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Understanding Bank Reform The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

On July 21, 2010, President Barack Obama signed the Dodd-Frank Act becoming the largest financial reform law since the era of the New Deal of the 1930s. The 60-38 Senate vote on the 2300-page law is outlined below providing an overview of the law's new rules and their implications on the financial industry.

Financial Reform – a Historical Snapshot

1785	The U.S. adopts decimal coinage system and the Dollar is chosen as the money unit for the United States
1791	Creation of The First Bank of the United States providing national currency and acting as the government's fiscal agent
1863	National Bank Acts establishes a system of national charters for banks
1913	Imposition of the Federal Income tax on individuals and corporations Federal Reserve Act divides country into twelve districts, each with a Federal Reserve bank
1932-'33	Series of new bills to rescue the economy Glass-Steagall Act; Emergency Bank Act (preventing Fed collapse); Gold Standard abolished; restructuring of the Federal Reserve Regulatory measures: introduction of deposit insurance, the FDIC and the SEC
1999	Gramm-Leach Bliley Act (also known as the Financial Services Modernization Act of 1999) repeals Glass-Steagall Act of 1933
2010	Dodd-Frank Wall Street Reform Act

New Rules for Government/Regulators

- **The Financial Stability and Oversight Council will be created to monitor systemic risk and make recommendations to regulators – an “independent” agency within the Federal Reserve**
 - It will eliminate the Office of Thrift Supervision
 - Will help identify threats to financial stability and gaps in regulation
 - Will provide recommendations for capital and leverage requirements
 - Will facilitate coordination across Federal and State agencies
 - Has limited enforcement power, can only make recommendations
- **FDIC given more oversight to unwind large failing financial firms**
 - Treasury, FDIC and Federal Reserve must agree a company is in financial distress
 - Shareholders and unsecured creditors will bear losses and management will be removed
 - Taxpayer funds will not be used to rescue failing financial firms
 - FDIC may recover up to 2 years of compensation from senior executives substantially responsible for financial company failure
 - Large, complex institutions must periodically submit plan for own unwind
 - Most large financial firms that fail are expected to be resolved through the bankruptcy process

- **The Federal Reserve will broaden its supervisory scope**
 - Will oversee the new Consumer Financial Protection Bureau
 - Will work with the new Financial Stability Oversight Council to set tougher standards for disclosure, capital and liquidity that will apply to banks and non-bank financial companies
 - Will disclose counterparties and discount window lending and open market transactions
- **The Federal Reserve will experience more checks and balances**
 - The Treasury must approve any lending program
 - Emergency lending to individual entities will be prohibited
 - Collateral must be sufficient to protect taxpayers from losses
 - To prevent bank runs, the FDIC can guarantee debt of solvent, insured banks after meeting onerous approval requirements from the Fed, FDIC, Treasury, the President and Congress
 - Will face new governance rules and ongoing audits

New Rules for Banks/Corporations

- The Financial Stability Oversight Council will make recommendations for increasingly strict rules for companies that grow in size and complexity
- Volcker Rule will be established to limit bank activity in higher risk businesses such as proprietary trading, hedge fund and private equity businesses
 - Proprietary trading will be prohibited
 - Securitization activities will be limited to prevent conflicts of interest
 - Investments in and sponsorship of hedge funds and private equity funds will be restricted
 - Merger and Acquisition restrictions will be implemented
- A floor for capital will be established that cannot be lower than the standards in effect today
- Stricter leverage limits and liquidity requirements will be imposed
- Stress tests must be conducted by the Federal Reserve
- Credit exposures to non-affiliates cannot exceed 25% of capital stock and surplus
- Risk committees will be established for financial companies with total consolidated assets greater than \$10 billion
- The Federal Reserve will establish enhanced leverage and risk-based standards and capital requirements for systemically important firms
- A comprehensive new set of rules will be established to reduce counterparty risk and increase transparency
 - The Dodd-Frank Act established the broad outline of such regulation, but the CFTC and SEC will determine the details of the following: central clearing, exchange trading, "major swap participant", swaps push-out provision, capital requirements, margin requirements, post trade reporting and FX swaps
 - Foreign financial companies operating in the US will be impacted by these rules
- A Federal Insurance Office will be established, but with little enforcement power
 - Mandates study for potential future changes in insurance regulation

New Rules for Investors

- Securitization through risk retention, exemptions and disclosure will align the interests of issuers of asset-backed debt with ABS investors and reduce the risks posed by asset-backed securities
 - Risk retention
 - Lenders must hold at least a 5% stake in the asset-backed debt they structure and sell
 - Regulators can tailor risk retention rules to specific products
 - Retained credit risk may not be hedged

