>9</sup> Rasmussen, *supra* note 2. When pollsters ask U.S. adults if they support the creation of the Bureau, the results are even with forty-one percent in favor and forty-one percent opposed. When compared to the other result, this may be indicative of effective stumping for the Bureau by Warren and Obama or could represent a public misunderstanding of Bureau functions.

<sup>10</sup> Dodd-Frank, *supra* note 1 at § 1017(a)(2). Funding will be in the form of 10%-12% percent of the revenues of the Federal Reserve with an additional \$200 million available to the Director upon request.

<sup>11</sup> Dave Clark and Rachelle Younglai, *U.S. Senator Wants to Reopen Wall St. Bill*, Reuters (Sept. 20, 2010), available at <http://uk.reuters.com/article/idUKN2010700820100920> (reporting that many Republican Senators want to repeal Dodd-Frank due to its broad nature and its potential to change the makeup of the U.S. financial sector).

<sup>12</sup> Pat Garofalo, *Rand Paul's Job Plan: Repeal Financial Reform*, The Wonk Room (Nov. 2, 2010), available at <http://wonkroom.thinkprogress.org/2010/11/02/paul-finreg-repeal/>.

If Title X survives Republican wrath, however, the Director will sit for a five year term, terminable only for cause.<sup>13</sup> The Director will have exclusive authority to shape the Bureau, from staffing and budgeting to rule-making, regulation and adjudication.<sup>14</sup> Accordingly, the Federal Reserve's Board of Directors will have no authority to set aside Bureau rules, second-guess administrative decisions, or consolidate divisions of the Bureau.<sup>15</sup> Indeed, once a Director has been confirmed, she will be able to perform her duties without interruption or delay from outside influences.<sup>16</sup> Only the new Financial Stability Oversight Council can set aside or stay a Bureau rule, but the procedural mechanisms for this kind of maneuver are weighty, making this a minor if not insignificant check on the director's power.<sup>17</sup> If Congressional Republicans do decide to take aim at Title X, additional checks on the Director's power might be a good starting point. There is room here to significantly weaken the Director position with only minor changes, thereby avoiding the potentially unsavory political position of repeal.

Additionally, the Bureau will swallow up the consumer financial regulatory powers and personnel of various other agencies who are currently regulating the consumer financial markets in checkerboard fashion.<sup>18</sup> For better or worse, Obama and the Democrats were able to consolidate into one organization nearly all of the federal regulators of consumer financial products and services.<sup>19</sup> Finally, the Bureau will contain at least four specialized

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<sup>13</sup>Dodd-Frank, *supra* note 1 at § 1011(b)-1012(a) (summarizing the specifications of the Director and Deputy Director of the Bureau of Consumer Financial Protection and their executive powers).

<sup>14</sup>*Id.*

<sup>15</sup>*Id.* at § 1012(c)(2) (explaining that the Board of Governors of the Federal Reserve may not “. . .(A) intervene in any matter or proceeding before the Director, including examinations or enforcement actions, unless otherwise specifically provided by law; (B) appoint, direct, or remove any officer or employee of the Bureau; or (C) merge or consolidate the Bureau, or any of the functions or responsibilities of the Bureau, with any division or office of the Board of Governors or the Federal reserve banks.”).

<sup>16</sup>*Id.* at § 1012(c) (delegating the autonomous nature of the Bureau).

<sup>17</sup>*Id.* at § 1023(c)(3) (explaining the process by which the Council of Economic Advisers can decide to set aside or stay a Bureau rule).

<sup>18</sup>*Id.* at § 1064 (delegating all personnel and powers that are now shifted to the Bureau).

<sup>19</sup>*See generally* Pellerin, Walter & Wescott, *The Consolidation of Financial Market Regulation: Pros, Cons, and Implications for the United States.*

offices: the Office of Fair Lending and Equal Opportunity, Office of Financial Education, Office of Service Member Affairs and Office of Financial Protection for Older Americans in order to better meet the needs of particularly vulnerable consumers.<sup>20</sup>

## 2. Function

The Bureau is to have three principle functions: 1) information gathering and reporting; 2) regulation; and 3) enforcement.

### i. Information Gathering and Reporting

Various divisions of the Bureau will be in charge of different information gathering and reporting projects. Information gathering and reporting consists of “collecting, researching, monitoring and publishing information relevant to the functioning of markets for consumer financial products and services.”<sup>21</sup> The Bureau will also be required to report to Congress on a large number of topics including education loans, reverse mortgages and how to end the conservatorship of Fannie Mae and Freddie Mac.<sup>22</sup>

In addition to the Congressional Reports, the Bureau must make certain data available to consumers to promote informed purchasing decisions.<sup>23</sup> The Bureau’s specialty offices are to be specifically involved in the research and community education and outreach schemes adopted to serve their unique interests.<sup>24</sup> The Office of Financial Protection for Older Americans, for example, will be required to offer literacy and counseling services and disseminate

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Working Paper Series of the Federal Reserve Bank of Richmond. WP 09-08 (2009) (for an analysis of the pros and cons of a more centralized financial regulatory system), available at, [http://www.richmondfed.org/publications/research/working\\_papers/2009/pdf/wp09-8.pdf](http://www.richmondfed.org/publications/research/working_papers/2009/pdf/wp09-8.pdf) (discussing the pros, cons and implications of consolidating financial market regulation).

<sup>20</sup>Dodd-Frank, *supra* note 1 at § 1013(c)-(g).

<sup>21</sup>*Id.* at § 1021(c)(3).

<sup>22</sup>*Id.* at § 1077 (education loans); *id.* at §1076 (reverse mortgages); *id.* at §1074 (Fannie and Freddie). *See also id.* at § 1016.

<sup>23</sup>*Id.* at § 1021(b)(1)(“The Bureau is authorized to exercise its authorities. . . with the purposes of ensuring that. . . consumers are provided with timely and understandable information to make responsible decisions about financial transactions.”).

<sup>24</sup>*Id.* at § 1013(c)-(g).

financial information to Americans over sixty-two years old.<sup>25</sup> Congress is generally interested in seeing the Bureau provide better guidance, counseling and information regarding consumer financial products to traditionally underrepresented or underserved areas and populations, as well as to the average consumer.<sup>26</sup>

## ii. Regulation

The regulatory arm of the Bureau has broad authority to require reporting of covered persons, to write rules affecting covered persons and to monitor them for compliance with those rules and other federal consumer financial laws.<sup>27</sup> The regulatory component will operate differently depending on the nature of the financial product or service and on the size of the business for depositories and credit unions.<sup>28</sup> For non-depository covered persons,<sup>29</sup> the Bureau will have exclusive federal authority to make rules, require reports and examine business activities.<sup>30</sup> Concerning large banks and credit unions with more than \$10 billion in assets, the Bureau will be the exclusive regulator for reporting and supervision for the purposes of assessing compliance with the federal consumer financial laws.<sup>31</sup> For smaller banks and credit unions the Bureau may but need not require reporting and may examine these entities only on a sampling basis and in connection with their prudential regulator.<sup>32</sup> The Bureau must also coordinate examinations with other regulators so as to keep the regulatory burden to a minimum.<sup>33</sup>

The most interesting question regarding the Bureau's rule-making authority is how they will choose to define and interpret

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<sup>25</sup> *Id.* at § 1013(g).

<sup>26</sup> *Id.* at § 1013(b)(1).

<sup>27</sup> *Id.* at § 1016(c).

<sup>28</sup> *Id.* at §§ 1024-26.

<sup>29</sup> *Id.* at § 1024. A large class of businesses including: an offeror of origination, brokerage, or servicing loans secured by real estate; private education loan providers; payday loan businesses; and other entities which "the Bureau has reasonable cause to determine . . . that such person is engaging in conduct that poses risks to consumers . . ." The Bureau will need to define which entities are subject to their jurisdiction under this section within one year of the transfer date.

<sup>30</sup> *Id.* at §§ 1024-25.

<sup>31</sup> *Id.* at § 1025.

<sup>32</sup> *Id.* at § 1026

<sup>33</sup> *Id.* at §§ 1024-26

“unfair, deceptive and abusive acts or practices.”<sup>34</sup> Congress did give some guidance on how to interpret “unfair” and “abusive,” but the standards are sufficiently vague so that Bureau determinations should survive judicial review.<sup>35</sup> In particular, it will be interesting to see how the Bureau interprets “abusive,” as this is a new term not found in the Federal Trade Commission Act and therefore represents “uncharted” regulatory waters.<sup>36</sup>

### iii. Enforcement

The Bureau will have exclusive federal enforcement authority over non-depository covered persons and primary federal enforcement authority for large banks and credit unions.<sup>37</sup> But with respect to other smaller banks and credit unions, the Bureau can only suggest enforcement proceedings to the prudential regulator.<sup>38</sup> For those subject to enforcement, Bureau investigations and administrative discovery may take the form of subpoenas, production of documents or other tangible evidence and demands for written reports or answers to interrogatories.<sup>39</sup> The Bureau may also initiate hearings and adjudicative proceedings in order to enforce federal consumer financial laws and to issue cease-and-desist orders.<sup>40</sup> Finally, subject to the constraints above, the Bureau may bring civil actions before a United States District Court.<sup>41</sup>

Relief is available to the Bureau in the form of rescission or reformation of contract, refund of monies or return of real property,

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<sup>34</sup> *Id.* at § 1031 (setting forth the guidelines for defining unfair and abusive acts or practices).

<sup>35</sup> *Id.* at § 1031(c)-(d)

<sup>36</sup> Dee Pridgen, *How the New Consumer Financial Protection Law Will Affect FTC Authority*, Public Citizen (Sept. 27, 2010), available at <http://pubcit.typepad.com/clpblog/2010/07/how-the-new-consumer-financial-protection-law-will-affect-ftc-authority-.html> (opining on how the Federal Trade Commission’s loss of authority and new legislative terms like “abusive” will affect the industry).

<sup>37</sup> Dodd-Frank, *supra* note 1 at § 1025. Another agency with enforcement authority may only proceed after notifying the Bureau of the infraction and allowing the Bureau 120 days to respond with its own suit.

<sup>38</sup> *Id.* at § 1026.

<sup>39</sup> *Id.* at § 1052 (covering the process for investigations and administrative discovery).

<sup>40</sup> *Id.* at § 1053.

<sup>41</sup> *Id.* at § 1054.

restitution, disgorgement, money damages, limiting activities or functions of personnel and penalties.<sup>42</sup> Only punitive damages are expressly forbidden, ensuring that overzealous bureaucrats cannot topple these financial institutions.<sup>43</sup> However, potential penalty fines are very steep, with knowing violations punished most severely—up to one million dollars per day.<sup>44</sup>

#### D. Expectations and Implications

Right now there is tri-fold uncertainty: what will the Bureau mean for consumers; what will it mean for the entities under the umbrella of the Bureau's authority; and what will it mean for the safety and soundness of America's financial products and services sector generally? Until the designated transfer date and perhaps even for some time after that, these questions will remain largely unanswered. It is yet to be seen how Elizabeth Warren will shape the Bureau in her interim role, and there is even more uncertainty as to which direction the permanent Director will take the Bureau once appointed.<sup>45</sup> What is certain is that the Bureau's mandate is broad and ambiguous enough to accept many different interpretations, and there is next to nothing in the Act for a District Court Judge to hang her hat on should she be looking to overturn a Bureau rule or reverse an adjudicative determination.<sup>46</sup>

One of the more interesting aspects of the legislation is the tension in the Bureau's mandate between cracking down on large fees and penalties while at the same time ensuring that these financial products and services are available to traditionally underrepresented groups. On the one hand, a larger swath of consumers will not have access to certain consumer financial products if banks and credit unions are forced to change their practices in areas that have been a

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<sup>42</sup> *Id.* at § 1055(a)(2).

<sup>43</sup> *Id.* at § 1055(a)(3).

<sup>44</sup> *Id.* at § 1055(c)(2).

<sup>45</sup> Chip Read, *Elizabeth Warren Unlikely to Run Consumer Protection Bureau*, CBS News (Sept. 16, 2010), available at [http://www.cbsnews.com/8301-503544\\_162-20016745-503544.html](http://www.cbsnews.com/8301-503544_162-20016745-503544.html). Especially now that it looks increasingly unlikely that Mrs. Warren will be named permanent director. Her interim appointment appears to be a compromise that acquiesces to the demands of consumer advocates while allowing for the possibility of a permanent director more sympathetic to the realities and uncertainties facing the financial services sector.

<sup>46</sup> Dodd-Frank, *supra* note 1 at § 1022(b)(4)(B).



boon for years. These include hiding large overdraft fees, transfer fees and adjustable interest rates in marginally-intelligible, multi-volume contracts. On the other hand, if the structure of consumer financial instruments must change to accommodate accessibility concerns while minimizing deceptive practices, then consumers with above average credit are likely to see higher interest rates going forward. However, there is some evidence that banks might not lose out as badly as anticipated while maintaining traditional profitability schemes even in the face of new regulations.<sup>47</sup> It is yet to be seen how and if the Bureau can juggle these interests.

At this point, however, it seems quite certain that if a financial product or service does not fit one of Title X's exceptions,<sup>48</sup> then rules affecting the terms of that product or service will be set in the near future. Certain aspects of the Bureau's functioning must wait until the designated transfer date, but rule-making is not one of them.<sup>49</sup>

Another aspect of Title X sure to leave ripples in the financial services industry is the scaling back of federal preemption doctrine.<sup>50</sup> The bill makes clear that states are free to enact "greater protections" and that the federal consumer financial laws are the regulatory floor rather than the ceiling.<sup>51</sup> Accordingly, Subtitle "D" is meant to overturn the Supreme Court decision in *Watters v. Wachovia*, which held that "operating subsidiaries of national banks and federal thrifts (which generally are state incorporated entities)

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<sup>47</sup> See Am. Banker's Ass'n, *supra* note 8.

<sup>48</sup> *Id.* at §1022(b)(3)(B). There are many entities explicitly excepted from the Bureau's authority: those regulated by the CFTC, SEC and Farm Credit Administration, real estate brokers, modular home manufacturers, auto dealers and others. See also Dodd-Frank, *supra* note 1 at § 1027. The Bureau may also choose to except certain classes of covered persons from their rules either conditionally or unconditionally after weighing certain factors affecting consumers.

<sup>49</sup> *Id.* at § 1029A. But Cf. Dave Clark, *Geithner: New Consumer Rules to Wait Until 2011*, Reuters (Sept. 22, 2010), available at <http://www.reuters.com/assets/print?aid=USTRE68L5ME20100922>.

<sup>50</sup> Sonnenschein Client Alert, *Financial Regulatory Reform—Bureau of Consumer Financial Protection*, Sonnenschein Nath & Rosenthal LLP, Aug. 26, 2010, available at [http://www.snrrenton.com/news\\_insights/alerts/financial\\_regulatory\\_reform-3.aspx](http://www.snrrenton.com/news_insights/alerts/financial_regulatory_reform-3.aspx)

<sup>51</sup> *Id.*

are not subject to state laws.”<sup>52</sup> As a result, national banks previously subject only to federal rules are now potentially subject to additional regulations in every state in which they operate.<sup>53</sup> Accordingly, the Act brings consolidation of regulation at the federal level, but at the price of multiplying the number of state regulators with jurisdiction to enforce the federal consumer financial laws.

### E. Conclusion

In the final analysis, the Bureau is both heralded and condemned as a powerful agency with a sweeping mandate and great regulatory potential. Exactly what shape the new agency will take, however, is largely speculative and unknown. Title X creates more questions than it answers in terms of the effect that the Bureau’s rule-making and enforcement powers will have on consumers, on the financial services industry and on the economy generally. Notwithstanding concerns of the constitutionality of Professor Warren’s recent appointment,<sup>54</sup> there is also concern that she may be disconnected from the industry or too interested in populist politics. If the Bureau reaches out to the industry in a meaningful way, however, and does not worry about scoring the best headlines, then consumers and banks can both win with regulations that keep banks profitable and protect consumer interests.

Benjamin R. Cox<sup>55</sup>

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<sup>52</sup> HOUSE COMM ON FIN. SERV’*S*, 111TH CONG., SUMMARY OF REP ON H.R. 4173 (2009).

<sup>53</sup> Sonnenschein, *supra* note 48.

<sup>54</sup> Bruce Ackerman, *Obama, Warren and The Imperial Presidency*, WALL ST. J., Sept. 22, 2010, at A21 (arguing that Warren’s appointment as special adviser to Treasury Secretary Timothy Geithner is an usurpation of Senate authority).

<sup>55</sup> Student, Boston University School of Law (J.D. 2012).

## **VI. *Asset-Backed Securities Regulation under the Dodd-Frank Act***

### **A. Introduction**

The pervasive securitization of financial assets played a central role in provoking the financial crisis in recent years. The precise mechanisms of securitization have become highly complex and widely varied, but the following description illustrates a basic example of how financial assets, such as loans or receivables, are converted into securities. Financial institutions such as investment banks, commercial banks and thrift institutions often accumulate sets of financial assets by extending credit or purchasing assets from a distinct originating entity.<sup>1</sup> After collecting a set of assets, a financial institution usually creates an entity called a special purpose vehicle (“SPV”) and transfers the assets to the SPV.<sup>2</sup> With the right to receive principal and interest payments made on its assets, the SPV sells classes, or “tranches”, of securities that give investors the right to receive the cash flow from these payments.<sup>3</sup> Tranches themselves can be transferred and pooled to collateralize another hierarchy of marketable securities.<sup>4</sup> These relatively simple securitizations often spawn more complicated financial instruments, the value of which hinges ultimately on the credit quality of underlying assets.<sup>5</sup>

As the housing bubble expanded, securitization provided a number of perceived economic benefits, including increased liquidity and a consequent expansion in lending.<sup>6</sup> Secondary and tertiary credit markets appeared to dilute high lending risks by dispersing them across a universe of sophisticated investors who were thought to be well equipped to bear them.<sup>7</sup> Depository institutions in particular benefited by holding tranches of asset-backed securities with high

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<sup>1</sup> Issuer Review of Assets in Offerings of Asset-Backed Securities, 75 Fed. Reg. 64182, 64184 (proposed Oct. 19, 2010) (to be codified at 17 C.F.R. pt. 229).

<sup>2</sup> STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, 111TH CONG., SECURITIZATION AND THE MORTGAGE CRISIS 5 (2010).

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at 9.

<sup>5</sup> *See id.* (illustrating the complexity of some collateralized debt obligations).

<sup>6</sup> Mary L. Schapiro, Chairman, SEC, Statement at the SEC Open Meeting (Oct. 13, 2010).

<sup>7</sup> STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 2, at 18.

credit ratings, rather than loans with low credit ratings; doing so allowed them to lower their regulatory capital requirements.<sup>8</sup>

As the housing bubble burst, however, mortgage-backed securitization contributed significantly to the unfolding financial crisis. The moral hazards inherent in securitization likely increased the frequency of mortgage defaults and simultaneously exacerbated market sensitivity to those increases.<sup>9</sup> When lenders hold the loans they originate, they have strong incentives to responsibly screen borrowers before subjecting themselves to potential financial losses.<sup>10</sup> Yet if lenders fully divest themselves of the assets they originate, the incentive to originate high-quality loans is replaced by an incentive to originate sellable loans without regard for quality.<sup>11</sup> The same logic can be applied to issuers of securities backed by high-risk loans. When a secondary purchaser obtains assets only to sell the right to receive payment on those assets, the purchaser has motive to acquire and pool even junk, so long as investors stand ready to purchase the corresponding securities.<sup>12</sup> In such an environment, all credit risk is transferred to the investor, whose perception of the risk attached to his securities may be clouded by complex securitization processes and dubious credit ratings.<sup>13</sup>

This moral hazard and lack of transparency probably hastened the deterioration of loan underwriting practices while accelerating the proliferation of securities collateralized by risky loans.<sup>14</sup> Hence, securitization helped increase the number of mortgage defaults when home values tanked and multiplied the losses suffered by investors as a result of defaults.<sup>15</sup> Provisions of the Dodd-Frank Act (“Act”) aim to mitigate some of the risk associated with asset-backed securitization and thereby prevent similar

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<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 19.

<sup>11</sup> Ryan Bubb & Alex Kaufmann, *Securitization and Moral Hazard: Evidence from a Lender Cutoff Rule*, Federal Reserve Bank of Boston, Public Policy Discussion Paper No. 09-5 (Sept. 23, 2009), available at <http://www.bos.frb.org/economic/ppdp/2009/ppdp0905.pdf>.

<sup>12</sup> See James D. Shilling et al., *Moral Hazard and Adverse Selection for Subprime Lending and Securitization—Priced or Not Priced?* 4 (Feb. 2008) (unpublished manuscript, on file with author).

