THE DODD-FRANK ACT AND THE FINANCIAL CRISIS OF 2008

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IN THE UNITED STATES, MAJOR FINANCIAL REGULATORY REFORM ONLY OCCURS AFTER A SERIOUS FINANCIAL CRISIS

- GREAT STOCK MARKET CRASH OF 1929 AND DEPRESSION OF 1930'S

SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934

- ENRON SCANDAL OF 2001

SARBANES-OXLEY ACT OF 2002

- FINANCIAL CRISIS OF 2008

DODD-FRANK ACT OF 2010

BUT, U.S. FINANCIAL LEGISLATION USUALLY DELEGATES THE ACTUAL RULE-MAKING TO ADMINISTRATIVE AGENCIES

For example, the Dodd-Frank Act mandates:

1. Creation of at least 243 new rules by administrative agencies (including 95 by the SEC, 61 by the CFTC, and 54 by the Federal Reserve)
2. Preparation of 67 one time reports or studies by government agencies
3. Preparation of 22 new periodic reports by agencies

BUT, CONGRESS HAS NOT INCREASED THE SEC'S BUDGET TO COMPLETE ALL THIS WORK

ACCORDINGLY, ALTHOUGH THE DODD-FRANK ACT IS A VALID LAW, THE FINANCIAL REFORM IT REPRESENTS IS NOT YET COMPLETED

- Much rule-making and other work remains to be done by government agencies
- Interested third parties, including financial institutions, private equity funds and securities law firms, all continue to try to influence the final shape of the rules
- Still, many of the major regulatory innovations can be seen from the Act itself, and can be analyzed and discussed

BASIC FEATURES OF THE DODD-FRANK ACT

1. Systemic Risk Regulation
2. Orderly Liquidation Authority
3. The Volcker Rule (limitations on proprietary trading by financial institutions)
4. Derivatives Regulation
5. Investor Protection (including rating agencies and hedge fund regulation)
6. Corporate Governance

SYSTEMIC RISK REGULATION

- Under the Act, federal regulators must establish enhanced prudential standards for all systematically important financial institutions.

- These will be promulgated by the Federal Reserve Board, (the main U.S. banking regulator), with input from the newly created Financial Stability Oversight Council. The new standards are due within 18 months of enactment of the Act.

- The new prudential standards will include enhanced risk-based capital, leverage and liquidity requirements, overall risk management requirements, resolution plans, and credit exposure reporting.

SYSTEMIC RISK REGULATION

- Because of their central role in the economy, banking activities, and particularly the risks undertaken by banks, have been a matter of careful government scrutiny and regulation.
- In the U.S., the financial crisis of 2008 appears to have been brought on by the collapse of companies like Bear Stearns, Lehman Brother and AIG, *none of which were banks*.
- This raises the question:

WHAT IS A BANK?

- Commercial Banks?
- Bank Holding Companies?
- Investment (Merchant) Banks?
- Insurance Companies?
- Investment Funds?
- In the United States, these have traditionally been regulated by different agencies and even by different levels of government.

FINANCIAL STABILITY OVERSIGHT COUNCIL

- Established by Dodd-Frank
- 15 members (10 voting) consisting of the heads of all major federal agencies with regulatory authority over financial institutions
- Purpose is to identify risks to U.S. financial stability and recommend “enhanced prudential standards” for “systematically important” financial institutions.

SYSTEMATICALLY IMPORTANT NONBANK FINANCIAL INSTITUTIONS

- Bank Holding Companies with more than $50 billion in assets automatically included.
- Bank Holding companies receiving TARP funds included forever (“Hotel California” provision)
- Financial Stability Oversight Council can designate others.
- Must be “predominantly engaged in financial activities” defined to include, among others, securities underwriting, dealing and market-making, insurance activities, and merchant banking activities.
- May include foreign banks, bank holding companies and other financial institutions

Enhanced Prudential Standards: Some Questions

- Given the relationship between risk and return, will enhanced prudential standards lead to lower returns for shareholders of systematically important financial institutions?
- Will it place them at a competitive disadvantage relative to less regulated (less important) financial institutions?
- Will it place them at a competitive advantage as financial institutions recognized as "too big to fail?"
- Should the government be regulating institutions or institutional practices, regardless of size?

