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Financial Services Report

Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act

This report summarizes the major provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") passed by the U.S. House of Representatives on June 30, 2010 and awaiting approval by the U.S. Senate. The Dodd-Frank Act contains provisions impacting the largest financial institutions as well as regional banks and community banks throughout the country. Given the range of topics covered by the bill and the voluminous regulations to be implemented under the bill, the full impact of the Dodd-Frank Act will not be fully known for some time; however, it is clear that the federal bank regulatory agencies, as well as the new Consumer Financial Protection Bureau and the SEC, will have more authority and discretion to regulate and supervise financial institutions.

The following discussion focuses on those provisions of the Dodd-Frank Act which are generally applicable to, or otherwise impact, large, regional and small banks and thrifts located throughout the country.

Capital Requirements. After much discussion of the original Collins amendment, which would have prevented institutions from including trust preferred securities as Tier 1 capital, the final bill allows smaller institutions to continue to treat trust preferred securities as Tier 1 capital.

- *Trust Preferred Securities*. Holding companies with less than $15 billion in assets as of December 31, 2009 may continue to include trust preferred securities issued before May 19, 2010 as Tier 1 capital. Future issuances of trust preferred securities will be included as Tier 2 capital for these companies. Companies with assets greater than $15 billion as of December 31, 2009 must begin to reduce Tier 1 capital represented by trust preferred securities incrementally over a three-year period. **Timeline**: Bank holding companies required to reduce their Tier 1 capital over three years must begin doing so on January 1, 2013.

- *Capital Levels*. The Dodd-Frank Act requires the banking agencies to review and establish capital levels on a consolidated basis for depository institutions and holding companies. Although the Dodd-Frank Act does not provide specific guidance on these new capital levels, it does provide that the capital levels currently in effect will serve as a floor to any new capital requirements. Therefore, banks and bank holding companies should expect higher required capital levels in the future. In addition, the Dodd-Frank Act amends current law to provide that banking regulators should establish regulations such that capital levels required to be maintained should increase during times of economic expansion and decrease in times of economic contraction, subject to safety and soundness considerations.

Mortgage Reform and Minimum Lending Standards. The Dodd-Frank Act also requires the establishment of minimum standards for originating mortgages and regulates the compensation of mortgage brokers. **Timeline**: The mortgage amendments will become effective within 18 months of the transfer date, which will be 6 to18 months after the enactment of the Dodd-Frank Act (with a possible six-month extension).

- *Minimum Standards*. Mortgage lenders must not make residential mortgage loans unless the lender makes a "reasonable and good faith determination," based on verified and documented information, that the borrower has the ability to repay the loan. Among other things, the lender must verify amounts of income and assets that the lender relies upon to determine repayment ability. The Dodd-Frank Act provides a safe harbor pursuant to which there is a presumption that the ability to repay exists if several conditions are met; however, the Dodd-Frank Act specifically provides that the Federal Reserve may prescribe regulations that revise such criteria.

- *Defense to Foreclosure*. In a foreclosure action brought by a lender, a borrower may assert a violation of the minimum-standards provisions as a set-off or recoupment defense.

- *Compensation Limitations; Prohibited Penalties*. The Dodd-Frank Act generally prohibits compensation paid to mortgage originators to vary based on loan terms, other than the amount of the principal. The bill also limits prepayment penalties on traditional mortgages and prohibits such penalties on more complex loan products.

Consumer Financial Protection Bureau. The Dodd-Frank Act provides for the establishment of a Consumer Financial Protection Bureau that will have broad authority to develop and implement rules regarding most consumer financial products. **Timeline**: The provision relating to the new Consumer Financial Protection Bureau will become effective on the transfer date, which will be 6 to18 months after enactment of the Dodd-Frank Act (with a possible six-month extension).

- *Scope of Bureau's Authority*. The Bureau will be an agency of the Federal Reserve and will be funded by the Federal Reserve. Its director will be appointed by the President and confirmed by the Senate. The Bureau's sole focus will be on developing, implementing and, with respect to financial institutions with more than $10 billion in assets, enforcing consumer protection rules. Financial institutions with less than $10 billion in assets will be subject to the Bureau's rules; however, these institutions' primary federal regulators will supervise compliance with these rules. The Bureau will also have the authority to implement rules regulating the activities of non-bank entities such as payday lenders, debt settlement firms and debt counseling firms.