<sup>13</sup> STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 2, at 19.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

contributions to a future financial crisis.<sup>16</sup> Most prominently, the Act requires originators and “securitizers” to retain a portion of the credit risk associated with assets that collateralize asset-backed securities.<sup>17</sup> The Act supplements credit risk retention rules with asset-level disclosure requirements to prompt better-informed decisions by investors.<sup>18</sup> Proponents expect these measures to minimize the moral hazard faced by lenders and issuers, and illuminate the darkness supposedly wandered in by institutional investors.<sup>19</sup>

## **B. Credit Risk Retention**

### **1. Framework**

By April 15, 2011, The Securities and Exchange Commission (“SEC”), in conjunction with the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation (“Federal Banking Agencies”), must prescribe rules requiring issuers of asset-backed securities to retain a percentage of the credit risk for securitized assets.<sup>20</sup> The Federal Housing Finance Agency (“FHFA”) and the Secretary of Housing and Urban Development (“Secretary”) will work with the SEC and Federal Banking Agencies to promulgate regulations specific to securitized residential mortgages.<sup>21</sup> Section 941 of the Act provides a broad framework to guide and limit agency discretion in establishing credit risk retention regulations. The rules must specify the amount, form and duration of risk retention, while prohibiting securitizers from hedging or transferring their share of the risk.<sup>22</sup> Specifically, the regulations must compel securitizers to retain at least five percent of the credit risk for any asset sold,

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<sup>16</sup> Dustin Hall, *Improvements to the Asset-Backed Securitization Process Under the Dodd-Frank Wall Street Reform Bill*, July 7, 2010, <http://www.bankbryancave.com/improvements-to-the-asset-backed-securitization-process-under-the-dodd-frank-wall-street-reform-bill>.

<sup>17</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941(b), 124 Stat. 1376 (2010) (to be codified at 15 U.S.C. § 780-11).

<sup>18</sup> *Id.* § 942 (to be codified at 15 U.S.C. § 780).

<sup>19</sup> *See* Hall, *supra* note 16.

<sup>20</sup> Dodd-Frank, *supra* note 17, at § 941(b) (to be codified at 15 U.S.C. § 780-11).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

transferred, or conveyed to a third party through the issuance of an asset-backed security.<sup>23</sup>

Section 941 weaves a rather intricate web of exceptions and qualifications into this general rule, beginning with a total exemption of residential mortgages that exhibit certain low-risk characteristics. The SEC, Federal Banking Agencies, FHFA and Secretary will jointly define the meaning of the term “qualified residential mortgage” by considering data that historically indicates a low probability of default, such as documentation of the borrower’s financial resources and a high ratio of borrower income to debt.<sup>24</sup> If an asset-backed security is collateralized only by qualified residential mortgages, then every asset backing that security is wholly exempted from risk retention requirements.<sup>25</sup> However, securitizers must retain five percent of the credit risk even for a qualified residential mortgage, if it collateralizes the same security as an asset that is not a qualified residential mortgage.<sup>26</sup>

Residential mortgages represent just one of at least four asset classes that the SEC and Federal Banking Agencies will regulate under § 941. The SEC and Federal banking Agencies must adopt separate rules for commercial mortgages, commercial loans, auto loans and any other asset class these agencies deem appropriate to establish.<sup>27</sup> For each class, the Federal Banking Agencies must delineate underwriting standards for loans within that class that indicate a low risk of default.<sup>28</sup> If an asset meets these class-specific standards, the risk retention rate imposed on the securitizer will decrease to some rate below five percent.<sup>29</sup> Depending on the precise rates to be established, this decrease will amount to a total or partial exemption for assets that are not qualified residential mortgages, but nevertheless exhibit sufficiently low-risk features to loosen regulators’ collective grip on their securitization. Unlike the exemption provided for qualified residential mortgages, these exemptions are variable, and granted without regard for the attributes of other assets collateralizing the same security.

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<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

Still broader exemptions are granted for the securitization of financial assets with other characteristics. The rules must allow for a total or partial exemption of any asset guaranteed by the United States or an agency thereof (excluding Fannie Mae and Freddie Mac), or by any State.<sup>30</sup> Furthermore, the SEC and Federal Banking Agencies may provide for the exemption of any securitization, “as may be appropriate in the public interest and for the protection of investors.”<sup>31</sup> Section 941 even permits exceptions or adjustments for entire classes of institutions and assets, with respect to both risk retention and the prohibition on hedging.<sup>32</sup> Any such exception must ensure high-quality underwriting standards, encourage risk management, improve access to credit, or otherwise be in the public interest.<sup>33</sup>

The Act also addresses the role of lenders in the asset-backed securitization process. When a securitizer purchases an asset from a separate originator, the requisite percentage of risk retention for that asset must be allocated between securitizer and originator.<sup>34</sup> For example, a securitizer otherwise required to retain five percent of the credit risk for a mortgage might only be required to retain three percent, while the originator retains the other two percent. In determining how to divide credit risk between securitizers and originators for a given set of assets, the SEC and Federal Banking Agencies will consider: (1) whether the assets sold to the securitizer exhibit low-risk characteristics, (2) whether market conditions incentivize imprudent origination of the given asset type and (3) the potential effects of the risk retention obligations on credit markets.<sup>35</sup>

## 2. Study on Credit Risk Retention

By January 17, 2011, the Chairman of the Financial Services Oversight Council (“Chairman”) must conduct a study and submit a report to Congress on the macroeconomic impact of credit risk retention.<sup>36</sup> This study will focus on how risk retention requirements might help stabilize real estate markets, and Section 946 of the Act

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<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at § 946 (to be codified at 15 U.S.C. § 77g).

provides several suggestions to guide this focus.<sup>37</sup> The Chairman's report may include an analysis of how credit risk retention might have limited the economic havoc wrought by plunging home prices in the recent financial crisis.<sup>38</sup> It may also speculate on the feasibility of preventing future asset bubbles by preemptively adjusting retention rates according to market conditions, and opine as to what entity should exercise such an adjustment authority.<sup>39</sup> Though potentially informative, most findings from this study will remain speculative, as rules for residential mortgages remain ineffective for one year after publication, and rules for all other asset classes remain ineffective for two years after publication.<sup>40</sup>

### 3. Discretion and Potential Deficiencies

Provisions of the Act governing credit risk retention raise more questions than they provide answers. The SEC and Federal Banking Agencies have great flexibility to shape regulation according to their findings, and the precise impact of regulation will remain unknown until the new rules are implemented. The form and duration of risk retention, the establishment of asset classes and the delineation of qualified residential mortgages and other exemptions will color the Act's fuzzy sketch of the coming regulatory structure.

Exemptions are especially vague under § 941. Depending on the precise data used to label a residential mortgage "qualified," the proportion of residential mortgages wholly exempted from risk retention could be relatively small or large. Similar indeterminacies accompany exemptions in other asset classes. The underwriting standards used to identify commercial mortgages, commercial loans and auto loans as low-risk could substantially influence the results of regulation. Retention of "less than five percent" of the credit risk for these assets could vary anywhere between 0% and 4.99%, according to agency preference. Furthermore, the nature and scope of exemptions "appropriate in the public interest and for the protection of investors" are potentially consequential, particularly if such exemptions apply across entire institutions or asset classes.

Even the broad guidelines the Act provides, however, cast doubt on the effectiveness of ensuing regulations at eliminating the

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<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at § 941(b) (to be codified at 15 U.S.C. § 78o-11).



moral hazard faced by securitizers and originators. Intuitively, five percent seems like a rather small portion. If pooling assets allowed securitizers to offer investors high returns on junk by issuing tranches of securities, it seems plausible that future bubble-prone market conditions for a given asset class might encourage issuers to sell securities at a premium that exceeds their slight risk exposure. While such calculations will depend on a multitude of currently unknown variables, relatively small risk retention rates could prove insufficient to offset securitizers' prospective profits under the right market conditions. Variable risk retention rates could reduce this threat, assuming regulators possess the information, expertise and incentives to respond appropriately to changing market conditions.

The retention rates appear even less potent in light of the mandated allocation of credit risk between securitizers and originators, together with the Act's selective prohibition on hedging. When a bank issues securities backed by high-risk loans originated in-house, that bank will have to retain at least five percent of the credit risk for those loans.<sup>41</sup> Yet if the same bank securitizes loans purchased from a distinct originator, the bank's risk retention rate will automatically be reduced by the percentage imposed on the originator.<sup>42</sup> Thus, securitizers can cut their risk retention obligations by securitizing assets created exclusively by other institutions. Furthermore, the Act does not prevent originators from hedging against their share of the credit risk.<sup>43</sup> Aggregate risk retention could be significantly diluted if securitizers reduce their credit risk by sharing it with originators, and originators evade much of their risk by hedging against it. In theory, the higher the percentage of risk assigned to originators, the less effective retention requirements will be at eliminating the same moral hazards that previously prompted irresponsible lending and the issuance of risky loan-backed securities.

History provides further evidence that credit risk retention rules might fail to curtail loose lending and the proliferation of high-risk securities transactions. Leading up to the financial crisis, many lenders kept some original loans on their books as well as tranches of their own mortgage-backed securities.<sup>44</sup> Others retained loan servicing rights, which maintained a quantifiable connection between

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<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 2, at 20.

loan performance and originator revenues.<sup>45</sup> Many originators and securitizers failed or sustained billions of dollars in losses when loan defaults spiked, suggesting that they in fact retained a substantial amount of credit risk.<sup>46</sup> If voluntary retention failed to prevent financial disaster before, compulsory retention could prove inadequate going forward, particularly now that the United States has demonstrated a willingness to shovel out rescue dollars when profits turn to losses.<sup>47</sup>

### **C. Disclosure and Warranties**

#### **1. Asset-Level Information**

To supplement credit risk retention under § 941, § 942 of the Act instructs the SEC to adopt regulations requiring issuers of asset-backed securities to disclose asset-level data.<sup>48</sup> This data should allow investors to compare securities collateralized by similar assets, by comparing the characteristics of the underlying assets themselves.<sup>49</sup> To allow investors to perform such due diligence, the rules will probably require issuers to disclose: (1) unique identifiers corresponding to the originators of assets backing a given security, (2) the compensation received by the originators and (3) the respective amounts of risk retained by the originators and securitizer.<sup>50</sup>

#### **2. Something Old, Something New**

History also suggests that disclosure rules could have a limited impact on the decisions of sophisticated institutional investors, who suffered crushing losses when the value of asset-

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<sup>45</sup> *Id.*

<sup>46</sup> *Id.* See also Richard M. Hynes, *Securitization, Agency Costs, and the Subprime Crisis*, 4 VA. L. & BUS. REV. 231, 243 (2009).

<sup>47</sup> See James K. Glassman, *The Hazard of Moral Hazard*, COMMENTARY MAGAZINE, Sept. 2009, at 29 (contending that government intervention in financial crises promotes unsafe business practices, as protection from adverse consequences reduces the incentive to avoid excessive risk-taking).

<sup>48</sup> Dodd-Frank, *supra* note 17, at § 942 (to be codified at 15 U.S.C. § 780).

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

backed securities plummeted in response to credit defaults.<sup>51</sup> Most investors already had ways to assess the risk in purchasing a given asset-backed security.<sup>52</sup> The use of credit scores in loan underwriting allowed secondary market participants to gauge the risk of default for underlying assets.<sup>53</sup> Many investors would not buy a loan-backed security for which the original borrowers' credit scores were unavailable.<sup>54</sup> Other important risk factors previously available to securitizers and investors include borrower income data and loan-to-value ratios.<sup>55</sup> Thus, § 942 essentially mandates the disclosure of information to which investors were largely privy prior to the financial crisis.

Market participants also took steps to mitigate the risk posed by low-quality loans, which may show that they understood the incentive problems posed by securitization.<sup>56</sup> Securitizers sometimes required lenders to provide a random sample of loans on their books, which limited lenders' ability to sell only their riskiest loans.<sup>57</sup> Moreover, securitizers usually required originators to make representations and warranties regarding their underwriting practices.<sup>58</sup> Agreements often obliged originators to repurchase loans that breached these warranties or defaulted soon after sale, and such obligations were frequently enforced.<sup>59</sup> Section 943 of the Act at least appears to enhance these preexisting safeguards by requiring securitizers to disclose all repurchase requests for underlying assets, allowing investors to flag originators that consistently inject bad loans into the market.<sup>60</sup>

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<sup>51</sup> See, e.g., Mark Whitehouse, *Number of the Week: \$132 Billion of Lost Synthetic Mortgage Bets*, WALL STREET JOURNAL, May 1, 2010, <http://blogs.wsj.com/economics/2010/05/01/number-of-the-week-132-billion-of-lost-synthetic-mortgage-bets> (chronicling enormous losses suffered by major institutional investors).

<sup>52</sup> STAFF OF FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 2, at 7.

<sup>53</sup> *Id.* at 20.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> Dodd-Frank, *supra* note 17, at § 943 (to be codified at 15 U.S.C. § 78o-7).

### C. Problem Solved?

The Act facilitates the adoption of rules reasonably geared toward addressing some pitfalls of asset-backed securitization that contributed to the recent financial crisis. However, the broad discretion given federal agencies makes it difficult to evaluate the impact forthcoming requirements will have on financial markets. Perhaps analyses from the study conducted pursuant to § 946 will shed some light on this uncertainty.<sup>61</sup> Yet even the Act's very general framework suggests that the new rules might only induce negligible or conditional changes to securitization practices. It remains to be seen whether the regulations will reign in asset-backed securities markets to an extent that will help prevent their contributions to a future crisis.

David J. Harris, Jr.<sup>51</sup>

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<sup>61</sup> *Id.* at § 946 (to be codified at 15 U.S.C. § 77g).

<sup>51</sup> Student, Boston University School of Law (J.D. 2012).

## VII. *The Federal Reserve and Its Expanded Authority under the Dodd-Frank Act*

### A. Introduction

In late 2007, the economic crisis, triggered by a lack of liquidity, resulted in the collapse of large financial institutions, bailouts of banks and large downturns in financial markets across the world. In the United States, the housing market has been one of the biggest casualties as prices have plummeted on houses and foreclosures have reached all-time highs.<sup>1</sup> As our country moves forward, it is hard to ignore the role that the Federal Reserve (“Fed”) played in its implementation of monetary policy and in its role as a bank regulator. In July of 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Act”). This broad legislation sets up guidelines for agencies and regulators involved with monitoring financial services, including the Fed, which is set to experience a makeover in its regulatory duties. One of the biggest changes to the Fed’s authority is that it will now have expanded authority to regulate any systemically significant nonbank financial firm.<sup>2</sup> It is still too early to determine the impact the Dodd-Frank Act will have on economic recovery but there is no doubt that it will have an effect on the way the Fed operates.

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<sup>1</sup> See *Case-Shiller Index*, STANDARD AND POOR’S, <http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff-p-us----> (last updated Oct. 26, 2010); See also *5 Yr. Bloomberg Mortgage Delinquency % Foreclosure*, BLOOMBERG.COM, <http://www.bloomberg.com/apps/quote?ticker=BBMDFCL:IND#chart> (last updated Oct. 31, 2010)(BBMDFCL:IND); *5 Yr. Bloomberg Mortgage Delinquency % Subprime Foreclosures*, BLOOMBERG.COM, <http://www.bloomberg.com/apps/quote?ticker=BBMDSFCL:IND#chart> (last updated Oct. 31, 2010) (BBMDSFCL:IND); Les Christie, *Foreclosures: “Worst three months of all time,”* CNNMONEY.COM (Oct. 15, 2009, 7:34AM), [http://money.cnn.com/2009/10/15/real\\_estate/foreclosure\\_crisis\\_deepens](http://money.cnn.com/2009/10/15/real_estate/foreclosure_crisis_deepens).

<sup>2</sup>Clients & Friends Memo, *Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, CADWALADER, WICKERSHAM, & TAFT LLP July 20, 2010, at 2, available at [http://www.cadwalader.com/assets/client\\_friend/TheDoddFrankAct\\_Impacts.pdf](http://www.cadwalader.com/assets/client_friend/TheDoddFrankAct_Impacts.pdf).

## B. The Federal Reserve System

The Federal Reserve Act of 1913 states that the Fed is responsible for formulating and executing the nation's monetary policy in order to "promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."<sup>3</sup> Since its enactment, the Fed has used three main tools to achieve its goals: the discount rate, reserve requirements and the federal funds rate.<sup>4</sup>

The federal funds rate is the most closely-monitored<sup>5</sup> and thus the most important tool to effectuate the Fed's monetary policy. Banks maintain deposits at the Fed, called federal funds, which are actively lent to other banks.<sup>6</sup> The rate charged on such loans is the federal funds rate, which is heavily influenced by the Fed's use of open market operations.<sup>7</sup> However, during the global financial crisis, the Fed has dropped rates to near zero and has needed to figure out new, controversial ways to stimulate lending.<sup>8</sup>

In addition to monetary policy, the Fed has a regulatory role as well. It has primary supervisory authority for state banks that want to become a part of the Federal Reserve System. It shares regulatory duties with the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") to help "ensure the safety and soundness of financial institutions."<sup>9</sup> The recent financial crisis clearly shows that the Federal Reserve failed in its regulatory duties because many banks in the Federal Reserve System became involved in risky consumer lending.<sup>10</sup> One of the aims of the Dodd-Frank Act is to revamp the Fed's regulatory duties

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<sup>3</sup>Credit Suisse Basis Points, *Federal Reserve Insights: Structure, Function, Decision Makers*, CREDIT SUISSE, Apr. 29, 2010, at 3.

<sup>4</sup>BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *THE FEDERAL RESERVE SYSTEM PURPOSES AND FUNCTIONS* 3 (9th ed. 2005).

<sup>5</sup>Credit Suisse, *supra* note 3.

<sup>6</sup>*Id.*

<sup>7</sup>*Id.*

<sup>8</sup>*See Id.* The Fed has adopted new controversial tools such as Asset Purchasing (also known as quantitative easing) and paying interest over excess reserves ("IOER") in order to help stimulate lending.

<sup>9</sup>BOARD OF GOVERNORS, *supra* note 4, at 59-60.

<sup>10</sup>ALAN GREENSPAN, *THE CRISIS*, 7 (2010).

in order to prevent any future economic meltdowns from developing.<sup>11</sup>

### **C. The Federal Reserve's Role Leading Up to the Economic Crisis**

Currently, there is much debate on the role of the Fed leading up the crisis and to what extent it should bear blame. Former Chairman of the Fed, Alan Greenspan, has said that the Fed's mistakes were regulatory in nature and not due to mismanagement of monetary policy.<sup>12</sup> Greenspan claimed that the Fed failed in its duty to regulate the subprime mortgage market but he also blamed government-sponsored enterprises such as Fannie Mae and Freddie Mac.<sup>13</sup> Others have contested this notion, arguing that low federal funds rates during the 2000s led to cheap mortgage financing, which in turn fueled the housing boom.<sup>14</sup> Regardless, the Fed has inherited the daunting task of navigating the U.S. monetary system through this recession.

### **D. The Federal Reserve's Expanded Authority as a Regulator under Dodd-Frank**

In response to the Fed's failure to regulate, Congress enacted the Act with the purpose of promoting financial stability in the United States through improved accountability and transparency.<sup>15</sup> This Act is set to have a big impact on how the Fed operates in a few

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<sup>11</sup>Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010). ("An Act To promote the financial stability of the United States by improving accountability and transparency in the financial system...").

<sup>12</sup>GREENSPAN, *supra* note 10 at 7, 40.

<sup>13</sup>*See id.* at 6-7 (arguing that these firms drove up demand--which drives up prices--during the housing bubble by purchasing nearly half of all subprime mortgage securities); *See also* Jason M. Breslow, *Greenspan Defends Fed's Role in Run-up to Financial Crisis*, THE RUNDOWN (April 7, 2010, 2:50 PM), <http://www.pbs.org/newshour/rundown/2010/04/greenspan-defends-feds-role-in-run-up-to-crisis.html>.

<sup>14</sup>*See* Jamus Lim, *How Exactly was the Fed Responsible for the Financial Crisis?*, PROSPECTS FOR DEVELOPMENT (March 19, 2010, 6:05PM), <https://blogs.worldbank.org/prospects/how-exactly-was-the-fed-responsible-for-the-financial-crisis>.

