Obama Administration Enacts Sweeping Financial Regulatory Reform

July 21, 2010

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Act**") into law. The Act represents the most comprehensive reform of the U.S. financial regulatory framework in generations. Although many important details have been left to individual agencies and bureaus to define through administrative rulemaking, the broad contours of the new regulatory framework are now apparent. This Alert provides a high-level overview of major features of the Act and its likely impact on the U.S. financial services industry:

- ***Proprietary Trading***. The Act curtails in certain respects the ability of banks, bank holding companies and their affiliates and subsidiaries to engage in proprietary trading and invest in or sponsor private equity and hedge funds.
- ***Consumer Financial Protection Bureau***. The Act creates an independent bureau within the Federal Reserve Board ("**FRB**") that consolidates federal rulemaking and enforcement authority over a wide range of consumer financial products and services.
- ***Systemic Risk Regulation and Resolution Authority***. The Act creates an interagency Financial Stability Oversight Council ("**Council**"), supported by an Office of Financial Research, to monitor and respond to systemic risks to the financial system. The Act provides the Council with authority to bring "systemically" important nonbank financial companies under the supervision of the FRB, and to recommend to primary financial

regulators heightened prudential regulatory standards (e.g., leverage limits, risk-based capital requirements, etc.) for institutions or activities contributing to systemic risk. The Act establishes a new orderly liquidation authority for liquidating financial companies in certain circumstances. Under the new authority, which is modeled in large part on the Federal Deposit Insurance Act, the Treasury Secretary may appoint the Federal Deposit Insurance Corporation ("**FDIC**") as receiver of any financial company (including nonbank financial companies) if certain conditions are satisfied.

- ***Regulation of Advisers to Hedge Funds and Private Equity Funds***. The Act requires U.S. and foreign advisers to hedge funds and private equity funds to register with the Securities and Exchange Commission ("**SEC**"), maintain books and records and file reports with the SEC, and comply with the Investment Advisers Act of 1940 (the "**Advisors Act**").
- ***Interchange Rate Regulation and Other Payment Card-Related Provisions***. The Act authorizes the FRB to promulgate regulations governing the reasonableness of interchange fees charged by issuers with respect to electronic debit transactions. The statutory language essentially equates "reasonable" with the incremental cost incurred by the issuer with respect to each individual debit transaction. In addition, merchants will now be allowed to offer discounts preferring a particular form of payment, whether cash, credit, or debit, thus paving the way for the elimination of industry-wide bans on surcharges and credit card minimums.
- ***Swaps and Derivatives Reform***. The Act requires banks to establish non-federally insured affiliates for the purpose of trading certain "risky" derivatives and establishes a clearing house structure to be approved and monitored by the SEC and the Commodities Futures and Exchange Commission ("**CFTC**").
- ***Securitization***. With certain exceptions, the Act generally requires securitizers to retain not less than 5% of the credit risk of any asset transferred, sold or conveyed through the issuance of an asset-backed security.
- ***Credit Rating Agencies***. The Act strengthens SEC oversight, mandates significant corporate governance and employee conflict of interest standards, and requires increased disclosure of rating agency methodologies and performance.

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I. Proprietary Trading ("The Volcker Rule").

Section 619 of the Act, commonly referred to as the "Volcker Rule," generally prohibits banks and bank holding companies with U.S. operations, their affiliates and subsidiaries (collectively, "**banking entities**") from engaging in most proprietary trading activities and from investing in or sponsoring private equity and hedge funds (collectively, "**private funds**"). A banking entity may, however, sponsor and invest in a private fund if the banking entity's total investment in the fund does not exceed 3% of the fund’s equity and the banking entity’s total outstanding investments in all private funds does not exceed 3% of the banking entity’s Tier 1 capital. A banking entity may provide capital in excess of the 3% single fund cap when seeding a private fund with start-up capital but must reduce its investment to meet the 3% cap within a year of the private fund’s initial closing through dilution, redemption, or other means. In no event, however, may a banking entity invest in a private fund if it would (a) involve or result in a conflict of interest between a banking entity and its clients, customers or counterparties, (b) materially expose the banking entity to high-risk assets or trading strategies, (c) pose a threat to the safety and soundness of the banking entity, or (d) pose a threat to the financial stability of the banking entity or the United States.