- *Appeal of Bureau Rules*. The federal bank regulatory agencies can appeal a proposed rule to the Financial Services Oversight Council (see below) on the basis that the rule threatens the safety and soundness of the banking system, and the Council may veto the proposed rule (two-thirds vote required to veto).

Sale of Mortgage Loans. The SEC and federal banking agencies are required to establish regulations to require any issuer of an asset-backed security to retain five percent (5%) of the credit risk for any asset, including certain residential mortgage assets that the issuer transfers, sells or conveys to a third party. **Timeline**: Regulations to be established within 270 days from the date of enactment.

- *Risk Retention*. Regulations to be implemented will prohibit an issuer from directly or indirectly hedging or transferring the credit risk that the issuer is required to retain.

- *Exception for Traditional Mortgages*. There will be an exemption for qualified residential mortgages. The term "qualified residential mortgage" will be defined by the appropriate banking regulators taking into account underwriting and product features that historically indicate a lower risk of default, e.g., documentation of income and the ratio of mortgage payments to income.

FDIC Insurance-Related Provisions. Many of the FDIC provisions below are a codification of similar programs enacted as a result of the financial crisis at the end of 2008 or are in direct response to the significant number of bank failures resulting from the crisis.

- *FDIC Assessment Base*. For purposes of calculating assessments related to FDIC insurance, the assessment base for depository institutions will be based on the total assets of the depository institution, less tangible equity. The assessment base has historically been based on the deposit liabilities of depository institutions, less certain items. This new calculation should be advantageous to community banks, as community banks rely more heavily on deposits to fund lending activities than do larger banks. **Timeline**: Effective upon enactment.

- *Deposit Insurance Fund (DIF)*. Pursuant to the Dodd-Frank Act, the DIF is no longer capped at 1.5% of insured deposits, and the FDIC is no longer required to refund amounts in the DIF that exceed the 1.5% of insured deposits. **Timeline**: Effective upon enactment.

- *FDIC Insurance Limits*. FDIC deposit insurance is permanently increased to $250,000, with retroactive application to any depository institution for which the FDIC was appointed as receiver between January 1, 2008 and October 3, 2008. FDIC insurance on non-interest-bearing transaction accounts will be fully insured by the FDIC through January 1, 2013. It should be noted that the unlimited insurance on transaction accounts does not extend to NOW accounts and IOLTAs, as the Transaction Account Guarantee Program did. **Timeline**: Effective upon enactment.

- *Interest on Transaction Accounts*. The Dodd-Frank Act repeals the current prohibition on paying interest on transaction accounts. **Timeline**: Amendment goes into effect one year after enactment.

- *FDIC Debt Guarantee*. The FDIC will have the authority to guarantee the debt of solvent insured depository institutions and their holding companies, similar to the Temporary Liquidity Guarantee Program enacted near the end of 2008. The Federal Reserve and the FDIC must determine that there is a liquidity event that threatens the financial stability of the United States, and the Treasury must approve the terms of the guarantee program.

Preemption Standards for National Banks. National banks will be permitted to preempt state consumer laws only pursuant to the standards set forth in the Dodd-Frank Act. Pursuant to the Dodd-Frank Act, a state consumer law can be preempted only if (i) the application of such law would discriminate against national banks; (ii) the state law "prevents or significantly interferes" with the exercise of the national bank's powers (current OCC preemption rules refer to "obstructing or interfering" with the exercise of powers); or (iii) the state consumer law is preempted by other federal law. These preemption provisions will likely make national bank preemption of state consumer protection laws more difficult, as these standards appear to be higher standards than those of the OCC, and will give state attorneys general greater authority to enforce state consumer protection laws against national banks. **Timeline**: Effective upon enactment.

Abolishment of OTS. The OTS will be merged into the OCC; however, the thrift charter will continue to exist. The OCC will take over responsibility for supervising federal savings associations and is expected to create a separate division to supervise savings associations. The Federal Reserve will take over responsibility for supervising savings and loan holding companies and any other subsidiary (other than a depository institution) of a savings and loan holding company. The FDIC will take over the OTS' duties in supervising state savings associations. **Timeline**: OTS abolished 90 days after the 12-month period following the enactment of the Dodd-Frank Act (with a possible extension of six months).