<sup>15</sup>Dodd-Frank Act, *supra* note 11.

key areas. The Fed will now have expanded authority as a regulator with the added responsibility of supervising all systemically significant nonbank financial firms and enforcing more stringent capital regulations.<sup>16</sup> The Act calls for the creation of the Financial Stability and Oversight Council (“FSOC”),<sup>17</sup> which has general authority to issue recommendations to the primary financial regulatory agencies regarding standards and safeguards as well as the consequential ability to designate systemically significant nonbank financial firms.<sup>18</sup>

According to the guidelines, any nonbank firm deemed “predominantly engaged in activities that are financial in nature” and where “material financial distress exists or the nature, scope, size, scale, concentration, interconnectedness, or the mix of the activities” of the firm could “pose a threat to the financial stability” of the United States, will be under the Fed’s supervision.<sup>19</sup> The first prong of this designation is clear as it covers firms that have financial activities contributing 85 percent or more of its annual gross revenues or have financial activities accounting for 85 percent or more of the firm’s total consolidated assets.<sup>20</sup> The second part of this designation is much more subjective as it attempts to address the prevailing concern of “too big to fail.”<sup>21</sup> In addition, the Fed is now forced to maintain heightened prudential standards for these systemically significant nonbank financial firms and for bank holding companies with assets exceeding fifty billion dollars.<sup>22</sup> These heightened standards include risk-based capital and leverage requirements, liquidity requirements, risk management requirements and other requirements set up to ensure long-term stability in these firms.<sup>23</sup>

Along with this expanded authority, the Fed will have new powers that can affect the way systemically significant nonbank financial firms and bank holding companies are structured. One of the Fed’s newfound powers is the ability to force these nonbank

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<sup>16</sup>CADWALADER, *supra* note 2, at 2.

<sup>17</sup>*Id.*

<sup>18</sup>*Id.* at 3.

<sup>19</sup>*Id.* at 3.

<sup>20</sup>*Id.* at 4.

<sup>21</sup>Dodd-Frank Act, *supra* note 11.

<sup>22</sup>CADWALADER, *supra* note 2 at 5.

<sup>23</sup>*See Id.* at 5-7



firms to “silo” all or part of their financial activities.<sup>24</sup> This power is predicated on the concept of “separation of banking and commerce” and would force nonbank firms to create intermediate holding companies for all of its activities deemed financial in nature.<sup>25</sup> Thus, this will create significant administrative burdens as some nonbank firms may need to undergo a serious corporate reorganization<sup>26</sup>. The Fed will now be able to limit certain acquisitions, including acquisition of shares or assets of a bank or BHC, of nonbank financial firms because they will be held to the approval requirements of the Bank Holding Company Act.<sup>27</sup> In addition, further notice must also be given to the Fed if a company being acquired has assets in excess of ten billion dollars.<sup>28</sup> This will give the Fed the authority to oversee the acquisition, imposing another regulatory hurdle on the firm.

Another significant power given to the Fed is the authority to require large bank holding companies and significant nonbank financial firms to terminate certain activities and divest certain assets if the Fed determines that these activities or assets pose a grave threat to U.S. financial stability.<sup>29</sup> This in essence allows the Fed to deny mergers or acquisitions, restrict the offering of certain financial products, force companies to terminate or impose conditions on certain activities and require the company to sell or transfer assets or off-balance-sheet items to unaffiliated entities. In addition, the Act includes a non de-banking provision that applies to entities that were bank holding companies with consolidated assets of fifty billion dollars or more and received assistance under the Capital Purchase Program as of January 1, 2010.<sup>30</sup> This provision states that the Fed will automatically regulate these entities and their successors if they ever cease to be bank holding companies,<sup>31</sup> meaning that they will remain subject to these provisions regardless of their size at any time or whether they remain bank holding companies. However, forcing these predetermined entities to face such stringent requirements could lead to inequitable results. For example, if a bank holding

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<sup>24</sup>*Id.* at 8-9.

<sup>25</sup>*Id.*

<sup>26</sup>*Id.*

<sup>27</sup>*Id.* at 10.

<sup>28</sup>*Id.*

<sup>29</sup>*Id.*

<sup>30</sup>*Id.*

<sup>31</sup>*Id.*

company decides to acquire a large amount of non-financial assets and is not subject to the same systemic risks of others in the industry, it will still need to be properly capitalized and subject to the Fed's authority.

## **E. Reactions and Future Outlook**

Amidst all of these new provisions and changes lie two simple questions: are these new regulatory provisions necessary to provide financial stability and will they help our economy avoid another financial crisis?

### **1. Interpreting Dodd-Frank**

The Act gives the Fed new authority that can have a large impact on the operations of many large financial firms. The criteria set out for the Fed is vague and subject to much interpretation. At this point, finding when a company's "nature, scope, size, scale, concentration, interconnectedness, or mix of activities . . . could pose a threat," is difficult and will lead to intense debate as these definitions could mean the difference between costly regulatory compliance as a systemically significant firm. It seems, however, that many of the large financial institutions in the shadow banking sector,<sup>32</sup> such as large hedge funds, money market funds, investment banks, Fannie Mae and Freddie Mac, will qualify as systemically significant and will thus be monitored by the Fed.<sup>33</sup> This will potentially double the size of the Fed's jurisdiction as nonbank financial firms make up about half of the assets in the financial sector.<sup>34</sup>

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<sup>32</sup>See PRELIMINARY STAFF REPORT, FINANCIAL CRISIS INQUIRY COMM'N, SHADOW BANKING AND THE FINANCIAL CRISIS 4 (2010). Shadow banking refers to bank-like financial activities that are conducted outside the traditional commercial banking system. This sector contributes to more than half of the financial activity in the U.S.

<sup>33</sup>See Peter Eavis, *A Harsher Regulatory Light Will Shine on GE Capital*, WALL ST. J., Aug. 16, 2010, at C6; See King & Spalding, *Client Alert: Effects of Dodd/Frank Act on the Regulation of Advisers to Private Equity and Hedge Funds* (2010).

<sup>34</sup>See *Id.*, at 7-8 (Figure 1 compares assets of those in the shadow banking sector versus those of depository institutions).

## 2. Past Reactions to Heightened Regulations

One concern is the Act's potential impact upon the profitability of financial institutions.<sup>35</sup> The Act will force significant upfront costs on many financial corporations attempting to comply with the new regulations.<sup>36</sup> Some corporations may need to restructure, which takes significant amounts of time and money. These changes, as adaption to the Sarbanes-Oxley Act has shown us, may have a negative impact on the profitability of these firms as restructuring and higher capitalization measures cost money.<sup>37</sup> In addition, corporations will be subject to new sets of fines and litigation costs. Combine this with the Fed's ability to prohibit products, services or activities labeled as "systemically risky" and it becomes clear that financial companies could be in for a costly transition. These heightened capitalization requirements and concentration limits may inhibit a financial company's ability to maximize its potential earnings and may even hinder recovery from the recent financial crisis.

While the Act will force these systemically significant firms to adhere to capitalization and transparency requirements, financial markets have always found ways around new regulations; for example, the shadow banking sector was created out of excess regulation during the early 1900s.<sup>38</sup> Financial institutions are constantly evolving and have always found ways to remain profitable in the face of stringent financial regulations. Shadow banking evolved in the face of the intense regulation of the new deal and the Glass-Steagall Act,<sup>39</sup> and recently, financial companies have been

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<sup>35</sup>See John B. Taylor, *The Dodd-Frank Financial Fiasco*, WALL ST. J., July 1, 2010, at A19.

<sup>36</sup>Cadwalader, *supra* note 2, at 9.

<sup>37</sup>See Michael R. Crittenden, *Financial Overhaul Stymies Top Regulators: New Law Might need Altering Already, as Implementing its Restrictions on the Use of Credit Ratings Stirs Concerns*, WALL ST. J., Aug. 11, 2010, at C3 (For many companies, complying with Sarbanes-Oxley significantly increased administrative costs); See also THOMAS E. HARTMAN, THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY, FOLEY & LARDNER LLP 1-3 (2007); Taylor *supra* note 34.

<sup>38</sup>See FINANCIAL CRISIS INQUIRY COMM'N *supra* note 32, at 11-13.

<sup>39</sup>*Id.* at 7-8; See Zoltan Pozsar, Et. Al., *Shadow Banking*, 458 FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS 1 (2010).

continuously developing new products and markets such as derivatives and mortgage-backed securities<sup>40</sup>.

Historically, it seems that banking and finance companies will inevitably find a way around the FSOC requirements and work around the responsibilities of added regulations. For example, the non de-banking provision will prevent current bank holding companies from restructuring in order to escape these heightened standards; however, nothing in the Act bars nonbank firms from restructuring to avoid regulation. As history has shown, the banking and finance industry is quick to adapt to regulatory changes, much more so than its government counter parts, exemplified by the recent financial crisis.

### 3. Does Dodd-Frank Properly Address the Fed's Failures?

A third issue is the fact that the Act is predominantly concerned with the regulatory nature of the Federal Reserve. While many say that the meltdown was due to regulatory failures, many economists blame the mismanagement of the federal funds rate as a key factor in the housing bubble.<sup>41</sup> They argue that keeping the federal funds rate low during the early part of the 2000s caused a housing bubble because mortgage financing became extremely cheap.<sup>42</sup> Proponents of this argument show that while the Fed directly controls short term rates, it inevitably controls long term rates by bringing inflation expectations down<sup>43</sup>.

The opposing thought, framed by Alan Greenspan and Ben Bernanke, is that the relationship between short- and long-term rates broke down in the 1990s.<sup>44</sup> Thus, because the Fed only controls short-term rates, they did not have an impact on long-term lending

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<sup>40</sup>See FINANCIAL CRISIS INQUIRY COMM'N *supra* note 32, at 17-23.

<sup>41</sup>Lim, *supra* note 13

<sup>42</sup>*Id.*

<sup>43</sup>See Angela Maddaloni & Jose-Luis Peydro, *Bank Risk-Taking, Securitization, Supervision and Low Interest Rates: Evidence from the Euro Area and the U.S. Lending Standards* 20-21 (Eur. Cent. Bank, Working Paper No. 1248, 2010). Infer that lower inflation rates are consequences of lower reserve (short-term) rates. Also, low short term rates soften standards for all types of loans.

<sup>44</sup>See GREENSPAN, *supra* note 10 at 40.

through mortgages.<sup>45</sup> Greenspan notes that the housing bubble was created by long-term lending rates and not the federal funds rate, as short-term rates are not used to determine capitalization rates of real estate.<sup>46</sup> He pointed to the surge in housing demand as the main reason that housing prices went up.<sup>47</sup> Due to the fact that the Board of Governors is appointed by the President, even if mismanagement of the federal funds rate was to blame, there does not seem to be much that Congress could do legislatively except to repeal or amend the Federal Reserve Act.

#### **4. The Fed's Regulatory Failure during the Housing Bubble**

One final concern is that the Fed previously failed in its regulatory duties. Enacting tougher legislation will be ineffective if the Fed fails to enforce it. In addition, many feel that the Fed's decision-making in the wake of the financial crisis has been poor.<sup>48</sup> Many critics point to the predictability of the Fed's actions with regards to the federal funds rate as an indication that it is not suited to serve as a regulatory agency.<sup>49</sup> Critics also refer to the bailout of Bear Stearns and the decision to not bail out Lehman Brothers as a dangerous sign of inconsistency that has injected significant uncertainty into the financial sector.<sup>50</sup>

Despite these criticisms, no agency is better able to handle this authority over the financial sector than the Fed. The FSOC, which determines which companies are systemically significant, makes decisions separate of Fed approval.<sup>51</sup> It consists of a diverse group of members, many of whom are not affiliated with the Fed.<sup>52</sup>

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<sup>45</sup>*See id.*

<sup>46</sup>*Id.* at 39.

<sup>47</sup>*Id.* at 41.

<sup>48</sup> *The Diviner of Systemic Risk*, WALL ST. J. Sept. 4, 2010, at A14, available at <http://online.wsj.com/article/SB10001424052748704206804575467872819971324.html>; *See* Lim, *supra* note 14.

<sup>49</sup> JOHN B. CARLSON, ET. AL., FOMC COMMUNICATIONS AND THE PREDICTABILITY OF NEAR-TERM POLICY DECISIONS, FEDERAL RESERVE BANK OF CLEVELAND (2006).

<sup>50</sup> John Ydstie, *Federal Reserve Mulls Its Role One Year After Crisis*, NPR, Sept. 14, 2009, <http://www.npr.org/templates/story/story.php?storyId=112767144>.

<sup>51</sup> *See* CADWALADER, *supra* note 2, at 2-3.

<sup>52</sup> *See id.*

In addition, while the Fed did fail in its regulatory duties during the financial crisis, there was much less transparency for the nonbank financial institutions. The Fed's regulatory authority was also considered by some as a secondary duty to its monetary policy.<sup>53</sup> In response to this, the Act calls for limitations on the Fed's ability as a lender of last resort, forcing it to consult with the Treasury before it is allowed to give assistance.<sup>54</sup> Additionally, the Act has set up an audit system for Special Federal Reserve System Credit Facilities and enhanced the transparency of the Fed.<sup>55</sup> This increase in the Fed's regulatory authority, along with increased transparency and limits on its lending powers, are clear attempts to elevate the importance of the Fed's regulatory duty.

#### F. Conclusion

The landmark Dodd-Frank Act will change the character of financial services, the face of the Fed and the way financial firms do business. Because the Act mostly delegates power to agencies to create regulations, the future outlook is vague and much is left to be decided. Much of the impact that this Act will ultimately have lies in the type of oversight that the Fed chooses to take on. If the Fed plays a hands-off role, it seems that the new transparency requirements will be a sufficient indicator of when the Fed has to step in and use its authority. If however, the Fed constantly or inconsistently invokes its ability to restrict acquisitions, prohibit novel financial activities and require divestiture of assets and off-balance-sheet items, the Act may undermine its desired effects. This could upset many financial institutions, potentially leading to intense litigation which no party wants.

The Fed has now been given the intimidating task of ensuring that our economy does not suffer another crisis. In addition, it will be forced to monitor a much wider array of financial services which will need to comply with much heavier regulation. While these will be the clear and immediate effects on the Fed and financial companies, the overall impact of the Act on the safety and soundness of our economy is left to be determined. It is quite clear that there is

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<sup>53</sup>Lim, *supra* note 13.

<sup>54</sup>MAYER BROWN LLP, UNDERSTANDING THE NEW FINANCIAL REFORM LEGISLATION: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 126-127 (2010).

<sup>55</sup>*Id.* at 130.

not one piece of legislation that will remedy our economy or protect us from future economic disasters, but the Act, if implemented properly, could become the foundation for sound economic reform that supports growth while curbing risk.

Robert DeLeon<sup>56</sup>

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## **VIII. *The Changing Landscape of Executive Compensation after Dodd-Frank***

### **A. Introduction**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or “the Act”), signed into law by President Obama on July 21, 2010, contains several provisions that add significant new executive compensation and corporate governance requirements for U.S. public companies.<sup>1</sup> Government interest in regulating executive compensation has been a fairly recent development, predicated mainly on the assertion that lack of oversight and poor incentives based on current pay packages may have been a significant factor in exacerbating the recent financial crisis.<sup>2</sup> The goals of including provisions within the Act to regulate executive compensation are mainly to decentralize power when it comes to determining executive pay and to provide public shareholders with the information and power to influence the decisions of the corporate directors and executives whom they elect.<sup>3</sup>

### **B. Executive Compensation Regulation Prior to Dodd-Frank**

One of the major objectives behind the inclusion of the new executive compensation regulations in the Dodd-Frank Act was to increase accountability for a system that many believed was partly responsible for the financial crisis of 2008.<sup>4</sup> Prior to the financial crisis, there was little regulation regarding executive compensation beyond mere shareholder approval.<sup>5</sup> Even before the current financial crisis, some analysts began to study the newer generation of executives of publicly-held companies and believed these executives

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> Christopher Keller and Michael Stocker, *Executive Compensation’s Role in the Financial Crisis*, CORPORATE COUNSEL (Nov. 18, 2008), <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202426091714>.

<sup>3</sup> Joe Masterson, *Dodd-Frank Act ‘Could be a Home Run’*, BIZTIMES (Sep. 3, 2010), <http://www.biztimes.com/news/2010/9/3/dodd-frank-act-could-be-a-home-run>.

<sup>4</sup> Keller & Stocker, *supra* note 2.

<sup>5</sup> *Id.*



were gambling long-term stability in favor of achieving short-term financial goals.<sup>6</sup> Some analysts believe this focus on short-term goals was driven primarily by compensation packages that awarded executives with excessive bonuses for meeting short-term and low-aspiring targets.<sup>7</sup> In 2007 and early 2008, it appeared that there was a growing disconnect between performance-based compensation and the actual value added to the corporation by many executives.<sup>8</sup> Bonuses in 2007 increased approximately ten percent while the companies analyzed lost more than \$200 billion in shareholder value.<sup>9</sup>

As the market began to trend downward, efforts were put in place to increase regulation but the steps were incremental and, at first, not very effective.<sup>10</sup> One of the first major changes was a Securities and Exchange Commission regulation that required public companies to disclose the compensation packages of their top-level executives.<sup>11</sup> While compliance with this new regulation was limited, it was the first round of company failures and the subsequent government bailouts that set the stage for the Dodd-Frank Act regulations.<sup>12</sup> Following public outrage at the bonuses paid to executives at American International Group and other bailout money recipients, the U.S. Treasury Department implemented the “Interim Final Rule.”<sup>13</sup> The rule significantly restricted the compensation that could be paid to recipients of money from the government’s Troubled Asset Relief Program (“TARP”).<sup>14</sup> The new regulation limited or prohibited most bonuses and other equity incentive rewards for top executives and other key employees in an attempt to deter the same type of short-term focus that caused many of these companies to gamble on risky assets in the first place.<sup>15</sup> This “Interim Final Rule” contained versions of many of the regulations that were

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<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> Contributors from the Executive Compensation Emerging Issues Task Force, *The Economic Crisis: Broader Executive Compensation Reforms Coming Soon*, K&L GATES LLP (July, 2009), <http://www.klgates.com/newsstand/detail.aspx?publication=5777>.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

incorporated into the Dodd-Frank Act, yet the rule only applied to companies receiving TARP money.<sup>16</sup> Following the implementation of this rule and the increase in scrutiny of executive compensation from both public shareholders and the government, it became clear that executive compensation regulation was a key issue that would need to be included in any future reform measures.<sup>17</sup>

### **C. Key Changes to Executive Compensation in Dodd-Frank**

The major provisions on executive compensation in the Dodd-Frank Act fall into three general categories: (1) shareholder input on compensation; (2) additional disclosures to the public; and (3) checks and balances on pay.<sup>18</sup>

#### **1. Shareholder Input**

Perhaps the most publicized of the compensation provisions are the “Say on Pay” and “Say on Golden Parachutes” provisions.<sup>19</sup> Regarding the “Say on Pay” provision, the Act will require that public companies hold a non-binding shareholder vote on the compensation of their named executives at least once every three years.<sup>20</sup> In addition, these companies must hold a non-binding vote at least once every six years to determine if the vote on compensation will take place every one, two, or three years.<sup>21</sup> Both of these votes must be included in the company’s first proxy statement occurring on or after January 22, 2011.<sup>22</sup>

Similar to the “Say on Pay” provision is a regulation granting shareholders a “Say on Golden Parachutes,” which requires a non-

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 §§951-57, 124 Stat. 1376 (2010).

<sup>19</sup> *Id.* at §951.

<sup>20</sup> *Dodd-Frank Act: Executive Compensation and Corporate Governance Provisions*, CHADBOURNE & PARKE LLP (Aug. 12, 2010), <http://www.chadbourne.com/files/Publication/378ecd84-5e42-48ca-8192-83741f05f35c/Presentation/PublicationAttachment/4cbcf580-82ad-4554-8a8e-99ea0560c05a/Corporate%20--%20DoddFrank%20CA%20-%20Aug%202010.pdf> [hereinafter *Chadbourne*].

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

binding shareholder vote on “golden parachute” compensation whenever the shareholders are asked to approve a merger, sale, or acquisition.<sup>23</sup> A “golden parachute” is a large payment that an executive is due to receive when their employment is terminated.<sup>24</sup> Additionally, this provision requires that persons soliciting proxies must provide clear disclosure of all arrangements and understandings with any named executive officers that provide for compensation based on the merger, sale, or acquisition and the total amount to be paid to those executives.<sup>25</sup> Upon receiving this information, shareholders will be able to enter a non-binding vote on any of these “golden parachute” payments that have not already been subject to the normal “Say on Pay” shareholder votes at previous meetings.<sup>26</sup>

One notable point on the shareholder input votes is that they are non-binding with regard to the board’s decisions.<sup>27</sup> This means that a “negative vote cannot overrule any company or board decision, change or create any fiduciary duties for the company or board members or limit shareholders’ ability to submit executive compensation proposals for inclusion in the company’s proxy materials.”<sup>28</sup> It is expected that despite their non-binding nature, these shareholder votes will be given considerable weight by public company boards and compensation committees when choosing how best to implement and respond to them.<sup>29</sup> This is due to other changes in corporate governance regulation in the Act that will make it easier for shareholders to nominate new directors to replace those who do not comply with shareholders’ suggestions.<sup>30</sup>

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<sup>23</sup> Amy C. Seidel, *The Dodd-Frank Act: Executive Compensation*, FAEGRE & BENSON LLP (July 15, 2010), <http://www.faegre.com/showarticle.aspx?Show=11703>.