The Volcker Rule also limits the types of transactions banking entities and their affiliates may enter into with private funds they manage, advise or sponsor. With a limited exception for certain prime brokerage accounts, these transactions will now be subject to the same limitations imposed on transactions between member banks and their affiliates under Sections 23A and 23B of the Federal Reserve Act. Subject to these limitations, banking entities may continue to act as investment managers to private funds.

The Volcker Rule will not apply to systemically significant non-bank financial companies; however, such companies will be subject to additional capital requirements and quantitative limits on fund investment and sponsorship activities promulgated by the FRB.

The Volcker Rule will become effective on the earlier of (a) 12 months after the date regulators issue final implementing rules or (b) two years after the date the Act is enacted. Banking entities and nonbank financial companies will then have up to two additional years to bring their activities and investments into compliance, with the possibility of up to three one-year extensions if granted by regulators. A banking entity may apply for an additional 5-year extension for any one fund if the banking entity had a contractual obligation in effect on May 1, 2010 to invest in or provide capital to an “illiquid fund,” generally defined as private funds that invest in private equity, real estate, and venture capital investments. Whether any of these extensions will run concurrently is unclear from the text of the statute and will be left to regulators to determine. Regulators may impose additional capital requirements and other restrictions on banking entities’ private fund investment activities during the transition period.

Ultimately, the ramifications of the Volcker Rule for banking entities and nonbank financial companies will depend greatly on the scope of the final rules and regulations implemented by federal regulators. Some banking entities undoubtedly will elect to divest certain fund interests, thereby creating opportunities for suitable buyers. Further, opportunities for banking entities to continue sponsoring such funds may be limited if investors insist on capital commitments by fund sponsors greater than the Volcker Rule will allow, or if investors see greater value in investing with sponsors that have the ability to make additional cash infusions when a fund is in danger of failing.

II. Consumer Financial Protection Bureau.

The Act creates a new financial regulator, the Consumer Financial Protection Bureau ("**CFPB**"), with authority to enact consumer protection rules governing all financial institutions —including banks and non-banks— that offer consumer financial products or services. The CFPB will have enforcement authority over banks and credit unions with assets in excess of US$10 billion, as well as all mortgage-related businesses (*e.g*., originators, servicers and brokers), pay day lenders, student loan originators, debt collectors and consumer reporting agencies. The CFPB consolidates the consumer protection responsibilities previously held by several federal agencies, including the Office of the Comptroller of the Currency ("**OCC**"), the Office of Thrift Supervision (abolished by the Act), Federal Deposit Insurance Corporation ("**FDIC**"), the FRB, National Credit Union Administration ("**NCUA**"), the Department of Housing and Urban Development ("**HUD**"), and the Federal Trade Commission ("**FTC**"). The CFPB will have responsibility for overseeing the enforcement of existing federal consumer financial services and fair lending statutes.

Autonomous and Independent Bureau. Although the CFPB is designated as a bureau within the FRB, the CFPB is fully autonomous with a director appointed by the U.S. President and subject to Senate confirmation. The Act expressly prohibits the FRB from intervening in any proceeding or enforcement action before the CFPB, and no rules or orders promulgated by the CFPB are subject to Fed review or approval. The U.S. Treasury Secretary will serve as interim director until the new director is appointed.

Authority to Regulate "Abusive" Practices. The Act provides the CFPB authority to enforce existing federal consumer financial protection statutes and, in addition, provides the new bureau a supplemental grant of authority to regulate "abusive practices" with respect to consumer financial products and services. Although it is difficult to know how the CFPB may interpret what constitutes an "abusive practice,"[1] this formulation represents a potentially significant expansion of existing federal consumer protection regimes prohibiting "deceptive acts and practices." Industry participants subject to CFPB regulation and oversight should expect to see expanded prohibitions on consumer financial services and products beyond the existing case law and prior FTC and federal banking agency precedent.