Federal Reserve Supervisory and Emergency Lending Powers. The Federal Reserve's supervisory powers remain intact, while its emergency lending powers are subject to more regulation.

- *Supervisory Powers*. The Federal Reserve will continue to supervise state member banks as well as bank holding companies. In addition, the Federal Reserve will also supervise savings and loan holding companies in connection with the abolishment of the OTS (described above).

- *Emergency Powers*. The Federal Reserve must establish regulations to ensure that any future Federal Reserve emergency lending is for liquidity purposes only and not aid failing institutions. Furthermore, the Federal Reserve is prohibited from lending to insolvent borrowers or allowing insolvent borrowers to participate in broad-based emergency programs. The Federal Reserve is required to publish the counterparties to transactions conducted pursuant to its emergency powers. The Comptroller General of the United States is authorized to conduct audits of future transactions conducted pursuant to the Federal Reserve's emergency powers as well as a one-time audit on the emergency programs enacted by the Federal Reserve since December 1, 2007.

Interchange Fees for Debit Transactions. The Dodd-Frank Act has given the Federal Reserve the authority to prescribe rules to regulate the reasonableness of interchange fees charged by financial institutions with $10 billion or more in assets with respect to electronic debit transactions. **Timeline**: Regulations to be implemented within nine months from the enactment of the Dodd-Frank Act.

- *Reasonable Fees*. The bill provides that the amount of interchange fees that issuers may charge must be "reasonable and proportional" to the cost incurred by the issuer. The Federal Reserve is directed to prescribe regulations not later than nine months after the date of the enactment of the bill that will establish standards to determine whether an interchange fee is reasonable and proportionate.

- *Exemption for Smaller Institutions*. The interchange fee provisions of the Dodd-Frank Act provide an exception for small issuers, i.e., issuers that, together with their affiliates, have assets of less than $10 billion. The interchange fee provisions also will not apply to certain government-administered payment programs and certain prepaid debit cards.

Volcker Rule. The Dodd-Frank Act amends the Bank Holding Company Act of 1956 to limit banking entities' ability to engage in proprietary trading and to own interests in hedge funds or private equity funds. A banking entity must limit its ownership interest in a hedge fund or private equity fund to 3% of the total ownership interests of the fund. The total aggregate of all of the banking entity's interests in such hedge funds or private equity funds may not exceed 3% of the Tier 1 capital of the banking entity. The term "banking entity" is defined to include an insured depository institution, any company controlling an insured depository institution and such company's affiliates and subsidiaries. A banking entity must bring activities and investments into compliance no later than two years after the requirements of this section become effective (three one-year extensions may be requested). The aim of this provision is to reduce the amount of speculative investments on large firms' balance sheets. **Timeline**: The effective date is the earlier of (i) 12 months after the issuance of rules on implementation or (ii) two years after the date of enactment of the bill.

Regulation of Derivatives/Swaps. The Dodd-Frank Act establishes a regulatory framework for the derivatives market and restricts federally insured depository institutions from participating in some of the riskiest derivative and swap transactions.

- *Derivatives Regulation*. Requires the promulgation of new SEC and CFTC regulation of the over-the-counter derivatives market, including any puts, calls, caps, floors, collars or similar options based on the value of one or more interest rates or currency, commodity, security, instrument of indebtedness, index, quantitative measure or other financial or economic interest. In addition, the bill gives the CFTC the authority to issue rules requiring the public disclosure of swap transactions' pricing data. **Timeline**: The bill requires such rules to be issued within 360 days after the date of enactment of the Dodd-Frank Act.

- *Banks Must Spin Off Derivatives Activities*. A federally insured depository institution must establish a separately capitalized affiliate to engage in higher-risk swap transactions such as uncleared credit default swaps. The precise nature of the affiliations that will be permitted will be defined in regulations to be adopted. **Timeline**: Banks will have up to 24 months to transfer the swaps activity into an affiliate or cease the activities that require registration as a swaps entity after the rules are effective, which will be one year after enactment of the bill.