<sup>24</sup> Joseph Alley, Jr., Terrell E. Gilbert, Jr. and Robert F. Dow, *Executive Comp and Governance Provisions of Dodd-Frank Act*, BUSINESS ETHICS (July 22, 2010), <http://business-ethics.com/2010/07/22/1640-executive-compensation-and-corporate-governance-provisions-of-the-dodd-frank-act/>.

<sup>25</sup> Seidel, *supra* note 23.

<sup>26</sup> *Id.*

<sup>27</sup> *Chadbourne*, *supra* note 20.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *See generally id.*

## 2. Increased Disclosures

Another major issue sought to be resolved via provisions in the Act is the imbalance of information that exists between the executives and board members of a corporation on the one hand and its shareholders on the other. As such, the Act includes a few provisions designed to require additional disclosures to be released to shareholders, mainly focused on executive compensation and competing incentives.<sup>31</sup> In order for shareholders to have an understanding of the executive's value, the Act now requires that companies disclose the relationship between executive compensation actually paid and the company's financial performance, including any change in value to the company's shares and any distributions or dividends.<sup>32</sup>

Additionally, companies will have to disclose information that provides a frame of reference for the executives' compensation, including the median annual total compensation for all employees not including the CEO, the CEO's annual total compensation and the ratio of the one to the other.<sup>33</sup> The disclosure provisions also allow shareholders to examine the incentives for executives that are tied to share price.<sup>34</sup> Specifically, a company must disclose in its proxy statements whether any employee or director is permitted to purchase financial instruments that are designed to hedge against any decrease in the equity value of securities granted as compensation to the director or employee.<sup>35</sup> These provisions are designed to increase transparency and provide shareholders with more information with which to make informed decisions when utilizing their newly minted rights via the non-binding votes.

## 3. Checks and Balances

The final changes implemented by the Act are designed to ensure the integrity and accuracy of executive compensation by establishing new standards for compensation committee independence, as well as a "Clawback" provision to ensure no excess

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<sup>31</sup> Alley, Jr. et. al., *supra* note 24.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

payment is made based on falsely reported data.<sup>36</sup> In an attempt to eliminate biased recommendations by a corporation's compensation committee, the Act requires the securities exchanges to establish standards requiring the committee's directors to satisfy heightened independence standards in order to maintain the company's listing on the exchange.<sup>37</sup> These standards will include examining the sources of a director's compensation, any fees for consulting or advising they may obtain from the company and whether they are affiliated with any subsidiary or other affiliates of the company.<sup>38</sup> Only after meeting these standards will a director be considered independent and allowed to serve on the compensation committee, to which the Act grants sole discretion over the hiring of consultants or other advisors on the issue of compensation.<sup>39</sup>

While the new rules on independence for committee members helps legitimize the compensation process at the early stages, the new "Clawback" provision is designed to ensure no over-compensation occurs when it is time to pay out to these executives.<sup>40</sup> This "Clawback" rule requires companies to maintain policies providing for the recovery of incentive compensation paid to current or former executives.<sup>41</sup> The "Clawback" is triggered in the event of "an accounting restatement due to material noncompliance with financial reporting requirements for the three-year period preceding the date of the restatement" allowing the recovery of any excess bonuses paid.<sup>42</sup>

#### **D. Potential Implications of Dodd-Frank Compensation Reform**

While there are a wide variety of beliefs as to how these new regulations will affect the corporate world moving forward, one thing is clear: the changes will have a serious impact on how shareholders, executives and corporations interact. Much has been made of how

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<sup>36</sup> *Alert – What You Need to Know About the Dodd-Frank Act*, BRIGGS & MORGAN (Aug. 6, 2010), <http://www.briggs.com/what-you-need-to-know-about-the-dodd-frank-act-08-06-2010/>.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *See generally id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

these regulations developed to fix issues with incentives, which were causing executives to focus primarily on short-term goals at the expense of long-term stability. However, it is unclear whether these regulations will help correct this problem or exaggerate it. Those who fear the Dodd-Frank provisions will have the opposite effect than originally intended argue that because the “Say on Pay” provisions require management’s performance to be tested periodically with shareholder votes, CEOs “will be focused relentlessly on producing short-term results to avoid the substantial potential consequences from a no-confidence vote by shareholders.”<sup>43</sup> This could create the unintended consequence of narrowing the focus of executives further instead of encouraging a more forward-looking approach to management.<sup>44</sup>

Beyond creating the desire to keep shareholders satisfied on a short-term basis, the new system will also vastly increase the power of large institutional investors such as hedge funds.<sup>45</sup> These funds can use their large voting blocks to put pressure on executives and directors to amend their corporate strategies through the threat of disapproval of compensation packages or the exercise of new corporate governance rights.<sup>46</sup> Other groups likely to gain influence from the new regulations are proxy advisory firms, whose approval of a given pay package will likely have a strong influence on the uninformed shareholders and institutional investors who may lack the expertise to personally evaluate an executive compensation package.<sup>47</sup>

This shift in power will likely be accompanied by a shift in standards. For one thing, a more homogenized executive pay structure across companies could emerge, as corporate boards may try to tailor their executive pay packages to meet advisory firm standards in an effort to avoid negative votes.<sup>48</sup> As more companies

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<sup>43</sup> Lyle G. Ganske, Robert A. Profusek & Lizanne Thomas, *Reform Brings a Renewed Focus on Short-Term Results*, FORTUNE (July 29, 2010), [http://money.cnn.com/2010/07/29/news/financial\\_reform\\_short\\_term.fortune/index.htm](http://money.cnn.com/2010/07/29/news/financial_reform_short_term.fortune/index.htm)

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> Ronald D. Orol, *Dodd-Frank's 'Say on Pay' Could Impact Executive Pay*, MARKETWATCH (Aug. 26, 2010), <http://www.marketwatch.com/story/new-say-on-pay-law-could-temper-ceo-pay-2010-08-26>.

<sup>48</sup> *Id.*

go through the approval process, a general framework of acceptable pay packages will likely develop, potentially driving directors to utilize these generally approved standards instead of tailoring a pay package more to the needs of their executives.<sup>49</sup> Others disagree; Professor Lucian Bebchuck believes shareholders will understand that compensation packages should differ based on the needs and expectations of an individual firm.<sup>50</sup> Yet even he believes that some pay practices will be eliminated entirely due to the new regulations, as they are so distasteful to shareholders as to warrant universal disapproval.<sup>51</sup> An example is a massive “golden parachute” payment to a director who will be retained as a top executive by an acquiring firm during a merger.<sup>52</sup> This potential benefit for public shareholders could create issues within the organization and opportunity costs that did not exist prior to the new regulations; some candidates may be cast aside as they are only attracted by more tailored packages or larger “golden parachutes” for job security.<sup>53</sup>

There are also those who believe that increased shareholder powers and required disclosures by corporations will send a message to directors that they will be accountable to shareholders like never before.<sup>54</sup> This increase in scrutiny could lead public companies and their directors to be more careful and diligent in establishing their corporate governance and compensation packages and in explaining these packages to the public, hopefully leading to greater confidence in the shareholders and a long-term improvement in financial performance.<sup>55</sup> Despite the many predictions touting potential benefits to shareholders and possible detriments to corporate operations that the Act’s provisions could bring about, it will not be until their implementation over the coming months and years that the lasting effects on our financial system can be measured.

### **E. Conclusion**

The executive compensation provisions of the Dodd-Frank Act were included to address what many regulators and analysts

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<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> Masterson, *supra* note 3.

<sup>55</sup> *Id.*

believed to be a significant factor in causing the 2008 financial crisis.<sup>56</sup> The goals of the new regulations are to increase executive accountability to shareholders and close the gap between executive compensation and actual company performance.<sup>57</sup> The changes enacted include required non-binding shareholder votes on executive compensation and golden parachutes, additional disclosures on compensation to the public and increased oversight on compensation to ensure it is unbiased and accurate.<sup>58</sup> Supporters of the Act believe that the increased accountability to shareholders will cause companies to be more careful in their establishment of compensation and that directors will give a greater focus to long-term improvements in financial performance.<sup>59</sup> In contrast, critics of the executive compensation provisions view the new shareholder votes as an incentive to focus exclusively on short-term performance in order to satisfy the scrutiny of the newly empowered shareholders.<sup>60</sup> Both sides agree that the Act will cause significant changes in the compensation packages for most executives, though debate remains whether pay will become homogenized across companies or adapt to the specific needs of each individual company.<sup>61</sup> While most of the predictions about the effects of the Act are mere speculation at this point, the results will become clearer when the Act takes effect in early 2011.

Andrew Dunning<sup>62</sup>

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<sup>56</sup> Keller & Stocker, *supra* note 2.

<sup>57</sup> Masterson, *supra* note 3.

<sup>58</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 18.

<sup>59</sup> Masterson, *supra* note 3.

<sup>60</sup> G. Ganske et. al., *supra* note 43.

<sup>61</sup> Orol, *supra* note 47.

<sup>62</sup> Student, Boston University School of Law (J.D. 2012).



**IX. *Too-Big-To-Fail and the Financial Stability Oversight Council***

**A. Introduction**

The 2008 financial crisis exposed the U.S. financial system's vulnerability to "systemic risk," the danger that the dissolution of a financial company will produce negative macro—economic effects. The crisis was unique among financial disasters because "nonbank financial companies"—securities firms and other investment banks—produced much of the systemic risk.<sup>1</sup> Politicians feared that the failure of certain large and interconnected nonbank financial companies would bankrupt its creditors and counterparties. To preserve the stability of the financial system, the federal government "bailed out" several companies that were regarded as too-big-to-fail.<sup>2</sup> Multi-billion dollar loans<sup>3</sup> and coerced acquisitions<sup>4</sup> epitomized this trend and the public outcry reached a fever pitch after Congress established the Troubled Asset Relief Program, committing \$700 billion toward future bailouts.<sup>5</sup>

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act seeks to reduce systemic risk by establishing the Financial

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<sup>1</sup> See Alison M. Hashmall, Note, *After the Fall: A New Framework to Regulate "Too Big to Fail" Non-Bank Financial Institutions*, 85 N.Y.U. L. REV. 829, 836 (2010) ("The failure of "non-bank" financial institutions, such as hedge funds and investment banks, can also pose serious systemic risk to the financial system.").

<sup>2</sup> See e.g. *id.* at 837-38 (stating that the J.P. Morgan's acquisition of Bear Stearns "effectively protected Bear Stearns's creditors and counterparties from losses they would have otherwise incurred in bankruptcy, which helped mitigate systemic risk.").

<sup>3</sup> See e.g. Matthew Karnitschnig et al., *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, at A1 (describing the Federal Reserve's loan of \$85 billion to American International Group).

<sup>4</sup> See e.g. Louise Story & Jo Becker, *Bank Chief Says U.S. Pushed Merrill Deal*, N.Y. TIMES, June 12, 2009, at B1 (describing the congressional testimony of Ken Lewis, the former CEO of Bank of America, in which he "maintained that federal officials pressured him to keep the merger alive, and acknowledged that his job [would be] at risk if he did not").

<sup>5</sup> See generally David M. Herszenhorn, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1.

Stability Oversight Council (“FSOC” or “the Council”). Critics of the FSOC argue that the Council will simply perpetuate the use of bailouts, however.<sup>6</sup> This article challenges this criticism by proposing that the FSOC will actually decrease the reliance on bailouts by reducing uncertainty, repudiating too-big-to-fail and removing incentives for unstable growth.

### **B. The Financial Stability Oversight Council**

The Dodd-Frank Act authorizes the FSOC to oversee financial stability and subject particularly risky companies to supervision by the Federal Reserve. The FSOC’s oversight role is explicit in the Council’s stated purposes, which include “identify[ing] risks to the financial stability of the United States” and “respond[ing] to emerging threats to the stability of the United States financial system.”<sup>7</sup> Notably, the FSOC also should “promote market discipline, by eliminating expectations on the part of shareholders, creditors and counterparties of [financial] companies that the Government will shield them from losses in the event of failure.”<sup>8</sup> The FSOC’s duties also evoke supervisory responsibilities, including “monitor[ing] the financial services marketplace,” “recommend[ing] . . . supervisory priorities and principles,” and “identify[ing] gaps in regulation.”<sup>9</sup>

Most significantly, the FSOC can subject a nonbank financial company to supervision by the Federal Reserve.<sup>10</sup> Federal Reserve supervision is appropriate if two-thirds of the FSOC, including its chairperson, determine that the company poses a risk to financial stability.<sup>11</sup> To analyze systemic risk, the FSOC will consider, *inter alia*, the company’s liabilities, assets, off-balance sheet exposure and any other “risk-related factors.”<sup>12</sup>

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<sup>6</sup> See Peter J. Wallison, *The Dodd-Frank Act: Creative Destruction, Destroyed*, A.E.I. FINANCIAL SERVICES OUTLOOK (July-Aug. 2010), 3, available at <http://www.aei.org/outlook/100983> (“The real danger is that the Fed will implement ‘too big to fail’ privately, outside public view, through its new powers under the [Dodd-Frank Act].”).

<sup>7</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 112, 12 U.S.C.A. § 5322 (2010).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* § 5323

<sup>12</sup> *Id.*

The Federal Reserve must apply stricter supervision than normally applied to nonbank financial companies.<sup>13</sup> Additionally, the Federal Reserve's supervision must "increase in stringency" if a company becomes more risky.<sup>14</sup> This supervision can include regulation authored by the Federal Reserve or recommended by the FSOC.<sup>15</sup> The Federal Reserve may impose limits on risk-based capital, leverage, liquidity, concentration of assets, contingent capital, short-term debt and "overall risk."<sup>16</sup> Upon a two-thirds vote from the FSOC, the Federal Reserve may restrict a nonbank financial company's ability to engage in mergers, acquisitions or financial activities.<sup>17</sup> Finally, if these restrictions are insufficient, the Federal Reserve may force the company to sell assets or terminate activities.<sup>18</sup>

A key component of the Federal Reserve's supervision is the ability to conduct stress tests,<sup>19</sup> and require resolution<sup>20</sup> and early remediation plans.<sup>21</sup> The FSOC also may require regulatory agencies with representation on the FSOC and the Office of Financial Research to submit data regarding systemic risk.<sup>22</sup>

### C. The Too-Big-to-Fail Problem

Whether a company is bailed out hinges on the level of uncertainty surrounding the company's dissolution.<sup>23</sup> A company may be too-big-to-fail if the company holds significant assets, and if the company's bankruptcy would severely impact its counterparties and pose a significant administrative burden.<sup>24</sup> Predicting the macro-

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<sup>13</sup> *Id.* § 5365

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* § 5330

<sup>16</sup> *Id.* § 5325.

<sup>17</sup> *Id.* § 5331.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* § 5365.

<sup>20</sup> *Id.* § 5325.

<sup>21</sup> *Id.* § 5366.

<sup>22</sup> *Id.* § 5322.

<sup>23</sup> See GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 111 (2004) (arguing that the inability to predict the impact of a large bank's dissolution is the "primary motivation for bailouts").

<sup>24</sup> See Ann Graham, *Bringing to Heel the Elephants in the Economy: The Case for Ending "Too Big To Fail"*, 8 PIERCE L. REV. 117, 122 (2009)

economic effects of such a large, interconnected and complex financial company's dissolution is virtually impossible. Because of the great *potential* damage that a bankruptcy could cause, the government adopts the more risk-averse strategy of a bailout:

The underlying reality . . . is that the imminent failure of a large institution, whether in the banking sector of the economy or in some other sector, presents the government with great uncertainties. The possible impacts on economic activity in general, on employment, on related and not-so-related industries are of such magnitudes as to make nonaction by government authorities a difficult course to follow. Hardships are threatened, and governments are in the business of mitigating hardships.<sup>25</sup>

Bailouts can therefore be understood as a product of market uncertainty. Faced with potential widespread economic failure, the government will adopt a low-risk, albeit politically unpopular, strategy of rescuing the distressed company.

Too-big-to-fail poses significant problems, however. When applied consistently, bailouts create moral hazard problems. Moral hazard exists when a company interprets the government's willingness to prevent its bankruptcy as an implicit government guarantee. The company then will assume greater risk because it expects the government to bear the costs of the company's activities.<sup>26</sup> However, the application of too-big-to-fail during the 2008 financial crisis was inconsistent. The government's \$85 billion loan to American International Group, just days after allowing

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("Size is not the sole criterion for TBTF. The institutions marked for government bailout to prevent failure are described as 'too big to liquidate' and 'too interconnected to fail.'").

<sup>25</sup> DAVID S. HOLLAND, WHEN REGULATION WAS TOO SUCCESSFUL – THE SIXTH DECADE OF DEPOSIT INSURANCE 47 (1998); *see also* William K. Sjostrom, Jr., *The A.I.G. Bailout*, 66 WASH. & LEE L. REV. 943, 979 (2009) ("The bottom line is that nobody knew for certain the scope of damage that would result from an AIG bankruptcy. Because of AIG's size and interconnectedness, and the fact that financial markets were already under serious distress, it was feared that AIG's failure would lead to the collapse of the entire financial system. The federal government was unwilling to take this risk and, therefore, bailed out AIG.").

<sup>26</sup> Hashmall, *supra* note 1, at 832.

Lehman Brothers Holding Inc. to file the largest bankruptcy in U.S. history, exemplifies this trend.<sup>27</sup> The seemingly arbitrary use of bailouts highlights the lack of a bright-line rule to determine which companies are too-big-to-fail.<sup>28</sup> The resulting uncertainty chills market participants and imposes significant economic costs.<sup>29</sup> Consequently, bailouts have the perverse effect of creating more systemic risk, an irony that is wholly incompatible with financial reform.

#### **D. Enhanced Supervision and Too-Big-to-Fail**

The FSOC may be the Dodd-Frank Act's most divisive contribution. A central criticism is that the FSOC's authority to require Federal Reserve supervision will facilitate bailouts.<sup>30</sup> These critics argue that the responsibility to supervise risky financial companies will instill in the Federal Reserve a vested interest in a financial company's wellbeing.<sup>31</sup> The Federal Reserve therefore is more likely to bailout companies through unfavorable acquisitions and federal loans, instead of suffering embarrassment from a supervised company's bankruptcy.<sup>32</sup> Predictably, the government

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<sup>27</sup> Karnitschnig et al., *supra* note 3.

<sup>28</sup> See Vern McKinley & Gary Gegenheimer, CATO INST., POLICY ANALYSIS NO. 637, BRIGHT LINES AND BAILOUTS: TO BAIL OR NOT TO BAIL, THAT IS THE QUESTION 1 (Advance copy, 2009) (stating that "the bailouts over the past year do not reflect a well-defined, transparent, and verifiable policy justification.").

<sup>29</sup> See *id.* at 24 (suggesting that arbitrary bailouts "froze" the economy) (quoting AMITY SHLAES, THE FORGOTTEN MAN: A NEW HISTORY OF THE GREAT DEPRESSION 9 (2007)); Hashmall, *supra* note 1, at 832 ("[A] policy of constructive ambiguity . . . reduces the problem of moral hazard, but at the cost of creating uncertainty and panic, which can exacerbate systemic risk.").

<sup>30</sup> See Wallison, *supra* note 6, at 3 (arguing that the Federal Reserve will "implement 'too big to fail' privately, outside public view").

<sup>31</sup> See Chester S. Spatt, *Regulatory Conflict: Market Integrity vs. Financial Stability*, 71 U. PITT. L. REV. 625, 632 (2010) (arguing that systemic regulators will have a vested interest in the outcome of its activities).

<sup>32</sup> Wallison, *supra* note 6, at 3; see also Spatt, *supra* note 31, at 632 (arguing that the vested interests of systemic regulators will cause the regulators to coerce unwise corporate transactions to preserve systemically risky companies).

rejects this criticism.<sup>33</sup> The question therefore is whether the FSOC will be an effective alternative to too-big-to-fail.

As previously discussed, the reliance on too-big-to-fail is the product of the inability to accurately predict and quickly respond to financial instability in large, interconnected and complex financial companies. By enacting regulation to address the causes of this reliance, the government can establish policies that are less likely to create moral hazard and market uncertainty. Professor Ann Graham of Texas Tech University School of Law has suggested three methods.<sup>34</sup> First, the government should establish regulation that seeks to minimize uncertainty by providing for systemic risk oversight and rapid response plans in the event of financial instability.<sup>35</sup> Second, the government must issue a clear statement that it will not bail out any financial companies.<sup>36</sup> Third, the government should enact regulation that discourages financial interconnectedness and growth.<sup>37</sup> Each of these strategies is present in the Dodd-Frank Act, suggesting that the Act addresses the underlying causes of too-big-to-fail.

### 1. Reducing Uncertainty

The Federal Reserve's ability to require stress tests, early remediation plans and living wills, along with the FSOC's authority to gather financial data, reduces uncertainty and facilitates rapid responses to financial crises. These measures are effective for two reasons. First, the stress tests, remediation plans and living wills enable the Federal Reserve to detect systemic risk before it causes

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<sup>33</sup> See e.g. Donna Borak, *FCIC: Will Dodd-Frank Stop Future Bailouts?*, AM. BANKER, Sept. 3, 2010, at 1 (quoting Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, stating that "bailouts are just not acceptable going forward").