IN 2008-09, THE UNITED STATES GOVERNMENT "BAILED OUT" MANY MAJOR FINANCIAL INSTITUTIONS

Were they "too big to fail?"

Created serious political controversy

Was the financial crisis of 2008 the result of "moral hazard?"

Orderly Liquidation Authority

- Available for any financial firm, but only in extreme and unusual cases
- Essentially makes the FDIC the receiver for insolvent firm with power to liquidate assets.
- Power to “cherry pick” and transfer assets to third party without creditor or court approval
- Attempts to harmonize with creditors rights under bankruptcy code
- Possible “haircuts” for senior creditors
- Potential claims by FDIC against senior executives and directors for gross negligence, recovery of compensation and bans on service

RESOLUTION PLANS (“LIVING WILLS”)

- Required of Bank Holding Companies and Systematically Significant Nonbank Financial Institutions
- Must provide information that would facilitate an orderly resolution of claims under the U.S. Bankruptcy Code
- Includes information on ownership structure, cross guarantees, pledged collateral, assets, liabilities, etc.
- Reviewed by regulatory authorities
- Non-binding on courts or parties
- May be important for trans-national firms

CONTINGENT CAPITAL

- Debt issued by a corporation that automatically converts to equity upon the occurrence of a triggering event. (Possible triggers: bank's capital falls below a certain level, company defaults on a debt.)
- Dodd-Frank mandates a study of contingent capital by the General Accounting Office and permits the Federal Reserve to require it of systematically important financial firms.

Restrictions on Proprietary Trading (the “Volcker Rule”)

- As part of the banking reforms of 1933, Congress passed the Glass-Steagall Act, prohibiting commercial banks from engaging in securities underwriting or proprietary trading in equity securities.

- Glass-Steagall was repealed in 1999 as part of the deregulation of the financial industry.

- By 2008, that no longer seemed such a good idea, and former Federal Reserve Chair, Paul Volcker, proposed that the restrictions on proprietary trading by banks be reinstated.

- Such a restriction, although not in the original version of Dodd-Frank, was eventually included after being endorsed by President Obama.

The Volcker Rule

- Current law applies only to “banking entities” but can be extended by Federal Reserve to all systematically important nonbank financial institutions, i.e. all investment banks.
- Likely to result in higher capital requirements and ownership restrictions on such institutions.

The Rule has two principal elements:

- A ban on proprietary trading, subject to certain limited exceptions
- A ban on investing in hedge funds or private equity funds or sponsoring such funds, except for a 3% ownership stake. Such investments cannot exceed 3% of Tier 1 capital.

Rationales for the Volcker Rule

- Reduction of systemic risk for institutions subject to the Rule
- Removal of implicit federal guarantee for institutions not subject to the Rule
- Mild divestiture/antitrust considerations
- Fairness considerations/insider trading reduction

Exceptions to the Ban on Proprietary Trading

- Trading in U.S. debt
- Underwriting or market making activities
- “Risk-mitigating” hedging transactions
- Transactions made for customers

WILL THE EXCEPTIONS DESTROY THE RULE?

- Depends on how strictly the implementing regulations are written and enforced
- The Rule is politically popular and constitutes one of the few significant restrictions on large financial institutions in the Act.
- But financial institutions can increase bargaining power by threatening to move their proprietary trading activities overseas.

SECURITIZATION AND DERIVATIVES REGULATION

- A major perceived cause of the 2008 financial crisis was the huge increase in questionable housing and construction loans made by banks and other financial institutions in the prior decade.
- The banks willingness to make such loans was seen as the result of the increased ability to securitize such loans and sell them to other investors.

CREDIT RISK RETENTION

Under the Act, securitizers must retain at least 5% of the credit risk of the securitized loans or CDOs.

Securitizer may not hedge or transfer risk.

Securitizer must perform due diligence and provide it to investors.