- *Certain Lower-Risk Activities Permitted*. A bank must limit its own swap or derivatives activity to hedging, interest rate swaps or foreign exchange swaps, or similar risk-mitigating activities directly related to a traditional bank's activities, which generally includes assets that are permissible for investment by a national bank.

The Dodd-Frank Act also contains numerous provisions focused primarily on the regulation and supervision of larger, publicly traded banking institutions and non-bank institutions that present potential systemic risks to the banking industry. These provisions include the following:

Financial Services Oversight Council. The Dodd-Frank Act creates a ten (10) member Council that is authorized and directed to determine which large bank and non-bank entities are systemically significant and should be subject to stricter regulation. The Council will include the Secretary of the Treasury, Chairman of the Federal Reserve, FDIC Chairman, Comptroller of the Currency, SEC Chairman, CFTC Chairman, Federal Housing Finance Agency Chairman, Director of the Consumer Financial Protection Bureau, Chairman of the National Credit Union Administration and an individual selected by the President. The Federal Reserve will have supervisory authority over the applicable bank holding companies ($50 billion or more in assets) and non-bank entities designated by the Council and will have authority to set more stringent capital, liquidity and leverage requirements for these entities. **Timeline**: The provision establishing the Council will be effective upon enactment of the Dodd-Frank Act. The Federal Reserve will have 18 months to implement the regulations for capital, liquidity, leverage, etc.

Resolution Authority. The Dodd-Frank Act creates an orderly liquidation procedure for the resolution of failing bank holding companies, non-bank financial institutions supervised by the Federal Reserve (pursuant to a determination by the Council described above) and any other company that is primarily engaged in activities that are financial in nature, which pose a significant risk to the financial stability of the United States.

- *Systemic Risk Determination*. The Federal Reserve and the appropriate federal regulator must make a determination by a two-thirds vote that a banking institution poses a systemic risk; for financial companies, the Federal Reserve and the FDIC must make the recommendation; for a broker-dealer, the SEC and the Federal Reserve must make the recommendation; for an insurance company, the Federal Insurance Office (see below) and the Federal Reserve must make the recommendation. Once the determination is made, a recommendation is provided to the Treasury, and the Secretary of Treasury, in consultation with the President, can make the determination that the company poses a systemic risk.

- *Orderly Liquidation Process*. The Treasury thereafter may appoint the FDIC as receiver to resolve the failing systemically important company. In resolving such company, the FDIC must ensure that: (i) the shareholders of the company do not receive payments until after all other claims are repaid; (ii) creditors bear losses in accordance with the claims procedure; (iii) management and the board of the failing company are removed; and (iv) the FDIC does not take an equity interest or become a shareholder in any failing company of which the FDIC is appointed receiver. Once appointed, the FDIC has rights and obligations similar to its authority to resolve failed depository institutions, including a statutory claims process for the filing of claims with the FDIC.

- *Funding*. The bill provides that no taxpayer funds shall be used in the liquidation of a financial company under the resolution authority and that taxpayers shall bear no losses from the liquidation of the systemically important company. The final conference report removed any requirement to provide a pre-funded amount of liquidation. Instead, a fund will be created within the Treasury that will be used to fund any orderly liquidation, and the FDIC will have access to a line of credit from the Treasury. Repayment to the Treasury, if any, will be funded by assessments on regulated institutions with assets greater than $50 billion.

Corporate Governance Matters. The Dodd-Frank Act includes a variety of provisions intended to increase shareholders' rights and improve disclosure of compensation matters. The bill also directs the federal bank regulators to issue joint rules on compensation paid by financial institutions with at least $1 billion in assets (it is unclear whether the recently issued Interagency Policy on Incentive Compensation will be deemed to be the type of rulemaking required by the bill).

- *Say on Pay*. Similar to the TARP requirements, the bill requires publicly traded financial services companies to obtain a non-binding shareholder vote to approve compensation of named executive officers as disclosed in the proxy statement at least once every three years. **Timeline**: The effective date is the first shareholder meeting after the end of the six-month period beginning on the date of the bill's enactment.