<sup>34</sup> Graham, *supra* note 24.

<sup>35</sup> *Id.* at 141 ("We must restructure our regulatory framework to add an independent entity charged with macro-prudential oversight, which means keeping an eye on the big picture and having the tools to identify and contain systemic risk *before* an uncontrollable economic result swamps global financial systems again.").

<sup>36</sup> See *Id.* at 151 (arguing that the government should make a "clear, emphatic, and unequivocal statement" against too big to fail).

<sup>37</sup> See *Id.* at 134 (suggesting that previous legislation was ineffective because it failed "to address economic incentives for financial institution growth and interconnectedness").

financial instability.<sup>38</sup> The FSOC's evaluation of financial data fulfills a similar predictive function.<sup>39</sup> This combination of Federal Reserve supervision and FSOC analysis will enable the government to predict the impact of a too-big-to-fail company's dissolution. Second, by establishing a centralized overseer in the FSOC, the government closes regulatory gaps and prevents financial companies from circumventing regulation and creating unexpected risk.<sup>40</sup> The FSOC therefore limits uncertainty by establishing a regulatory framework that includes an *ex ante* analytical function that predicts systemic risk prior to its realization.

## 2. Rejecting Too-Big-to-Fail

A clear repudiation of too-big-to-fail increases market certainty and reduces moral hazard by reducing expectations that the government will bailout certain companies.<sup>41</sup> The Dodd-Frank Act rejects bailouts by describing the FSOC's purpose as the "promot[ion of] market discipline, by eliminating expectations on the part of shareholders, creditors and counterparties of [financial] companies that the Government will shield them from losses in the event of failure."<sup>42</sup> Additionally, government representatives have stated that the FSOC will not use bailouts.<sup>43</sup> Admittedly, the veracity of such statements will be uncertain until the government actively rejects too-big-to-fail. However, in lieu of such action, the Dodd-Frank Act and corresponding government statements have communicated a strong message rejecting the use of bailouts. If the government

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<sup>38</sup> See STERN & FELDMAN, *supra* note 23, at 113 ("Because stress testing and scenario planning can reduce supervisors' uncertainty about the riskiness of banks and banking sectors, they should play a role in the management of too big to fail. . . . Simulations also should help supervisors to take steps now to make such resolutions less likely in the first place.").

<sup>39</sup> See *supra* Part II (referencing the purposes and duties of the FSOC).

<sup>40</sup> See Sewell Chan et al., *Reform Bill Adds Layers of Oversight*, N.Y. TIMES, Mar. 16, 2010, at B1 (observing that, prior to Dodd-Frank, regulatory responsibilities were divided among multiple regulators, creating gaps in regulation and preventing consistent, cohesive action).

<sup>41</sup> Graham, *supra* at note 24, at 151.

<sup>42</sup> 12 U.S.C.A. § 5322.

<sup>43</sup> See e.g. Borak, *supra* note 33, at 1 (quoting Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, and Ben Bernanke, the Chairman of the Federal Reserve, rejecting the future use of bailouts).

continues to convey this message, it will take a step toward increasing market certainty and reducing the risk of moral hazard.

### 3. Encouraging “Small Enough to Fail”

The Federal Reserve’s enhanced supervision will counteract incentives that encourage nonbank financial companies to become too-big-to-fail. Although the size, complexity and interconnectedness of some companies are attributable to natural business growth, many companies reach too-big-to-fail status due to less benign factors. In particular, too-big-to-fail companies pay lower interest rates because the companies have an implied government guarantee, resulting in the functional equivalent of a taxpayer “subsidy” worth billions of dollars.<sup>44</sup> Meanwhile, these companies do not bear a proportionate share of the costs that they impose on the financial system.<sup>45</sup> The government can counteract the incentive to become too-big-to-fail by enacting regulation that forces companies to internalize the costs of systemic risk.<sup>46</sup> The Federal Reserve’s “stringent” supervision imposes a heavy burden on too-big-to-fail companies: in addition to liquidity, credit, debt, leverage and off-balance sheet limits, the Federal Reserve can prohibit activities and transactions outright.<sup>47</sup> This authority forces too-big-to-fail companies to comply with costly regulation, thereby counteracting incentives to become too-big-to-fail. Consequently, Federal Reserve supervision will discourage too-big-to-fail growth, which creates the uncertainty at the root of bailouts.

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<sup>44</sup> See Graham, *supra* note 24, at 145 (“[I]t is inarguable that becoming one of the protected TBTF entities results in substantially lower costs of funds. Smaller banks are charged a higher interest rate when they borrow funds because they lack the TBTF implicit federal government guarantee . . . .”; see also Gretchen Morgenson, *The Cost of Saving These Whales*, N.Y. TIMES, Oct. 4, 2009, at BU1 (referring to a study by the Center for Economic and Policy Research that found that the total annual subsidy of all too-big-to-fail banks was \$34.1 billion).

<sup>45</sup> See Hashmall, *supra* note 1, at 839 (explaining that the collapse of Lehman Brothers illustrated the external costs caused by the failure of a too-big-to-fail nonbank financial company).

<sup>46</sup> See *Id.* at 855 (arguing that forcing too-big-to-fail companies to internalize costs is one of the strengths of the Obama administration’s proposal for financial regulation).

<sup>47</sup> 12 U.S.C.A. §§ 5325, 5331.



### E. Conclusion

This article contends that the establishment of the FSOC eliminates the underlying catalysts of too-big-to-fail and thereby establishes a preferable form of systemic risk regulation. The criticism that the FSOC will facilitate too-big-to-fail policies therefore appears flawed.

Admittedly, certain sections of the Dodd-Frank Act appear to permit bailouts. In particular, the Act authorizes the use of Federal Deposit Insurance Corporation funds to make loans and purchase the debt obligations of companies that pose a risk to financial stability.<sup>48</sup> However, the predictive function of the FSOC is likely to minimize these bailouts. The ability to foresee systemic risk will reduce uncertainty and facilitate *ex ante* regulation, thereby allowing the government to avoid politically unpopular bailouts.

During the 2008 financial crisis, the government relied on bailouts due to its inability to accurately predict the macro-economic consequences of a large financial company's dissolution. The FSOC eliminates this uncertainty by analyzing the systemic risk of nonbank financial companies, reducing the expectation that certain companies will receive bailouts and counteracting incentives for unstable growth. The absence of this uncertainty will allow the government to reduce its reliance on bailouts. Indeed, if the FSOC is any indication, the days of bailouts may be numbered.

Emerich Gutter<sup>49</sup>

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<sup>48</sup> See *Id.* § 5384 (“[T]he [Federal Deposit Insurance Corporation] may make available . . . funds for the orderly liquidation of the covered financial company.”).

<sup>49</sup> Student, Boston University School of Law (J.D. 2012).

## X. *Credit Rating Agency Independence*

### A. Introduction

Credit ratings agencies (“agencies”) seek to give honest and fair opinions “through a “rigorous and objective review of the facts, free from bias.”<sup>1</sup> This is a noble goal. After all, investors, borrowers and regulatory agencies all rely on credit ratings as being accurate assessments of the companies and securities with which they deal.<sup>2</sup> Yet one aspect of the industry’s business model has sparked ongoing controversy: the agencies are paid by the entities whose securities they rate.<sup>3</sup> This facet of the ratings industry has been analogized to a legal system in which a judge’s salary is provided for by one of the parties.<sup>4</sup> Thus, an agency may be torn between serving investors, who rely on accurate ratings in making informed decisions, and serving the rated entities, which influence agency profit and market-share with their business.<sup>5</sup>

Agencies registered with the SEC are known as Nationally Recognized Statistical Rating Organizations (“NRSROs”).<sup>6</sup> There are currently ten registered NRSROs, but three firms dominate the industry: Moody’s Investor Services, Standard and Poor’s (“S&P”) and Fitch Ratings.<sup>7</sup> Recently, the Financial Crisis Inquiry Commission cited reliance on these agencies as a prime contributor to the recent financial crisis.<sup>8</sup> Evidence reveals pressure to retain market share and increase profits, which may have promoted

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<sup>1</sup> Who We Are, MOODY’S CORP., <http://files.shareholder.com/downloads/MOOD/1067585332x0x393522/00ea05d1-970e-4352-9825-31405472cc03/Mission-Values.pdf> (last visited Nov. 11, 2010).

<sup>2</sup> *Times Topics: Credit Rating Agencies*, N.Y. TIMES, [http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit\\_rating\\_agencies/](http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_rating_agencies/) (last updated Jun. 3, 2010).

<sup>3</sup> *Id.*

<sup>4</sup> *Ratings Agencies Face Glare of Meltdown Probe*, CBSNEWS, Apr. 23, 2010, <http://cbsnews.com/stories/2010/04/23/business/main6425009.shtml> [hereinafter *Meltdown Probe*].

<sup>5</sup> *Times Topics*, *supra* note 2.

<sup>6</sup> *Credit Rating Agencies – NRSROs*, U.S. SECURITIES AND EXCHANGE COMM’N, <http://www.sec.gov/answers/nrsro.htm> (last modified Sep. 25, 2008) [hereinafter *NRSROs*].

<sup>7</sup> *Times Topics*, *supra* note 2.

<sup>8</sup> FIN. CRISIS INQUIRY COMM’N, ABOUT THE COMMISSION, <http://www.fcic.gov/about/> (last visited Nov. 11, 2010).

inaccurate ratings for issuers and banks that sometimes shopped around for the best rating.<sup>9</sup> Congress now attempts to alleviate the alleged potential conflict of interest and promote agency independence through the Dodd-Frank Act (“the Act”).<sup>10</sup> Whether the Act’s effort will be a success or failure is not entirely known.

### **B. Credit Rating Agencies and the Credit Crisis**

From 2002 to 2007 Wall Street underwrote an estimated \$3.2 trillion of subprime mortgages, which were pooled into collateralized debt obligations (“CDOs”) that received high ratings.<sup>11</sup> The ratings on these structured financial products turned out to be inaccurate, resulting in catastrophe for the American and global economy.<sup>12</sup> By late 2008, over three quarters of the AAA-rated CDOs issued in 2006 and 2007 had been downgraded.<sup>13</sup> The flawed ratings fueled the collapse of Bear Stearns, Lehman Brothers and Merrill Lynch, which wrote-down \$523.3 billion in assets initially given high ratings.<sup>14</sup> Today, asset-backed securities remain frozen due to dissipated investor confidence; a total of \$1.8 trillion in write-downs worldwide is the result.<sup>15</sup>

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<sup>9</sup> Blake Ellis, *How Credit Watchdogs Fueled the Financial Crisis*, CNNMONEY.COM, April 24, 2010, [http://www.money.cnn.com/2010/04/23/news/economy/credit\\_rating\\_agencies\\_hearing/](http://www.money.cnn.com/2010/04/23/news/economy/credit_rating_agencies_hearing/).

<sup>10</sup> H.R. REP. NO. 111-517, at Sec. 931(4) (2010).

<sup>11</sup> Kathleen Casey and Frank Partnoy, *Downgrade the Ratings Agencies*, N.Y. TIMES, Jun. 6, 2010, at WK11, available at <http://www.nytimes.com/2010/06/06/opinion/06partnoy.html>.

<sup>12</sup> H.R. REP. NO. 111-517, at Sec. 931(5).

<sup>13</sup> Elliot Blair Smith, ‘Race to Bottom’ at Moody’s, S&P Secured Subprime’s Boom, Bust, BLOOMBERG, Sep. 25, 2008, [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya\\_Vtdo](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya_Vtdo) (stating that Moody’s lowered grades for 90 percent of all asset-backed CDO investments issued in 2006 and 2007, including 85 percent of CDOs previously rated AAA, and S&P followed suit, downgrading 84 percent of the CDOs it rated, including 76 percent of CDOs previously rated AAA).

<sup>14</sup> Elliot Blair Smith, *Bringing Down Wall Street at Ratings Let Loose Subprime Scourge*, BLOOMBERG, Sep. 24, 2008, <http://www.bloomberg.com/apps/news?pid=21070001&sid=ah839IWTLP9s> [hereinafter *Bringing Down*].

<sup>15</sup> Gretchen Morgenson, *BB? AAA? Disclosure Tells Us More*, N.Y. TIMES, Sep. 5, 2010, at BU1; Joshua Gallu, *SEC Says Dodd-Frank Law Lets Agency Chase Overseas Ratings Fraud*, BLOOMBERG, Sep. 1, 2010,

The titanic flow of capital into these toxic assets may not have occurred without the agencies' AAA stamp of approval.<sup>16</sup> The critical question then becomes: what was the cause of the inaccurate ratings? Several factors, including unprecedented market events, innovative modeling, formula transparency, increased volume and complexity of instruments and errors, can be causally linked to the unduly high ratings; however, a common denominator precedes most of these factors.<sup>17</sup> A conflict of interest, stemming from pressure to serve banks and issuers, may have induced the agencies to rate securities more favorably than they normally would.<sup>18</sup>

Because investment banks sometimes shopped around for the best grade, offering an unfavorably low rating could lead to lost business for an agency.<sup>19</sup> Furthermore, agencies could earn three times more from rating the new, complex CDOs than traditional corporate bonds.<sup>20</sup> Hence, in August of 2004 Moody's implemented a new rating methodology that allowed firms to sell more top-rated, mortgage backed securities.<sup>21</sup> One week later, with an internal email emphasizing the "threat of losing deals," S&P revised their own rating models.<sup>22</sup> The agencies' revenues increased threefold from 2002 to 2007.<sup>23</sup>

Methodology flaws and a pressure to please issuers accompanied the positive revenue gains. Employees at both S&P and Moody's discovered rating errors that overstated the quality of certain CDO securities.<sup>24</sup> Although the errors were corrected, the co-director of CDO ratings at S&P refused to tighten ratings criteria, saying: "Don't kill the golden goose."<sup>25</sup> Similarly, Moody's did not downgrade approximately \$1 billion of erroneous notes issued overseas because it might have damaged its reputation.<sup>26</sup> These responses are not surprising in light of the alleged heightened

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<http://www.bloomberg.com/news/2010-08-31/sec-says-it-declined-to-sue-moody-s-for-fraud-over-company-s-cdo-ratings.html>.

<sup>16</sup> Smith, *supra* note 13.

<sup>17</sup> *Id.*; *Times Topics*, *supra* note 2.

<sup>18</sup> Ellis, *supra* note 9.

<sup>19</sup> *Times Topics*, *supra* note 2.

<sup>20</sup> Smith, *supra* note 13.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Meltdown Probe*, *supra* note 4.

<sup>24</sup> Smith, *supra* note 13; Morgenson, *supra* note 15.

<sup>25</sup> Smith, *supra* note 13.

<sup>26</sup> Morgenson, *supra* note 15.

pressure to satisfy issuers. Employee statements and testimony portray a coercive environment and a focus on market share, rather than honest analysis.<sup>27</sup>

But some experts doubt that a potential conflict of interest materially contributed to the flawed ratings. Acknowledging that the issuer-pay business model raises eyebrows, perhaps justifiably so, why would an agency knowingly attach its reputation to faulty ratings?<sup>28</sup> After all, an agency's entire product is its reputation of accuracy and objectivity.<sup>29</sup> Risking the agency's core competency on a single security seems short-minded. Further, the reports of pressured and coercive work settings may be explained by the increased volume and complexity of securities.<sup>30</sup> The analysts were not necessarily pressured to assign ratings that favored issuers, but rather pressured to assign ratings *period* so that they could move on to the next security in line.<sup>31</sup>

### C. Dodd-Frank's Impact on Credit Rating Agencies

Recognizing the importance of accurate credit ratings, Congress declared the agencies' activities matters of public interest; hence, they justify a level of public oversight similar to that of securities analysts and auditors.<sup>32</sup> Accordingly, the Act directly addresses multiple aspects of credit rating agencies and their activities.<sup>33</sup> Changes include increased Securities and Exchange Commission ("SEC" or "Commission") oversight, liability exposure,

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<sup>27</sup> *Times Topics*, *supra* note 2 (asserting that the financial investigation commission's June hearing revealed sentiment among S&P employees that focus was on market share, rather than accurate ratings.); Ellis, *supra* note 9 (stating that a former vice president at Moody's said he felt pressured to accept deals, and his "unwillingness to say 'no' grew;" a Moody's employee felt pressure from Goldman Sachs to issue high ratings).

<sup>28</sup> Interview with William Chambers, associate professor of professional practice in administrative sciences, BOSTON UNIVERSITY, and former Managing Director, STANDARD & POOR'S, in Boston, Mass. (Nov. 10, 2010).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*; *Times Topics*, *supra* note 2.

<sup>31</sup> Interview with William Chambers, *supra* note 28.

<sup>32</sup> H.R. REP. NO. 111-517, at Sec. 931(3) (2010).

<sup>33</sup> *Id.*

removal of statutory references to credit ratings, internal control requirements and rating methodology regulations.<sup>34</sup>

Although skeptics may doubt the legitimacy of issuer influence on ratings, Congress has explicitly acknowledged a problematic conflict of interest and now seeks to alleviate the pressure to serve issuers.<sup>35</sup> Measures that provide direct ammunition for battling the problem include SEC involvement, employment regulations, public disclosure requirements and mandated studies by the Commission and the Government Accountability Office (“GAO”).<sup>36</sup> At first glance, stakeholders can expect increased time and information required to complete ratings, larger fees for rating services and a rise in the number of lawsuits against the agencies.<sup>37</sup> Proponents and opponents disagree about whether the Act helps or hurts the industry and, ultimately, investors.<sup>38</sup>

### 1. Increased SEC Oversight and Liability Exposure

The SEC is given new enforcement tools, including the ability to suspend or revoke NRSRO registration for certain classes of securities.<sup>39</sup> The Commission must establish an Office of Credit Ratings (“OCR”), which is to administer rules for the purpose of protecting investors, increasing accuracy and reducing conflicts of interest.<sup>40</sup> In addition to determining penalties for violations, the

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<sup>34</sup> *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact on Credit Rating Agencies*, PRICEWATERHOUSECOOPERS, LLP, Sep., 2010, <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-credit-rating-agencies.pdf> (last visited Nov. 11, 2010) [hereinafter *PWC*].

<sup>35</sup> H.R. REP. NO. 111-517, at Sec. 931(4) (2010).

<sup>36</sup> *PWC*, *supra* note 34.

<sup>37</sup> *The Dodd-Frank Act: Commentary and Insights*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, Jul. 12, 2010, at 77, available at [http://www.skadden.com/Cimages/siteFile/Skadden\\_Insights\\_Special\\_Edition\\_Dodd-Frank\\_Act1.pdf](http://www.skadden.com/Cimages/siteFile/Skadden_Insights_Special_Edition_Dodd-Frank_Act1.pdf) [hereinafter *Skadden*].

<sup>38</sup> Yuval Bar-Or, *Rating Agencies Should Get A Death Sentence*, FORBES.COM, Sep. 24, 2010, <http://www.forbes.com/2010/09/24/dodd-frank-moodys-financial-advisor-network-credit-ratings.html>.

<sup>39</sup> *PWC*, *supra* note 34, at 1.

<sup>40</sup> *Dodd-Frank Wall Street Reform and Consumer Protection Act: Credit Rating Agency Provisions*, ORRICK, HERRINGTON & SUTCLIFFE, LLP, July 16, 2010, available at <http://www.orrick.com/fileupload/2829.htm> [hereinafter *Orrick*].

OCR will conduct annual examinations of ethics policies, internal supervisory controls and management of conflicts of interest, among other inspections.<sup>41</sup>

Along with creating the OCR, the Act calls upon the SEC to mitigate conflicts of interest by establishing informational barriers and stringent filing requirements. The SEC must issue rules that prevent sales and marketing considerations from affecting an NRSRO's ratings.<sup>42</sup> The SEC is given the power to suspend or revoke registration for failed compliance.<sup>43</sup> Furthermore, rather than merely providing documents, credit ratings agencies must now "file" with the SEC, which opens the door for actions against agencies who file false or misleading information.<sup>44</sup>

Other provisions of the Act directly increase liability exposure. Notably, the Act gives the Commission the power to pursue litigation resulting from conduct occurring outside the U.S. that has a substantial effect within the U.S.<sup>45</sup> But the most drastic increase of liability exposure might be the elimination of agency exemption under two federal rules: Rule 436(g) and Regulation FD.<sup>46</sup> Without the Rule 436(g) exception, a rating agency will be forced to prove its ratings were reasonable and accurate.<sup>47</sup> The removal of the Regulation FD exception effectively means that material nonpublic information will no longer be provided to the agencies.<sup>48</sup> This particular removal seems inconsistent with the purpose of the Act. If

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<sup>41</sup> *Id.*

<sup>42</sup> Bene I. Ness, Matthew D. Root, & Timothy A. Stafford, *Dodd-Frank Measures Affecting Credit Rating Agencies*, DECHERT LLP, Aug. 2010, available at [http://www.dechert.com/library/Finance\\_and\\_Real\\_Estate-08-10-35-Dodd-Frank\\_Measures\\_Affecting\\_Credit.pdf](http://www.dechert.com/library/Finance_and_Real_Estate-08-10-35-Dodd-Frank_Measures_Affecting_Credit.pdf).