CREDIT DEFAULT SWAPS

- Another perceived factor in the financial crisis of 2008 were the very large numbers of credit default swaps and other derivative securities sold to and held by large investors and financial institutions.
- These derivative securities were negotiated on a contract by contract basis, sold over the counter, and were very lightly regulated. They were opaque and difficult to price, and a major source of profits for the large institutions that created and sold them.
- AIG, a major underwriter of credit default swaps, required a $173 bailout in 2008.

CLEARING AND EXCHANGE REQUIREMENTS

- Requires most swaps and securities-based swaps to be cleared by clearinghouses which will guarantee performance of the contracts. The clearinghouses may require collateral from the parties to the contract.
- All swaps that are required to be cleared must also be traded on an exchange.
- Expected to lead to standardization of swaps contracts and greater pricing transparency.

INCREASED DERIVATIVES REGULATION

- “Swap Dealers” and “Major Swap Participants” must register with the appropriate federal agency.
- Rules are expected governing capital requirements, margin requirements, disclosure to investors and other “business conduct standards.”

CONSUMER CREDIT PROTECTION

- Consumer protection for mortgages, credit card debt and other loans consolidated in a new “Consumer Financial Protection Bureau.
- Elizabeth Warren, a Harvard law professor, is acting head of the Bureau, but there is substantial political opposition to her permanent appointment.
- In her writings, she has argued not just for increased and simplified disclosure of rates and other contractual terms of loans, she also advocates prohibition of manipulative practiced by lenders that exploit cognitive biases of borrowers.

CREDIT RATING AGENCIES

- Seen as one of the major causes of the financial crisis
- Failed to properly analyze the risks of collateralized debt obligations and similar securities
- Potential conflict of interest since they were paid by debt issuers

INCREASED REGULATION OF CREDIT RATING AGENCIES

- Dodd-Frank repeals exemption of rating agencies, makes them potentially liable for false statements in prospectuses under Section 11 of the Securities Act.
- The new rule may have backfired. Rating agencies are now refusing to permit their ratings to be used in debt prospectuses and so far, the SEC is acquiescing.

OTHER NEW CREDIT RATING AGENCY REGULATION

- Requires disclosures of CRA methodologies and historical performance data
- Enhanced governance requirements including at least 50% independent directors
- New rules on conflicts of interest

HEDGE FUND REGULATION

- Not much
- All managers of over $150 million in assets must register with SEC.
- Must provide information to the SEC about their investment and business practices
- Must have a compliance program and a chief compliance officer
- A hedge fund could potentially be a “systemically important financial institution” or a “major swaps participant.”

CORPORATE GOVERNANCE REFORMS

- Applicable to all publicly traded companies, not just financial firms
- "Say on pay," non-binding resolution put to shareholders to approve compensation of top executive officers. Brokers may not vote the shares of beneficial owners.
- Enhanced compensation disclosure and some "clawback" provisions

PROXY ACCESS

- The Act authorizes the SEC to provide for "proxy access" which requires companies to include shareholder nominees for the board of directors in its proxy statement along with the nominees approved by management.
- The SEC has already issued such rules. They provide that 3% of the shares (held individually or by a group for at least 3 years) may nominate candidates for up to 25% of board seats through this method.

COORDINATION WITH FOREIGN BANK AND SECURITIES REGULATORS

- The Act seeks to foster coordination between U.S. and foreign regulators.

- It authorizes federal agencies to enter into coordination agreements with foreign regulators and to share certain confidential information with them. and CFTC to share.

- It also authorizes the Fed and the SEC to cut off access to the U.S. financial markets to foreign banks or brokers who present a “risk to the stability of the U.S. financial system” and whose home country has not “adopted or made demonstrable progress toward adopting” regulations to mitigate such risk.

WILL IT WORK?

- Just as every general prepares to fight the last war, every financial reform is designed to prevent the last financial crisis.
- As we have seen, the Dodd-Frank Act is largely designed to deal with the problems revealed by the 2008 financial crisis. It attempts to deal with the problem of “known unknowns” by emphasizing coordination and information sharing, both within the U.S. government and between the U.S. and foreign regulators.
- It will not prevent new financial crises, but, if administered well, may give regulators more effective tools for dealing with new crises.