- *Golden Parachutes*. In any proxy vote in which shareholders of publicly traded financial services companies are asked to approve an acquisition, merger, consolidation or proposed sale, the company making such solicitation shall disclose in the proxy any agreements or understandings that such a company has with any named executive officers of such issuer concerning any type of compensation that is based on or otherwise relates to the acquisition, and the aggregate total of all such compensation that may be payable to such executive officer upon consummation of the acquisition. Any such proxy must contain a non-binding shareholder vote to approve such agreements or understandings and compensation as disclosed. **Timeline**: The effective date is the first shareholder meeting at which shareholders are asked to approve an acquisition, merger, consolidation or proposed sale after the end of the six-month period beginning on the date of enactment of the bill.

- *New Executive Compensation Disclosure; Clawbacks*. The bill requires enhanced compensation disclosure showing compensation paid compared with financial performance of the issuer. In addition, each issuer will be required to develop policies for the recovery of incentive-based compensation from any current or former executive that was paid based on erroneous accounting information. **Timeline**: Effective upon enactment.

- *Shareholder Access*. The bill authorizes the SEC to issue rules that permit shareholders to include their nominees for director elections in the issuer's proxy solicitation materials. **Timeline**: The SEC will have the authority to issue these rules on the date of enactment of the bill.

- *SOX 404(b) Exemption for Smaller Issuers*. The bill also permanently exempts publicly traded companies with less than $75 million in public float from complying with the requirement in Section 404(b) of the Sarbanes-Oxley Act of 2002 to include an auditor attestation report on the issuer's internal control over financial reporting. **Timeline**: The smaller issuers will be exempt from SOX 404(b) on the date of enactment of the bill.

- *Fiduciary Duty of Broker-Dealers*. The bill authorizes the SEC to establish a fiduciary duty for brokers and dealers when providing personalized investment advice to retail customers—this proposed duty is the same standard applicable to investment advisers. **Timeline**: The authority granted pursuant to this section is effective upon the date of enactment of the bill.

Hedge Funds. The Dodd-Frank Act requires advisers to hedge funds and private equity funds to register with the SEC as investment advisers and provide information about their trades and portfolios necessary to assess systemic risk. **Timeline**: These new requirements become effective one year after the date of enactment of the bill.

- *Document Retention*. The SEC is required to conduct periodic and special inspections of the records of hedge funds and private equity funds maintained by an investment adviser.

- *Exemptions*. There is a carve-out in the bill exempting investment advisers to venture capital firms (to be defined by the SEC within one year of the date of enactment of the bill) from the new registration requirements. The bill specifically exempts any investment adviser to hedge funds and private equity funds that has assets under management in the United States of less than $150 million. Family offices are not included under the definition of investment adviser.

Credit-Rating Firms. The Dodd-Frank Act introduces a strict regulatory framework for credit-rating firms to improve quality of ratings, objectivity and accountability for poor analysis. **Timeline**: The SEC is required to issue rules with respect to credit rating firms within one year of the date of enactment of the bill.

- *SEC Oversight of Firms*. The bill creates an Office of Credit Ratings at the SEC with its own compliance staff and authority to fine agencies. The SEC will be required to examine Nationally Recognized Statistical Ratings Organizations (NRSROs) at least once a year and publicize findings. NRSROs will be required to submit an annual report to the SEC that will contain an assessment of the effectiveness of the internal controls and an attestation of the chief executive officer of the NRSRO. The SEC will have the authority to suspend or revoke the registration of NRSROs if it determines that a firm does not have the financial and managerial resources to consistently produce credit ratings with integrity.

- *Private Right of Action for Investors; Expert Liability*. The bill also introduces a private right of action for investors against rating agencies for a "knowing or reckless" failure to conduct a reasonable investigation. NRSROs will also be subject to "expert liability" with the nullification of Rule 436(g) of the Securities Act, which provides an exemption for ratings provided by NRSROs from being considered part of the registration statement.

Insurance. The Dodd-Frank Act creates a new federal agency with respect to insurance, but it does not include any provisions regarding a federal insurance charter. The bill establishes the Federal Insurance Office within the Treasury, which among other things would (i) monitor all aspects of the insurance industry, (ii) monitor the extent to which underserved communities have access to affordable insurance products, (iii) recommend to the Oversight Council that an insurer be regulated as a non-bank company by the Federal Reserve, and (iv) determine when state insurance measures are preempted. The Financial Insurance Office's authority does not apply to health insurance matters.

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