<sup>43</sup> PWC, *supra* note 34, at 2.

<sup>44</sup> *Id.* at 1.

<sup>45</sup> Joshua Gallu, *SEC Says Dodd-Frank Law Lets Agency Chase Overseas Ratings Fraud*, BLOOMBERG, Sep. 1, 2010, <http://www.bloomberg.com/news/2010-08-31/sec-says-it-declined-to-sue-moody-s-for-fraud-over-company-s-cdo-ratings.html>.

<sup>46</sup> Stephen Joyce, *Dodd-Frank Impact on Rating Agencies Includes Expanded Liability*, SEC Authority, BUREAU OF NAT'L AFFAIRS, Aug. 30, 2010.

<sup>47</sup> Orrick, *supra* note 40.

<sup>48</sup> *Id.*

Congress desires more accurate ratings, why would it limit the information available to the agencies?<sup>49</sup>

The increased vulnerability has already resulted in agency action. Immediately after the Act was passed, Moody's, S&P and Fitch stated that they would not give permission for their ratings to be used in registration statements.<sup>50</sup> For a case in point, a Ford bond offering was recently delayed because, as a result of the repeal of the Rule 436(g) exemption, the NRSROs refused to give their consent.<sup>51</sup> Thus, the increased exposure may result in a slowed registration process and additional lawsuits and costs.<sup>52</sup> However, despite increased costs and time requirements, proponents expect the Act to reduce fraudulent activity through the expanded regulatory tools it authorizes. The SEC has already warned NRSROs that it will utilize its expanded oversight power to mitigate fraudulent conduct overseas, an issue it had difficulty with prior to the Act.<sup>53</sup>

## **2. Internal Control Requirements and Disclosure Obligations**

In addition to increased liability exposure and SEC involvement, the Act imposes several internal control and rating methodology changes.<sup>54</sup> At least half of an NRSRO's board of directors must be independent.<sup>55</sup> Each NRSRO must establish an internal control structure regulating adherence to methods for determining credit ratings.<sup>56</sup> A chief compliance officer ("CCO") within each NRSRO, who is effectively disconnected from ratings

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<sup>49</sup> Interview with William Chambers, *supra* note 28 (indicating that in the past, such confidential information was shared with the agencies, who factored it into their models to provide more accurate ratings for investors).

<sup>50</sup> PWC, *supra* note 34, at 1.

<sup>51</sup> Joyce, *supra* note 46.

<sup>52</sup> Skadden, *supra* note 37, at 77.

<sup>53</sup> Yin Wilczek, *In Report, SEC Warns NRSROs to Have Adequate Controls Over Rating Procedures*, BUREAU OF NAT'L AFFAIRS, Sep. 1, 2010; Gallu, *supra* note 41, (indicating that the Commission will be able to deter conduct similar to the Moody's error in 2007, which resulted in \$1 billion of European securities bearing an inflated grade).

<sup>54</sup> PWC, *supra* note 34, at 2-3.

<sup>55</sup> *Id.* at 2.

<sup>56</sup> Ness, Root & Stafford, *supra* note 42.



activity, is required to annually report compliance status.<sup>57</sup> Additionally, the agencies must consider any issuer-related information they receive from a third party.<sup>58</sup> Ratings analysts must meet specific qualitative standards, and agencies must report employees who leave to work for a rated entity.<sup>59</sup>

These mandated internal controls are complimented by new disclosure rules, which increase transparency.<sup>60</sup> An NRSRO is required to clearly disclose on its website the initial rating, and any subsequent changes, of each type of security issued.<sup>61</sup> The agencies must provide information about the assumptions and principles used, the risks and limitations of the rating and a detailed account of any third-party influence on the rating.<sup>62</sup> Furthermore, the agencies must provide any information relating to conflicts of interest, along with an attestation that each rating is an objective and independent evaluation, based in no part on other business activities.<sup>63</sup>

In the near term, at least, the changes will likely increase the time and information needed to rate a security, prolonging a security's market deployment.<sup>64</sup> Third party source considerations and complex disclosure obligations, coupled with expanded liability exposure, will heighten due diligence requirements and increase operating costs.<sup>65</sup> Even so, the NRSROs will not bear the costs alone; the expenses will likely be passed on to issuers in the form of higher fees.<sup>66</sup>

### 3. Statutory Reference Removal and Mandated Studies

The Act requires several studies to be conducted by the SEC and the GAO, including two that are relevant to agency

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<sup>57</sup> PWC, *supra* note 34, at 2 (asserting that the CCO cannot work on credit ratings or receive compensation based on the financial success of the NRSRO.)

<sup>58</sup> *Id.* at 3.

<sup>59</sup> Ness, Root & Stafford, *supra* note 42.

<sup>60</sup> PWC, *supra* note 34, at 4.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.* at 4-5.

<sup>63</sup> *Id.* at 2.

<sup>64</sup> Skadden, *supra* note 37, at 77.

<sup>65</sup> *Id.*; PWC, *supra* note 34.

<sup>66</sup> Skadden, *supra* note 37, at 77.

independence.<sup>67</sup> Within three years the SEC must conduct an analysis on strengthening credit rating agency independence, focusing on the management of conflicts of interest and the impact of disallowing NRSROs from providing services other than ratings analysis.<sup>68</sup> The GAO will conduct a similar study on alternatives to the current business model in play, to be completed in two years, assessing the feasibility of alternative methods of compensation in order to improve ratings accuracy.<sup>69</sup> Whether the studies will result in further regulation or inaction is unknown, magnifying uncertainty for the agencies.<sup>70</sup>

In an effort to decrease regulatory reliance on ratings, the Act calls for the removal of many references to credit ratings from federal laws, effective two years after enactment.<sup>71</sup> The removal of references in the Securities Exchange Act of 1934 means the SEC must find another way to determine what qualifies as a mortgage-related or small-business-related security.<sup>72</sup> Similarly, the SEC must find an alternative standard of measuring the creditworthiness of securities held by state-regulated investment companies who seek exemption from the Investment Company Act of 1940.<sup>73</sup> Furthermore, modifications to the National Bank Act will require the 100 largest banks to have at least one debt instrument that meets credit standards issued by the Department of Treasury and Federal Reserve Board, as opposed to an NRSRO.<sup>74</sup>

The removals mean that regulatory agencies may need to develop alternative standards of measuring creditworthiness.<sup>75</sup> This aspect of the act raises questions about whether securities graded with a credit rating will satisfy various regulatory requirements in the future.<sup>76</sup> In the meantime, the call to develop new ratings mechanisms has been met with an international obstacle: the stalling of U.S. implementation of Basel, the international committee designed to set capital and liquidity requirements for banks

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<sup>67</sup> Joyce, *supra* note 46.

<sup>68</sup> PWC, *supra* note 34, at 7.

<sup>69</sup> Joyce, *supra* note 46.

<sup>70</sup> PWC, *supra* note 34, at 7.

<sup>71</sup> Orrick, *supra* note 40.

<sup>72</sup> PWC, *supra* note 34, at 5.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 6.

<sup>75</sup> Ness, Root & Stafford, *supra* note 42.

<sup>76</sup> *Id.*

worldwide.<sup>77</sup> The removal of references to credit ratings has forced U.S. regulators to begin anew in developing capital requirements consistent with both the Act and Basel standards.<sup>78</sup>

#### D. Conclusion

Supporters of the Act praise strengthened regulatory tools as deterring misconduct and protecting investors. These proponents can point to Congressional findings, which expressly indicate that the agencies play a “gatekeeper” role in the debt market, are burdened with serious conflict of interest problems, and therefore warrant increased accountability and public oversight.<sup>79</sup> Opponents of the Act disagree. By increasing regulatory controls, the argument goes, barriers to entry into the credit ratings industry are increased, and the supposedly flawed business model is perpetuated.<sup>80</sup> In addition to delaying securities offerings and postponing implementation of Basel requirements, the Act may demand too much from the SEC, given current staff levels.<sup>81</sup> But the broader concern, for some, lies in a business model that empowers the large NRSROs. Increased barriers to entry due to heightened regulation requirements will deter innovative business strategies and fair competition.<sup>82</sup> Rather than focusing on more regulation, Congress’s attempt to fix the problem should promote increased competition.<sup>83</sup> Maybe then investors would see the demise of the issuer-pay system in favor of a different model.

Notwithstanding differing opinions on the Act, the facts remain. Although credit agencies seek to provide objective and accurate ratings for investors, evidence of pressure to satisfy issuers is ample. The impact, if any, the conflict of interest has had on financial ratings may never be known, but Congress has not hidden its effort to promote agency independence through the Act.

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<sup>77</sup> Yalman Onaran, *Dodd-Frank Ban on Ratings Delays U.S. Implementing Basel Rule*, BLOOMBERG, Sep. 24, 2010, <http://www.bloomberg.com/news/2010-09-23/dodd-frank-ban-on-credit-ratings-delays-u-s-adopting-basel-trading-rules.html>.

<sup>78</sup> *Id.*

<sup>79</sup> H.R. REP. NO. 111-517, at Sec. 931(3) (2010).

<sup>80</sup> Bar-Or, *supra* note 38.

<sup>81</sup> Onaran; *GAO Report Says SEC Needs to Improve Registration, Exam Process for Credit Raters*, BUREAU OF NAT’L AFFAIRS, Sep. 24, 2010.

<sup>82</sup> Bar-Or, *supra* note 38.

<sup>83</sup> *Id.*

Regardless, entities will continue to pay agencies to rate their products, at least for now.

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## **XI. *Anti-Predatory Lending: Title XIV of the Dodd-Frank Act***

### **A. Introduction**

The Mortgage Reform and Anti-Predatory Lending Act (“Mortgage Reform Act”), incorporated as Title XIV of the Dodd-Frank Act, implements a variety of mortgage origination regulations aimed at eliminating practices believed to have contributed to the recent collapse of the real estate market.<sup>1</sup> The Mortgage Reform Act reflects the commonly held belief that mortgage brokers contributed to the collapse of the real estate market by originating questionable mortgages, many of which ultimately failed.<sup>2</sup> The Mortgage Reform Act addresses widespread mortgage origination practices, such as steering incentives and non-traditional mortgage arrangements, which were perceived to have facilitated high-risk lending and contributed to the recent economic collapse.<sup>3</sup> The ramifications of the Mortgage Reform Act are dramatic and the legislation is likely to fundamentally alter the mortgage brokerage industry.<sup>4</sup>

This article will examine the political and economic developments which preceded the Mortgage Reform Act and identify the perceived problems that the statute was intended to remedy. This article will then outline the most significant provisions of the statute, examine concerns surrounding the Mortgage Reform Act and identify possible consequences which may result from its enactment.

### **B. Historical Background**

Beginning in the mid-1990’s, the Federal Government implemented a variety of policies intended to increase the availability of home loans.<sup>5</sup> Increased pressure from the federal government to promote home ownership for lower income citizens, coupled with the

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<sup>1</sup> Jack Milligan, *A Massive Overhaul*, MORTGAGE BANKING, Sept. 2010, at 22-23.

<sup>2</sup> *Id.* at 23, 26.

<sup>3</sup> Robert M. Jaworski, *Back to the Future with the Mortgage Reform and Anti-Predatory Lending Act*, LexisNexis, 2010 Emerging Issues 5346 (October 6, 2010), at 1-2.

<sup>4</sup> Stephen F.J. Ornstein, Matthew S. Yoon & John P. Holahan, *Mortgage Reform and Anti-Predatory Lending Act*, LexisNexis, 2010 Emerging Issues 5294 (September 9, 2010), at 1.

<sup>5</sup> Jaworski, *supra* note 3, at 1-2.

growth of mortgage-backed securities and the corresponding market demand for mortgages, gave rise to an increase in subprime mortgage lending.<sup>6</sup> The success of mortgage-backed securities increased the availability of credit<sup>7</sup> while also generating tremendous demand for mortgages in the secondary mortgage market.<sup>8</sup> Some argue that this increased demand for mortgages caused investment bankers and others to pressure mortgage brokers to push unsafe mortgages on unqualified consumers.<sup>9</sup>

Whatever the motivation, the 1990s and 2000s saw an increase in high-risk lending practices and the rise of innovative mortgage arrangements.<sup>10</sup> Many mortgage brokers relaxed income verification standards (often permitting borrowers to report their income without providing any documentation), resulting in the origination of mortgages for consumers who lacked the ability to repay.<sup>11</sup> Additionally, mortgage originators began offering new mortgage arrangements, such as pay-option adjustable rate mortgages and interest only mortgages, which carried with them greater risks than did traditional mortgage arrangements.<sup>12</sup>

Critics allege that many mortgage brokers misled or failed to inform consumers of the risks posed by mortgage products in an attempt to maximize sales.<sup>13</sup> Brokers often received commission based on the size of the loan, meaning that brokers were rewarded for selling larger, unfavorable mortgages.<sup>14</sup> Because brokers faced no personal consequences if a particular mortgage ultimately failed, brokers had an incentive to promote loans with expensive, unfavorable terms to consumers, regardless of whether the consumer could realistically afford to repay the loan.<sup>15</sup> After the collapse of the real estate market, many observers identified irresponsible mortgage origination practices as contributing to the failure.<sup>16</sup>

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<sup>6</sup> *Id.* at 2.

<sup>7</sup> See Alvin C. Harrell, *The Great Credit Contraction: Who, What, Where, When and Why*, 26 GA. ST. U. L. REV. 1209, 1227-31 (Summer 2010).

<sup>8</sup> Charles W. Murdock, *Why Not Tell the Truth?: Deceptive Practices and the Economic Meltdown*, 41 LOY. U. CHI. L.J. 801, 858-59 (Summer 2010).

<sup>9</sup> *Id.*

<sup>10</sup> Jaworski, *supra* note 3, at 2.

<sup>11</sup> Murdock, *supra* note 8, at 843-46.

<sup>12</sup> Milligan, *supra* note 1, at 23.

<sup>13</sup> Murdock, *supra* note 8, at 846-848, 858-62.

<sup>14</sup> *Id.* at 845-46.

<sup>15</sup> *Id.* at 846.

<sup>16</sup> Milligan, *supra* note 1, at 26.

### C. **Mortgage Reform Act: Title XIV of the Dodd-Frank Act**

The Mortgage Reform Act was signed into law on July 21, 2010 as Title XIV of the Dodd-Frank Act.<sup>17</sup> The Dodd-Frank Act implements sweeping financial reforms and a new regulatory framework for financial services and institutions aimed at securing increased financial stability.<sup>18</sup> The Mortgage Reform Act imposes new duties upon mortgage originators and seeks to root out deceptive and predatory lending practices.<sup>19</sup> The following sections summarize the key provisions of the Mortgage Reform Act.

#### 1. **Definition of “Mortgage Originator”**

The Mortgage Reform Act defines a “mortgage originator” as “any person who, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain: (i) takes a residential mortgage application; (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or, (iii) offers or negotiates terms of a residential mortgage loan.”<sup>20</sup> Anyone who “performs purely administrative or clerical tasks” is not included in this definition.<sup>21</sup>

#### 2. **Steering Incentives**

The Mortgage Reform Act provides that “no mortgage originator shall receive from any person and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies

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<sup>17</sup> John L. Ropiequet, Christopher S. Naveja & Jason B. Hirsh, *An Introduction to the Dodd-Frank Act—The New Regulatory Structure For Consumer Finance Emerges*, BANKING & FIN. SERVICES POL’Y REP., Aug. 2010, at 1.

<sup>18</sup> *Id.*

<sup>19</sup> Joy H. Sperling, Lisa M. Gonzalo & David I. Shiefelbein, *Dodd-Frank Act Ushers in New Regulations for Mortgage Originators*, Mondaq Ltd., (September 1, 2010), available at [http://www.mondaq.com/unitedstates/article.asp?article\\_id=108992](http://www.mondaq.com/unitedstates/article.asp?article_id=108992).

<sup>20</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1401, 124 Stat 1376 (2010) (to be codified at 15 U.S.C. §1602(cc)(2)(A)(i-iii) (“Dodd-Frank Act”).

<sup>21</sup> *Id.* §1401 (to be codified at 15 U.S.C. §1602(cc)(2)(C)).

based on the terms of the loan.”<sup>22</sup> In the past, many unfavorable terms common in subprime mortgages increased the total value of the mortgage, thereby increasing demand in the secondary market.<sup>23</sup> Mortgage originators were often paid higher commissions for mortgages based on the total value of the loan, creating an incentive to increase the value of mortgages by including expensive, unfavorable terms.<sup>24</sup> Some commentators argue that these incentives often caused mortgage originators to push mortgages with unfavorable terms on consumers in an attempt to maximize the originator’s commission.<sup>25</sup> The anti-steering provisions are aimed at eliminating such incentives. Notably, mortgage originators may still receive increased commissions based on the principal amount of the mortgage<sup>26</sup>, as well as commissions “based on the number of residential mortgage loans originated within a specified period of time.”<sup>27</sup>

### 3. Anti-Steering Directives

Additionally, the Mortgage Reform Act prohibits “mortgage originators from steering any consumer” toward certain types of mortgages.<sup>28</sup> Under these provisions, a mortgage originator may not encourage a consumer to agree to a mortgage which “the consumer lacks a reasonable ability to repay”<sup>29</sup> or that “has predatory characteristics or effects (such as equity stripping, excessive fees, or abusive terms).”<sup>30</sup> Moreover, mortgage originators may not employ “abusive or unfair lending practices that promote disparities among consumers of equal credit worthiness but of different race, ethnicity, gender, or age.”<sup>31</sup>

The anti-steering provisions impose a duty on mortgage originators to not “mischaracteriz[e] the credit history of a consumer or the residential mortgage loans available to a consumer” or

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<sup>22</sup> *Id.* §1403 (to be codified at 15 U.S.C. §1639(B)(c)(1)).

<sup>23</sup> Murdock, *supra* note 8, at 859.

<sup>24</sup> *Id.* at 858.

<sup>25</sup> *Id.* at 845-46, 858.

<sup>26</sup> Dodd-Frank Act, § 1403 (to be codified at 15 U.S.C. §1639(B)(c)(1)).

<sup>27</sup> *Id.* § 1403 (to be codified at 15 U.S.C. §1639(B)(c)(4)(D)).

<sup>28</sup> *Id.* § 1403 (to be codified at 15 U.S.C. §1639(B)(c)(3)(A-C)).

<sup>29</sup> *Id.* § 1403 (to be codified at 15 U.S.C. §1639(B)(c)(3)(A)(i)).

<sup>30</sup> *Id.* § 1403 (to be codified at 15 U.S.C. §1639(B)(c)(3)(A)(ii)).

<sup>31</sup> *Id.* § 1403 (to be codified at 15 U.S.C. §1639(B)(c)(3)(C)).



“mischaracteriz[e]. . . the appraised value of the property securing the extension of credit.”<sup>32</sup> The Federal Reserve Board has been charged with the task of developing regulations to determine what particular practices are covered under these prohibitions.<sup>33</sup> Additionally, the statute grants the Federal Reserve Board the general power to regulate or restrict any “terms, acts or practices relating to residential mortgage loans that the Board finds to be abusive, unfair, deceptive, [or] predatory” insofar as such regulations are “necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers.”<sup>34</sup>

Additionally, the Mortgage Reform Act allows borrowers to hold mortgage originators liable for violations of the statute’s anti-steering directives.<sup>35</sup> Prior to the Mortgage Reform Act, consumers could hold only “creditors” (as defined by the Truth In Lending Act), not mortgage originators, liable for statutory violations.<sup>36</sup> Under the Mortgage Reform Act, mortgage originators may be ordered to pay “the greater of actual damages or an amount equal to 3 times the total amount of direct and indirect compensation or gain accruing to the mortgage originator in connection with the residential mortgage loan involved in the violation. . . .”<sup>37</sup>

The anti-steering provisions of the Mortgage Reform Act have been criticized as being extraordinarily vague.<sup>38</sup> Because the steering provisions are excessively broad and fail to offer specific guidance regarding compliance, mortgage brokers are left guessing what is or is not permitted under the new law.<sup>39</sup> The combination of the prospect of personal liability for violating the anti-steering provisions, coupled with the uncertain terms used in defining a mortgage originator’s duties with regard to those provisions, leaves a mortgage originator in the undesirable position of facing severe

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<sup>32</sup> *Id.* § 1403 (to be codified at 15 U.S.C. § 1639(B)(c)(3)(D)(i-ii)).