Shift from Disclosure-Based to Prohibition-Based Regulation. The Act directs the CFPB to adopt new disclosure rules to assist consumers of financial services and products to understand the "costs, benefits, and risks associated with the product or service" and expressly prohibits certain consumer financial products and practices. This legislative judgment to ban products (as opposed to simply mandating more robust disclosures) represents a major departure from prior consumer protection regimes with perhaps unintended consequences. As a result of banning some products outright, some consumers can expect to pay higher prices and have fewer financial services and products available to them.[2]

Preemption and the Potential Expansion of State Regulation of Consumer Financial Services. Individual states may bring civil actions to enforce the provisions of the Act against state-chartered entities, national banks or Federal savings associations. In addition, states may adopt their own consumer financial services laws, so long as the state law affords consumers "greater protection" than is otherwise provided by the Act. Stated differently, the Act establishes a regulatory floor for consumer financial protection, but permits the states to enact and enforce different or stricter substantive rules. Here again, industry participants should expect an increase in state enforcement activities as a result of the Act, and brace for the possibility of an even more complex web of overlapping or conflicting state law consumer financial protection regimes that require state-specific compliance strategies. Coupled with the increase in statutory penalties under certain federal consumer financial services statutes authorized by the Act, the potential expansion of liability under the CFPB is significant.

That said, the Act provides several bright spots for industry participants. First, the Act saves from preemption only "state consumer financial laws," that is, state laws that "directly and specifically" regulate the "manner, content, or terms and conditions of any financial transaction." State law consumer protection regimes of generally applicability, such as state unfair and deceptive acts and practices statutes, would seem to be preempted to the same extent as before adoption of the Act. In effect, then, the Act adopts a clear statement principle, requiring states to specifically enact consumer financial protection laws to avoid preemption. Second, state attorneys general (or their equivalents) are prohibited from bringing enforcement actions against national banks or federal savings associations except to enforce the specific provisions of the Act or its implementing regulations. Third, the Act preempts state law in accordance with the standard announced in *Barnett Bank v. Nelson*, 517 U.S. 25 (1996) and as determined by any court or by regulation or order of the OCC.

III. Systemic Risk Regulation.

One of the key concerns animating the desire for regulatory reform was the perception that the government had been compelled to "bail-out" institutions that were "too big to fail," *i.e.*, institutions the failure of which, due to size, leverage and interconnectedness, threaten the financial system. The framers of the Act sought to establish a framework for the identification and regulation of such institutions and, ultimately, for their resolution in the even of a failure. Congress's approach to financial and systemic stability centers around a new multi-agency Financial Stability Oversight Council ("**Council**") composed of the Secretary of the Treasury (who serves as chair), the Chairman of the Board of Governors of the FRB System, the Comptroller of the Currency, the Director of the CFPB, the Chairman of the SEC, the Chairperson of the FDIC, the Chairperson of the CFTC, the Director of the FHFA, the Chairman of the NCUA, and an independent member appointed by the U.S. President (all of the foregoing, voting members[3]).

The role of the Council is to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace, and to respond to such risks. To support the Council's role, the Office of Financial Research is given the authority to collect data on the activities of bank holding companies and large nonbank financial companies—including insurance companies and hedge funds—to assess their systemic significance.

By two-thirds vote (including the Treasury Secretary), the Council may determine that a U.S. nonbank financial company shall be supervised by the FRB and subject to prudential standards if the Council determines that material financial distress of the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States. The factors to be considered in making such a determination include leverage; off-balance-sheet exposures; transactions and relationships of the company with other significant companies; the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system; the extent to which assets are managed rather than owned by the company; the extent to which ownership of assets under management is diffuse; the nature, scope, size, scale, concentration, interconnectedness of the company; and the degree of reliance on short-term funding. Any entity that was a bank holding company on January 1, 2010, with more than US$50 billion in assets (including certain successor entities as defined by