<sup>33</sup> *Id.* § 1403 (to be codified at 15 U.S.C. § 1639(B)(c)(3)).

<sup>34</sup> *Id.* § 1405(a) (to be codified at 15 U.S.C. § 1639(B)(e)(1)).

<sup>35</sup> *Id.* § 1404 (to be codified at 15 U.S.C. § 1639(B)(d)(1)).

<sup>36</sup> Jaworski, *supra* note 3, at 8.

<sup>37</sup> Dodd-Frank Act, § 1404 (to be codified at 15 U.S.C. § 1639(B)(d)(2)).

<sup>38</sup> See Stuart Saft, *Anti-Predator Act? It’s More Anti-Lender*, American Banker, Sept. 1, 2010.

<sup>39</sup> See *id.* (“Unfortunately, there is no definition of unfair, deceptive or abusive, and what is ‘understandable’ will be left for a judge to determine. How lenders will be able to satisfy the regulators, judges and juries that they satisfied these subjective standards is a mystery”); Milligan, *supra* note 1, at 26.

consequences if the originator's good faith conduct is later determined to be a violation of the statute.<sup>40</sup>

#### 4. Verification of a Consumer's Ability to Repay

The Mortgage Reform Act requires that all mortgage originators "mak[e] a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan."<sup>41</sup> In order to determine whether a potential borrower is capable of repayment, a mortgage originator should consider the prospective borrower's "credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status and other financial resources other than the consumer's equity in the dwelling or real property. . . ."<sup>42</sup> Furthermore, rather than rely on a prospective borrower's statements regarding the borrower's income, the statute requires that a mortgage originator examine the borrower's "Internal Revenue Service Form W-2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income or assets."<sup>43</sup>

#### 5. Safe Harbor Provision and Qualified Mortgages

The statute also permits "[a]ny creditor . . . and any assignee of [a residential mortgage] loan" to "presume that the loan has met the [ability to repay] requirements of subsection (a), *if the loan is a qualified mortgage.*"<sup>44</sup> In order to be classified as a "qualified" mortgage, a mortgage must meet a slew of requirements.<sup>45</sup> The requirements include that the "the regular periodic payments for the loan may not . . . result in an increase of the principal balance . . . or

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<sup>40</sup> See Saft, *supra* note 38; Milligan, *supra* note 1, at 26.

<sup>41</sup> Dodd-Frank Act, § 1411 (to be codified at 15 U.S.C. § 1639(C)(a)(1)).

<sup>42</sup> *Id.* § 1411 (to be codified at 15 U.S.C. § 1639(C)(a)(3)).

<sup>43</sup> *Id.* § 1411 (to be codified at 15 U.S.C. § 1639(C)(a)(4)).

<sup>44</sup> *Id.* § 1412 (to be codified at 15 U.S.C. § 1639(C)(b)(1) (emphasis added)).

<sup>45</sup> *Id.* § 1412 (to be codified at 15 U.S.C. § 1639(C)(b)(2)(A)(i-ix)).

. . . allow the consumer to defer repayment of principal,<sup>46</sup> the mortgage may not include “a scheduled payment that is more than twice as large as the average of earlier scheduled payments,”<sup>47</sup> the mortgage may “not exceed thirty years,”<sup>48</sup> and “the total points and fees payable in connection with the loan [may] not exceed 3 percent of the total loan amount.”<sup>49</sup>

When issuing a non-qualified mortgage, the mortgage originator faces a substantial risk of liability based on the originator’s duty under the statute to ensure that the borrower is capable of repayment.<sup>50</sup> The presumption that these qualified mortgages have met these requirements, however, significantly reduces the mortgage originator’s risk of liability.<sup>51</sup> Along with the presumption that a “qualified mortgage” complies with the ability to repay directives outlined in the Mortgage Reform Act, the statute also exempts “qualified” mortgages from other regulations (such as the prohibition on prepayment fees)<sup>52</sup> that are applicable to mortgages not classified as “qualified.”<sup>53</sup> The Mortgage Reform Act’s reduced regulation of “qualified mortgages” provides mortgage originators with a strong incentive to originate qualified, rather than non-qualified, mortgages.<sup>54</sup>

Many observers see the definition of “qualified mortgage” as an attempt by Congress to promote traditional mortgage arrangements.<sup>55</sup> Critics argue that the Mortgage Reform Act’s distinction between qualified mortgages (which generally resemble traditional mortgages issued only to highly qualified borrowers) and all other mortgages will impede creativity in the mortgage broker industry and will stifle attempts to meet the needs of borrowers through innovative mortgage arrangements.<sup>56</sup> Some commentators argue that, as a result of increased regulation and more stringent mortgage

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<sup>46</sup> *Id.*, § 1412 (to be codified at 15 U.S.C. § 1639(C)(b)(2)(A)(i)(I-II)).

<sup>47</sup> *Id.*, § 1412 (to be codified at 15 U.S.C. § 1639(C)(b)(2)(A)(ii)).

<sup>48</sup> *Id.*, § 1412 (to be codified at 15 U.S.C. § 1639(C)(b)(2)(A)(viii)).

<sup>49</sup> *Id.*, § 1412 (to be codified at 15 U.S.C. § 1639(C)(b)(2)(A)(vii)).

<sup>50</sup> Jaworski, *supra* note 3, at 3.

<sup>51</sup> *Id.* at 3.

<sup>52</sup> Dodd-Frank Act, § 1414 (to be codified at 15 U.S.C. § 1639(C)(c)(1)(A)).

<sup>53</sup> *See* Jaworski, *supra* note 3, at 3-4.

<sup>54</sup> *Id.* at 3-4.

<sup>55</sup> *Id.* at 1-2.

<sup>56</sup> Milligan, *supra* note 1, at 23-24.

origination requirements, the statute will create more difficulty for consumers seeking to secure mortgage loans.<sup>57</sup>

These critics' primary concern is that the increased restrictions on the types of loans that may be made available to consumers, coupled with the added duties placed upon mortgage originators, may make obtaining a mortgage more difficult for marginally qualified borrowers or those who do not qualify for a "qualified mortgage."<sup>58</sup> One possible consequence of further restricting credit available for prospective home buyers is that property values may continue to decrease.<sup>59</sup> Additionally, some critics have noted the irony in the statute's conservative approach to lending,<sup>60</sup> given that the federal government has long been an ardent proponent of expanding the pool of homeowners and increasing the availability of credit for lower income prospective home buyers.<sup>61</sup> Ultimately, the increased regulation of mortgage origination carries the risk of worsening the credit crunch.<sup>62</sup>

#### D. Conclusion

The Mortgage Reform Act marks a dramatic shift in the law regarding mortgage origination and mortgage brokerage.<sup>63</sup> In an attempt to address perceived problems among mortgage originators, Congress enacted a law which fundamentally altered the standard practices within the mortgage broker industry which had developed in the mortgage industry over the past decade.<sup>64</sup> The Mortgage Reform Act seeks to protect customers from dishonest, unfair lending practices and to promote economic stability. Critics charge that the statute is misguided, and will serve only to further restrict access to credit and hurt future borrowers.<sup>65</sup> Whatever the

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<sup>57</sup> *Id.* at 24, 27; *See also* Ornstein, *supra* note 4, at 1.

<sup>58</sup> Milligan, *supra* note 1, at 24, 27; Jaworski, *supra* note 3, at 9.

<sup>59</sup> Jaworski, *supra* note 3, at 9.

<sup>60</sup> Milligan, *supra* note 1, at 27 (quoting a Jack Piatt, a partner at K&L Gates, as stating that, with regard to increasing the availability of credit for low income borrowers, "Congress is schizophrenic on this issue.")

<sup>61</sup> Jaworski, *supra* note 3, at 1.

<sup>62</sup> *Id.* at 9.

<sup>63</sup> Milligan, *supra* note 1, at 23.

<sup>64</sup> Jaworski, *supra* note 3, at 2.

<sup>65</sup> *See* Saft, *supra* note 38; Milligan, *supra* note 1, at 24.

consequences, the statute is certain to have a long-lasting and profound impact on home ownership and lending practices.

Joe Wonderly<sup>66</sup>

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## ***XII. Regulation of Swap Markets under the Dodd-Frank Act***

### **A. Introduction**

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“the Act”) creates a system to regulate both over-the-counter and securities-based swap markets.<sup>1</sup> This development article will look into several aspects of swap markets, including the perceived need to regulate, the regulations expressly established by Title VII and likely future actions of regulating agencies and market participants. It will begin with a brief introduction to swaps and their role in the financial crisis of 2008. The article will then discuss the effects of Title VII, focusing on three parts of the new regulatory regime: the regulation of swap dealers and other swap market participants, the clearing and exchange trading of swaps and the Swap Pushout Rule. For each major provision, the article will comment on how Title VII will affect swaps and those who participate in swap markets. In doing so, it will also address how markets might react and how federal agencies might choose to use the powers and uphold the responsibilities they have been delegated.

### **B. An Introduction to Swaps and Their Role in the Financial Crisis of 2008**

In a typical swap, two parties exchange future cash flows that have the same net present value.<sup>2</sup> For example, in an interest rate swap, party A might agree to pay party B interest for two years on some principal value at a variable reference rate such as the LIBOR. In an exchange, party B might agree to pay party A interest at a fixed rate for the same duration on another principal value such that the parties’ obligations have the same net present value.<sup>3</sup> The principal values are notional; they are not exchanged and need not exist.<sup>4</sup> Interest rate swaps have many uses. These uses include: hedging

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1, 124 Stat. 1376, 1379-80 (2010).

<sup>2</sup> JOHN HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES* 147 (7th ed. 2008).

<sup>3</sup> *See Id.* at 147-150 (providing an in-depth explanation of interest rate swaps).

<sup>4</sup> *Id.* at 147.

against an unfavorable change in interest rates<sup>5</sup>; taking advantage of a comparative advantage a company has in either fixed or variable rates<sup>6</sup>; and engaging in credit arbitrage.<sup>7</sup>

However, not all swaps are this straightforward. For example, in a credit default swap (“CDS”), one party accepts periodic payments in exchange for assuming some or all of the risk of default on an underlying credit obligation.<sup>8</sup> The debtor in the underlying obligation is not a party to the swap.<sup>9</sup> If a creditor buys a CDS on a credit obligation owed to her, she is in a similar position as she would be if she had sold some or all of the credit obligation; in this way, CDS and similar credit derivatives allow the hedging and diversification of credit risk.<sup>10</sup> However, an investor can also enter into a CDS without having an interest in the underlying obligation, effectively using the CDS to speculate or to concentrate risk.<sup>11</sup> Financial companies heavily invested in CDS transactions contribute to systemic risk, for if one party to a CDS cannot meet its obligations, its counterparty may then find itself unable to meet other financial obligations.<sup>12</sup> In 2008, Bear Stearns and AIG found themselves in this position.<sup>13</sup>

### C. Regulation of Swap Markets under Title VII of the Dodd-Frank Act

Title VII of the Act establishes a comprehensive regulatory regime on swap markets and those who participate in them.<sup>14</sup> Important provisions subject swap dealers, security-based swap

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<sup>5</sup> James Bicksler & Andrew H. Chen, *An Economic Analysis of Interest Rate Swaps*, 41 J. FIN. 645, 647-48 (1986).

<sup>6</sup> Robert H. Litzenger, *Swaps: Plain and Fanciful*, 47 J. FIN. 831, 839-841 (1992).

<sup>7</sup> *Id.* at 839.

<sup>8</sup> David Mengle, *Credit Derivatives: An Overview*, 92 ECON. REV., no. 4, at 1-2.

<sup>9</sup> *Id.* at 2.

<sup>10</sup> *Id.* at 16.

<sup>11</sup> *Id.* at 17.

<sup>12</sup> Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System*, 33 HARV. J.L. & PUB. POL'Y 671, 674-75 (2010).

<sup>13</sup> *Id.* at 675.

<sup>14</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1, 124 Stat. 1376, 1379-80 (2010) (to be codified at 12 U.S.C. § 5301).

dealers, major swap participants and major security-based swap participants<sup>15</sup> to capital requirements and require them to publicly report swap transaction data.<sup>16</sup> Most swaps will no longer be traded over-the-counter. Instead, they must be traded at exchanges after being cleared by a derivatives clearing organization.<sup>17</sup> Federal agencies will not be permitted to provide financial “bailout” assistance to certain swap dealers and swap market participants.<sup>18</sup> Each of these aspects will be discussed in detail below.

### 1. Regulation of Banks, Swap Dealers and Others

Under the Dodd-Frank Act, swap dealers and major swap participants are required to register with the SEC or CFTC.<sup>19</sup> These agencies will establish requirements pertaining to minimum capital, marginal capital, bookkeeping, reporting, conduct standards and other concerns with which swap dealers and major swap participants must comply.<sup>20</sup> The Act does not detail many of these provisions, instead giving the SEC and CFTC a lot of leeway as to how closely they regulate.<sup>21</sup> Swap dealers and major swap participants must comply with new business conduct requirements that require disclosure to counterparties of material risks and conflicts of interests, although these standards are more lenient than the fiduciary

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<sup>15</sup> The Act distinguishes between “swaps” and “security-based swaps;” between “swap dealers” and “security-based swap dealers;” and between “major swap participants” and “major security-based swap participants.” Compare, e.g., § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(47)) (definition of “swap”) with § 721(a)(19) (to be codified as 7 U.S.C. § 1(a)(42)) (definition of “security-based swap”). The primary difference is that the Securities and Exchange Commission is the relevant regulator with respect to anything “security-based,” while the Commodity Futures Trading Commission regulates anything not “security-based.” § 712(a). Hereinafter, this article will not distinguish between anything “security-based” and not.

<sup>16</sup> § 731 (to be codified at 7 U.S.C. § 6s).

<sup>17</sup> § 723(a) (to be codified at 7 U.S.C. § 2).

<sup>18</sup> § 716 (to be codified at 15 U.S.C. § 8305).

<sup>19</sup> § 731 (to be codified at 7 U.S.C. § 6s).

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*



duty that Title VIII imposes on brokers and dealers.<sup>22</sup> Swap dealers and major swap participants that enter into swaps with states, localities, governmental agencies and some other “Special Entities” are subject to additional requirements to be established by regulators.<sup>23</sup>

The Act defines a “swap dealer” as:

*any person who--*

*(i) holds itself out as a dealer in swaps;*

*(ii) makes a market in swaps;*

*(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or*

*(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps,*

*provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.*<sup>24</sup>

There are additional exceptions for entities who engage in de minimis swap transactions made on behalf of customers<sup>25</sup> and for people who enter into swaps for their own accounts.<sup>26</sup> The typical “major swap participant” will be a nonbank entity that “maintains a substantial position in swaps.”<sup>27</sup> The qualifications for classification as a swap dealer or a major swap participant are vague, and even if agencies establish brighter lines, there will likely be much litigation resulting from banks and other institutions that deal in swaps while maintaining that they are not swap dealers or major swap participants under the language of the Act. The Chairman of the CFTC has

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<sup>22</sup> Compare § 731 (to be codified at 7 U.S.C. § 6s(h)(3)) (business conduct standards for swap dealers) with § 913 (to be codified at 15 U.S.C. § 780) (fiduciary duty for brokers and dealers).

<sup>23</sup> § 731 (to be codified at 7 U.S.C. §§ 6s(h)).

<sup>24</sup> § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(49)(A)).

<sup>25</sup> Regulators will establish guidelines as to who qualifies for the de minimis exemption. § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(49)(D)).

<sup>26</sup> § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(49)(C)).

<sup>27</sup> See § 721(a)(16) (to be codified at 7 U.S.C. § 1(a)(33)(A)) (providing the full definition of “major swap participant”).

indicated that foreign firms that enter into swaps with U.S. counterparties can be treated as swap dealers or major swap participants, and will be subject to the same requirements as domestic firms.<sup>28</sup>

Additionally, the Volcker Rule of Title VI prohibits insured banks and their affiliates from acting as a principal with respect to some transactions involving swaps and other derivatives.<sup>29</sup> Although the Rule is primarily concerned with acting as a principal in speculative short-term investments, the SEC and CFTC are permitted to extend this ban to also cover longer-term investments.<sup>30</sup>

## 2. Clearing and Trading of Swaps

In an effort to reduce counterparty risk, the Act requires most swaps to be cleared by a derivatives clearing organization (“DCO”).<sup>31</sup> The Act defines an extensive set of criteria for registration as a DCO, including requirements regarding financial recourses, risk management and reporting.<sup>32</sup> Title VII defines “swap” broadly to include not only instruments typically referred to as swaps, but also most other derivatives, including put and call options.<sup>33</sup> However, the Act expressly excludes instruments regulated by the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>34</sup> In effect, most derivatives that are currently traded over-the-counter will be subject to the clearing requirements. Swap transactions entered into before these regulations go into effect will have to be reported but not cleared.<sup>35</sup> Swaps are exempt from the clearing requirement if one party is not a financial entity, is using the swap to hedge against risk, or gets special permission from

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<sup>28</sup> Asjylyn Loder, *Foreign Banks Selling Swaps in U.S. to Face Dodd-Frank Rules, Gensler Says*, BLOOMBERG, Oct. 21, 2010, <http://www.bloomberg.com/news/2010-10-21/foreign-banks-selling-swaps-in-u-s-to-face-dodd-frank-rules-gensler-says.html>.

<sup>29</sup> § 619 (to be codified at 12 U.S.C. § 1851).

<sup>30</sup> *Id.* For a more extensive analysis of the Volcker Rule, see William J. Sweet, Jr. & Brian D. Christiansen, *The Volcker Rule*, in THE DODD-FRANK ACT, COMMENTARY AND INSIGHTS 31, 31-36 (Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates ed., 2010).

<sup>31</sup> § 723(a) (to be codified at 7 U.S.C. § 2).

<sup>32</sup> § 725(c) (to be codified at 7 U.S.C. § 7a).

<sup>33</sup> § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(47)(A)).

<sup>34</sup> § 721(a)(21) (to be codified as 7 U.S.C. § 1(a)(47)(B)(iii)).

<sup>35</sup> § 723(a)(3) (to be codified at 7 U.S.C. § 2(h)).

regulators.<sup>36</sup> Foreign exchange swaps and forwards are also subject to regulation, although the Secretary of the Treasury has the power to exclude them from regulation.<sup>37</sup> European and other foreign regulators have been communicating with American regulators to try to ensure that swap market regulation will be as consistent as possible worldwide.<sup>38</sup>

Cleared swaps must be traded at a contract market, such as an existing securities exchange, or at a swap execution facility (“SEF”).<sup>39</sup> Except for “eligible contract participants,” no one may enter into a swap not traded on an exchange.<sup>40</sup> The Act provides requirements for registering SEFs, which are regulated by the SEC and the CFTC. A DCO differs from an exchange in that market making is more complicated for swaps than for many securities, since “many [swaps] require some element of customization or negotiation on terms, or are too specialized to trade on exchanges.”<sup>41</sup> Although regulators have not yet come up with the rules, many major exchanges have already expressed their intent to register as SEFs.<sup>42</sup> The Chairman of the SEC has expressed her desire to make swap markets more like other securities markets, and it is likely that agency rules will move swap markets in this direction.<sup>43</sup> Exchange trading of swaps should increase transparency, reduce counterparty risk and remove some comparative advantage currently enjoyed by

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<sup>36</sup> § 723(a) (to be codified at 7 U.S.C. § 2).

<sup>37</sup> § 722(h) (to be codified at 7 U.S.C. § 1b).

<sup>38</sup> Brai Odion-Esene, *US CFTC Gensler: Sees Rise in Swap Dealers due to Dodd-Frank*, MARKET NEWS, Sept. 16, 2010, <http://imarketnews.com/node/19351>.

<sup>39</sup> § 723(a)(2) (to be codified at 7 U.S.C. § 2(d)).

<sup>40</sup> *Id.* “Eligible contract participants” include financial institutions, federally-regulated investment companies, and state-regulated insurance companies. 7 U.S.C. § 1(a)(12). However, section 721(a)(9) of the Act will make the present definition more stringent.

<sup>41</sup> Roberta Rampton, Q+A-What’s at stake for swap-execution facilities?, REUTERS, Sept. 7, 2010, <http://www.reuters.com/article/idUSN0722464520100907>.

<sup>42</sup> *Id.*

<sup>43</sup> Rachele Younglai & Jonathan Spicer, *New Swaps Market Needs to be Like Stock Market: SEC*, REUTERS, Sept. 22, 2010, <http://www.reuters.com/article/idUSTRE68L5ZQ20100922>.

large firms and those with superior access to information.<sup>44</sup> Critics suggest that swap exchanges will attract hedge funds and other high-frequency traders, who will provide liquidity but increase volatility.<sup>45</sup> Leaders in the oil, airline and other industries fear the new trading system will increase the cost of hedging, despite a CFTC commissioner's statement that the overhaul will not make "legitimate hedge activities" more expensive.<sup>46</sup>

### 3. The Swap Pushout Rule

After the bailouts of Citigroup, Bank of America and others, there was public outcry that taxpayers were assuming the liabilities of banks and other financial institutions involved in risky transactions. In response, Congress included the Swap Pushout Rule in the Dodd-Frank Act. Under the Act, "*no Federal assistance may be provided to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity.*"<sup>47</sup> *Swaps entities include swap dealers and major swap participants.*<sup>48</sup> *Exceptions are made for major swap participants that are insured depository institutions, as well as swaps entities that limit their swap activities to hedging and other specially permitted activities.*<sup>49</sup> Here, "*Federal assistance*" refers only to the Federal Reserve's abilities; however, later in the section, a broader statement is made: "*Taxpayers shall bear no losses from the exercise of any authority under this title.*"<sup>50</sup> *The Act does not define "losses," and the directive seems impossibly vague. If the government invests in or "bails out" a financial firm, it*

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<sup>44</sup> John Carney, *Will Dodd-Frank Help High Frequency Traders Crash the Bond Market Too?*, CNBC.COM, Sept. 29, 2010, <http://www.cnbc.com/id/39419371>.

<sup>45</sup> *Id.*

<sup>46</sup> Aaron Clark & Asjlynn Loder, *Overhaul Won't Raise 'Legitimate' Hedging Costs, Chilton Says*, BLOOMBERG, Oct. 25, 2010, <http://www.bloomberg.com/news/2010-10-25/overhaul-won-t-raise-legitimate-hedging-costs-chilton-says.html>.

<sup>47</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716(a), 124 Stat. 1376, 1648 (2010) (*to be codified at 15 U.S.C. § 8305*).

<sup>48</sup> § 716(b)(2) (*to be codified at 15 U.S.C. § 8305*).

<sup>49</sup> § 716(d), § 716(g) (*to be codified at 15 U.S.C. § 8305*).

<sup>50</sup> § 716(i)(3) (*to be codified at 15 U.S.C. § 8305*).

may be years before the government knows whether it has gained or lost on the transaction.<sup>51</sup>

*The Act also prohibits the use of taxpayer funds to prevent the receivership of swaps entities that are FDIC insured or that pose a systemic risk.<sup>52</sup> For all other swaps entities, taxpayer resources cannot be used in the liquidation of such entities.<sup>53</sup> This gives FDIC insured swaps entities the same treatment in liquidation proceedings as that enjoyed by other financial companies under Title II of the Act, whereas swaps entities that are not FDIC insured are singled out for worse treatment.<sup>54</sup>*

#### **D. Conclusion**

Title VII, like the rest of the Dodd-Frank Act, is bold and comprehensive. It will bring to swap markets a level of regulation comparable to that seen in other securities markets. Assuming the regulatory regime is successful in preventing financial institutions from taking speculative swap positions, it remains to be seen whether this will meaningfully improve the soundness of these institutions, or whether they will be able to develop more opaque financial instruments in pursuit of the greatest returns. One way or another, the next few years will be interesting.

Joel Zoch<sup>55</sup>

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<sup>51</sup> For example, as of October 2010, the government has made significant net gains in its 2008 “bailout” investments in Citigroup, Goldman Sachs, and Morgan Stanley, although many contemporaneous bailouts still show losses. Yalman Onaran & Alexis Leondis, *Wall Street Bailout Returns 8.2% Profit Beating Treasury Bonds*, BLOOMBERG, Oct. 20, 2010, <http://www.bloomberg.com/news/2010-10-20/bailout-of-wall-street-returns-8-2-profit-to-taxpayers-beating-treasuries.html>.

<sup>52</sup> § 716(i)(1) (to be codified at 15 U.S.C. § 8305).

<sup>53</sup> *Id.*

<sup>54</sup> Compare *Id.* (liquidation of swaps entities) with §214 (liquidation of financial companies).

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### ***XIII. Investor Protections of Dodd-Frank***

#### **A. Introduction**

The investor protection provisions of Title IX of *Dodd-Frank* made sweeping changes in securities enforcement and regulation. For example, Title IX increased whistleblowers' incentives, lowered the mens rea requirement for secondary actors, increased SEC funding, created the ability for the SEC to impose fiduciary standards on brokers and to obtain penalty awards in administrative cases, fashioned industry-wide bars for securities professionals, and restricted the ability to craft customer arbitration agreements. These provisions significantly changed the way public companies and their directors and employees conduct business.

#### **B. Whistleblower Provision**

Section 922 of the Act contains specific requirements for qualifying for the significant monetary incentives (known colloquially as "bounties") that are available for individuals who know of a securities violation and contact the SEC (i.e. "blow the whistle").<sup>1</sup> In order to qualify for the bounty, the whistleblower must have voluntarily provided this information to the SEC and the information must be original.<sup>2</sup> Original information is information that was "derived from the independent knowledge or analysis" of the whistleblower.<sup>3</sup> Information that was known to the SEC from another source or was exclusively derived from external, publicly available information, such as a governmental report, hearing, audit or investigation, or from the news media does not qualify as "original".<sup>4</sup> Further, if a regulatory or self-regulatory agency, the

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376 (2010) to be codified at 15 U.S.C. § 78.

<sup>2</sup> *Id.* at § 922(b)(1).

<sup>3</sup> Kevin Griffith, *Whistleblowing Galore Under the Dodd-Frank Act*, BANKING & FINANCIAL LAW REPORT, Aug. 24, 2010, <http://www.bankingandfinancelawreport.com/2010/08/articles/bank-regulation/whistleblowing-galore-under-the-doddfrank-act/>.

<sup>4</sup> Gibson Dunn, *The Dodd-Frank Act Reinforces and Expands SEC Enforcement Powers*, July 21, 2010, <http://www.gibsondunn.com/publications/Pages/DoddFrankActReinforcesAndExpandsSECEnforcementPowers.aspx>.

Department of Justice, the Public Company Accounting Oversight Board, or a law enforcement organization employed the whistleblower, the whistle blower will not be able to benefit from the provision.<sup>5</sup> Even if the whistleblower is the offender himself, the bounty must still be paid to him unless he is criminally convicted of a crime related to the action.<sup>6</sup> However, it is not enough that the whistleblower just report the violation to the SEC. In order for the whistleblower to collect their bounty, the information provided must lead the SEC to a successful enforcement action with monetary sanctions over \$1 million dollars.<sup>7</sup>

If the above mentioned criteria are met, the whistleblower is entitled to a bounty of anywhere from 10% to 30% of the total monetary penalties imposed by the SEC.<sup>8</sup> With SEC enforcement actions historically resulting in penalties worth hundreds of millions of dollars, whistleblowers have a large carrot placed in front of them, but the stick can be ruthless.<sup>9</sup> “Basically, [whistle-blowing] ruins your life....What is worth your life getting ruined? It’s pretty expensive.”<sup>10</sup> Congress had similar concerns and greatly expanded the protections available to whistleblowers.<sup>11</sup> One of the greatest protections available is anonymity; whistleblowers may submit information to the SEC through counsel and remain anonymous until a bounty payment.<sup>12</sup> Further, if the identity of the whistleblower is known to the corporation, they may not “discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against” a whistleblower in the “terms and conditions of

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<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> Bruce Carton, *Pitfalls Emerge in Dodd-Frank Whistleblower Bounty Provision*, SECURITIES DOCKET, Sept. 09, 2010, <http://www.securitiesdocket.com/2010/09/09/pitfalls-emerge-in-dodd-frank-whistleblower-bounty-provision>.

<sup>8</sup> Michael F. Perlis & Wrenn E. Chai, *Will Whistle-Blowing Be Millions Well Spent?*, FORBES, Sept. 15, 2010, <http://www.forbes.com/2010/09/15/whistle-blowers-sec-opinions-columnists-perlis-chais.html>.

<sup>9</sup> Carton, *supra* note 7.

<sup>10</sup> Sara Johnson, *Paid to Whistle*, CFO.COM, July 23, 2010, [http://www.cfo.com/article.cfm/14512666/c\\_14512775?f=home\\_todayinfinance](http://www.cfo.com/article.cfm/14512666/c_14512775?f=home_todayinfinance).

<sup>11</sup> Stephen J. Crimmins, et al., *Investor Protection Provisions of Dodd-Frank Financial Services Reform Alert*, K&L GATES NEWSSTAND, July 1, 2010, available at <http://www.klgates.com/newsstand/detail.aspx?publication=6518>.

<sup>12</sup> *Id.*

his employment”.<sup>13</sup> For those whistleblowers who think they have been discriminated against, they can bring an action in federal court seeking double back pay, reinstatement with appropriate seniority, attorney and expert costs and other relief.<sup>14</sup>

The benefits of the whistleblower provisions are straightforward, but critics raise some legitimate arguments. More lucrative bounties plus greater whistleblower protection will result in more tips getting reported to the SEC and an increase in the number of whistleblowers coming forward.<sup>15</sup> Critics state that the provision will greatly increase the number of false claims that are reported to the SEC, and employees will prematurely report when they have any suspicion of fraudulent activity with the hopes of becoming millionaires.<sup>16</sup> The new whistleblower provision could also cause employees to head straight to the SEC and report the violation, not even giving the company a chance to fix the problem internally.<sup>17</sup> Furthermore, employees who feel secure in their jobs are more likely to report the violation internally than those who might be on the verge of being let go or are no longer with the company.<sup>18</sup>

The law will also affect company behavior. Companies are likely to start taking steps now to encourage their employees to report violations internally to their supervisors because a company does not want to find out about a violation for the first time when an SEC enforcement action official calls about it.<sup>19</sup> Companies have also started reexamining their internal whistleblower program to try and strengthen it.<sup>20</sup> Most publicly traded companies have had one since Sarbanes-Oxley was passed in 2002.<sup>21</sup> Because having an

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<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> Jim Kim, *Dodd-Frank prompting more whistleblowers already?*, FIERCE FINANCE, Sept. 06, 2009, <http://www.fiercefinance.com/story/dodd-frank-prompting-more-whistle-blowers-already/2010-09-16>.

<sup>16</sup> Carton, *supra* note 7.

<sup>17</sup> *Id.*

<sup>18</sup> James J. Baressi, et al., *Investor protections in the Dodd-Frank Wall Street Reform and Consumer Protection Act: companies need to act to avoid potential new expenses*, SQUIRE SANDERS, July 30, 2010, [http://www.ssd.com/investor\\_protections\\_in\\_the\\_doddfrank\\_wall\\_street\\_reform\\_and\\_consumer\\_protection\\_act\\_companies\\_need\\_to\\_act\\_to\\_avoid\\_potential\\_new\\_expenses/](http://www.ssd.com/investor_protections_in_the_doddfrank_wall_street_reform_and_consumer_protection_act_companies_need_to_act_to_avoid_potential_new_expenses/).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> Johnson, *supra* note 8.



anonymous tip-line might not suffice when the SEC is dangling a million-dollar carrot in front of employees, companies might also enact internal whistleblower programs that provide employees incentives like the SEC's program.<sup>22</sup> Finally, companies should strongly consider self-reporting violations to the SEC when made aware of them.<sup>23</sup> Although self-reporting will not save a company from all liability, it will often benefit by leading to a potentially lower fine or sentence.<sup>24</sup>

### C. Expanding the Scope of Secondary Liability

Section 929M of the Act provides for the SEC to impose aiding and abetting liability on persons who "recklessly" provide substantial assistance to someone who violates the Exchange Act.<sup>25</sup> Previously, federal court decisions held that under the Private Securities Litigation Reform Act of 1995, the aiding and abetting standard was "knowingly."<sup>26</sup> However, now those decisions are immaterial as the requisite mens rea has been reduced to recklessness. This lower standard of proof will ultimately make it easier for the SEC to bring aiding and abetting charges against someone who assisted in the fraud but did not have actual knowledge of it.

In addition, the Act clarifies the SEC's ability to bring claims based on control-person liability.<sup>27</sup> Under the control-person theory, a person who directly or indirectly controls another person who commits a securities violation is responsible for that violation unless that person can show that they acted in good faith and did not directly or indirectly induce the violation.<sup>28</sup> The SEC had rarely asserted control-person claims in the past, as there were doubts about whether the SEC could bring them.<sup>29</sup> However, the Act now expressly authorizes that the SEC can bring such actions.<sup>30</sup> Thus, not

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<sup>22</sup> Baressi, et al., *supra* note 18.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> Dodd-Frank, *supra* note 1, at § 929M (to be codified at 15 U.S.C. § 78j).

<sup>26</sup> Crimmins, *supra* note 11.

<sup>27</sup> *Id.*

<sup>28</sup> Laura Greco, *The Buck Stops Where? Defining Controlling Person Liability*, 73 S. CAL. L. REV., Vol. 169, 173-74 (1999).

<sup>29</sup> *Id.*

<sup>30</sup> Dodd-Frank, *supra* note 1, at § 929P (to be codified at 15 U.S.C. § 78t).

only does the SEC have a new means to investigate and prosecute senior managers, directors and board members, it also makes companies significantly more vulnerable to personal liability for lower level employees' securities violations.

#### **D. SEC Funding**

In the past, the SEC has suffered from inadequate resources to examine and investigate the roughly 35,000 entities it regulates.<sup>31</sup> The SEC sought self-funding for its operations through the fees it collects from registrants, but Congress refused to provide it, despite the absence of significant opposition.<sup>32</sup> However, Dodd-Frank did provide for major funding increases from \$1.3 billion in 2011 to \$2.25 billion in 2015, nearly doubling the SEC's budget.<sup>33</sup> The Act also established a \$100 million reserve account, allowing the SEC more flexibility in its long term planning.<sup>34</sup> Overall, these increases should significantly boost investor protection and confidence, as the number and complexity of enforcement cases the SEC files will certainly increase.

#### **E. Fiduciary Standard for Brokers**

The SEC is moving swiftly to conduct a study on whether there are regulatory cracks in the protection of retail customers with regard to the differentiating fiduciary standards of brokers and investment advisers when they provide "personalized investment advice about securities to a retail customer".<sup>35</sup> Most investors don't know whether their adviser is an investment adviser or a broker, nor do they know that they are held to different standards.<sup>36</sup> Currently, brokers, unlike investment advisers, are not considered fiduciaries;

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<sup>31</sup> Stephen Grocer, *Want to Fix SEC's Revolving Door? Give the Agency More Money*, WALL ST J. BLOG (JUN 16, 2010), <http://blogs.wsj.com/deals/2010/06/16/want-to-fix-secs-revolving-door-give-the-agency-more-money/>.

<sup>32</sup> Crimmins, *supra* note 11.

<sup>33</sup> *Dodd-Frank*, *supra* note 1, at § 991(c) (to be codified at 15 U.S.C. § 78ee).

<sup>34</sup> *Id.*

<sup>35</sup> Suzanne Barlyn, *SEC 'Moving Rapidly' To Complete Fiduciary Study*, WALL ST J. BLOG (Sept. 30, 2010), <http://online.wsj.com/article/BT-CO-20100930-712110.html>.

<sup>36</sup> Susanne Craig, *The Debate Over Broker Standards*, N.Y. TIMES, Sept. 27, 2010,

this means they can sell products to their clients that might be the right fit for the client but not the most beneficial option for them.<sup>37</sup> On the other hand, investment advisers have an obligation to “act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice,” and to disclose “any material conflicts of interest.”<sup>38</sup> If the standard would be applied uniformly in both instances the consumer would not have to worry whether their interest is being put at the forefront. However, litigation would likely increase due to the higher standard and we also may see increased costs being passed on to the consumer.

The Act gives the SEC until January 2011 to complete the study, and it is expected that the SEC will create a uniform standard.<sup>39</sup> However, whether the standard will be the same as the current standard for investment advisers is unknown. The SEC could propose a uniform standard that ends up lowering the current standard for investment advisers.<sup>40</sup> Overall, there is no question that changes will come next year.

#### **F. Penalties in Administrative Proceedings**

The SEC has long had the power to seek monetary penalties against individuals, but had to do so through filing an action in federal court.<sup>41</sup> Now it can do so through an administrative action.<sup>42</sup> This will not only make it easier procedurally for the SEC to file more cases, but will also significantly reduce the rights and protections that defendants would have in a civil trial.<sup>43</sup> There is no right to a jury trial or pretrial discovery, and perhaps most importantly the administrative law judge’s decision is reviewed *de novo* by SEC commissioners.<sup>44</sup> However, this will also give defendants the chance to resolve cases through an administrative

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<sup>37</sup> *Id.*

<sup>38</sup> Crimmins, *supra* note 11.

<sup>39</sup> Craig, *supra* note 36.

<sup>40</sup> *Id.*

<sup>41</sup> David Woodcock & Michael Holmes, *Get Prepared for Dodd-Frank*, Vinson & Elkins (Aug. 4, 2010) available at <http://www.velaw.com/uploadedFiles/VEsite/Resources/Dodd-FrankAct080410.pdf>.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

action as opposed to a potentially more costly federal district court proceeding.

## **G. Other Investor Protection Provisions in Title IX**

### **1. Securities Industry-Wide Collateral Bars**

Previously, the SEC could only seek to suspend an individual from the type of business the person was in when he committed the violation.<sup>45</sup> For example, an investment adviser would only be barred from working as an investment adviser; he could still work as a broker. However, now the SEC may bar that person's association with any "broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization."<sup>46</sup> Essentially, the consequences of being collaterally barred have significantly increased and actors are likely to think twice before committing a violation.

### **2. Limitation on Required use of Arbitration**

The SEC now has the authority to restrict customer arbitration agreements.<sup>47</sup> The SEC can either limit or completely prohibit mandatory predispute arbitration clauses which are commonly found in investor client forms.<sup>48</sup> This provision follows the trend among legislatures and courts alike to limit the use of mandatory arbitration clauses.<sup>49</sup> Customers will likely have greater freedom to litigate their claims in court with a jury and judge. However, the SEC may decide not to restrict a company's ability to require that disputes be handled exclusively in a particular venue or that the right to jury trial be waived, these conditions are generally found in such agreements.<sup>50</sup>

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<sup>45</sup> Crimmins, *supra* note 11.

<sup>46</sup> *Id.*

<sup>47</sup> *Dodd-Frank, supra note 1, at § 921*(to be codified at 15 U.S.C. § 78o).

<sup>48</sup> *Id.*

<sup>49</sup> Barresi et al., *supra* note 18.

<sup>50</sup> *Id.*

### 3. **Deadlines for SEC Enforcement Actions, Inspections and Examinations**

In an effort to accelerate the enforcement action process, Section 929U requires the SEC to file an action against an individual or notify them of their intent not to no later than 180 days after providing a written Wells Notice.<sup>51</sup> The provision's intent is to combat the criticism that the SEC has let matters go unresolved for years.<sup>52</sup> The Act requires the SEC to file an action against an individual or notify them of their intent not to no later than 180 days after providing a written Wells Notice.<sup>53</sup> The Act authorizes an additional 180 day extension for investigations or examinations that are decided to be complex by the Director of the Division of Enforcement or a designee of the Director.<sup>54</sup> The deadlines should also provide at least some peace of mind to targets of SEC investigations, but the deadlines do not apply until the Wells Notice is provided, so the SEC might not go forward to that stage until they are fully prepared or the deadlines could create a more aggressive SEC.

#### H. **Likely Future Developments**

Instead of making reforms in an array of controversial areas regarding investor protection, Dodd-Frank directed the SEC to conduct a wide variety of studies most, due within eighteen months.<sup>55</sup> These include:

- the effectiveness of existing standards of care applicable to brokers, dealers and investment advisers in providing personalized investment advice and recommendations about securities to retail customers, and regulatory gaps relating to these issues;
- whether the SEC should engage the assistance of SROs in conducting examinations of investment advisers;
- the adequacy of examinations of investment advisory activities of dually registered broker-dealers and investment advisers and their affiliates;

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<sup>51</sup> Dodd-Frank, *supra* note 1, at § 929U (to be codified at 15 U.S.C. § 78d).

<sup>52</sup> Dunn, *supra* note 4.

<sup>53</sup> Dodd-Frank, *supra* note 51.

<sup>54</sup> *Id.*

<sup>55</sup> Crimmins, *supra* note 11

- the level of financial literacy of retail investors, and what means might be most effective to further educate them;
- potential improvements in disclosures to investors regarding financial intermediaries, investment products and investment services;
- methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products, including shares of open-end companies; and
- how to better facilitate investor access to information regarding disciplinary actions; regulatory, judicial and arbitration proceedings; and other information about registered investment advisers, brokers and dealers.<sup>56</sup>

Although these studies do not immediately change any laws, their conclusions will likely lead to future legislation in this arena.<sup>57</sup> The effect of investor protection is nearly impossible to accurately predict, but the studies and regulation should bolster it to a degree.

Ryan Kelly<sup>58</sup>

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<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> Student, Boston University School of Law (J.D. 2012).