- Exemptions
 - All of the assets that collateralize the ABS must be qualified residential mortgages
 - Loans are guaranteed by the Federal Housing Administration, U.S. Department of Agriculture, and U.S. Department of Veterans Affairs
- Disclosure
 - Requires issuers to disclose more information about the underlying assets and to analyze the quality of the underlying assets
- Greater disclosure will be required on executive compensation and corporate governance
 - Disclosure of relationship between executive compensation and financial performance of the company
 - Disclosure of median annual compensation of all employees and the CEO
 - Disclosure of whether employees can hedge the value of equity securities
 - Shareholders have the right to a non-binding vote on executive pay and golden parachutes
 - SEC has the authority to grant shareholders the proxy access to nominate directors
 - Clawbacks will require that public companies set policies to take back executive compensation if it was based on inaccurate financial statements that do not comply with accounting standards
 - Companies must have a compensation committee consisting of independent directors, authorized to engage compensation consultants and other advisors
 - Directors must be elected by a majority of votes cast
 - Publicly traded non-bank financial companies and bank holding companies with total consolidated assets greater than \$10 billion must have risk committees
 - The Federal Reserve has the discretion to impose this requirement on companies with less than \$10 billion
- Increased investor protection and improved management and accountability of the SEC
 - SEC has the authority to raise standards for broker-dealers who give investment advice and can hold them to fiduciary responsibilities
 - SEC to develop rules increasing transparency of information available regarding securities lending
 - Establishes Investor Advisory Committee which will advise the SEC on its regulatory priorities and practices
 - Establishes Office of Investor Advocate which will identify areas where investors have significant problems dealing with the SEC and provide them assistance
 - Whistleblower rewards and protection
 - SEC will continue to have its budget approved by appropriators
 - Access to up to \$100 million every year to cover expenses
- Credit Rating Agencies will be better regulated
 - Prevention of ABS issuers from picking the agency they think will provide the highest rating
 - SEC to establish the Credit Rating Agency Board which will designate existing credit rating agencies as qualified to provide initial ratings for structured finance products
 - Office of Credit Ratings created within the SEC to administer rules, promote accuracy in ratings and ensure ratings are not influenced by conflicts of interest
 - Annual reviews of credit rating agencies
 - Ability to fine raters and authority to deregister a rating agency for providing bad ratings over time
 - Agencies must disclose their methodologies
 - More stringent threshold of evidence when bringing lawsuit against credit rater, requiring investors to demonstrate they were intentionally misled
 - At least half the board of a credit rating agency must be independent
 - Directors of a credit rating agency may only serve up to a 5-year term and compensation cannot be linked to business performance
- Hedge funds and private equity funds to be better regulated

- Hedge and private equity funds with assets greater than \$150 million must register with the SEC
- Stricter requirements when reporting information to the SEC about trades and portfolios
- Funds to be placed under the supervision of the Federal Reserve if determined to have grown too large or too risky
- Funds must hire a chief compliance officer and set up policies to avoid conflicts of interest
- More entities and investment advisors will come under state supervision
- More mandated studies
- Better regulation for municipal securities market
 - Registration and greater oversight of municipal advisors
 - Majority of board members on the Municipal Securities Rulemaking Board cannot be affiliated with broker-dealers, municipal dealers or advisors
 - A fiduciary duty is imposed on advisors
 - More studies on the municipal securities market

New Rules for Consumers

- Creation of Consumer Financial Protection Bureau
 - Has independent authority and the mandate of consumer protection on financial products
 - Agency is created within the Federal Reserve and has an independent head, budget and rule writing authority, but is not an independent agency
 - Consolidates previous responsibilities into one office
 - The Federal Reserve cannot prevent Consumer Bureau from issuing a rule, but the Financial Stability Oversight Council can overturn a rule with a 2/3 vote
 - State attorneys-general empowered to enforce certain rules issued by the Bureau
 - Has authority over banks with assets greater than \$10 billion, all mortgage-related businesses, payday lenders, student lenders and large non-bank financials
 - Auto dealers are exempt
- Enhanced Consumer Protections
 - The Federal Reserve must ensure that debit-card transaction fees are reasonable and proportional
 - Retailers can offer a discount based on form of payment and refuse credit cards for purchases less than \$10
 - Consumers will have free access to their credit score if it negatively affects them in a financial transaction or a hiring decision
 - Institutions must ensure that borrowers can repay loans they are sold
 - Prohibits incentives that encourage lenders to steer borrowers into more costly loans
 - Prohibits pre-payment penalties
 - Establishes penalties for irresponsible lending
 - Expands protections for high-cost mortgages
 - Requires additional disclosures for consumers on mortgages
 - Establishes an Office of Housing Counsel within HUD to boost homeownership and rental housing counseling
 - FDIC deposit insurance permanently increases to \$250,000

Indeed, we are living in a new era where reform is and may continue to be part of the political and economic landscape. We hope this information is helpful in the interpretation of this landmark financial reform law and please don't hesitate to contact us should you have further questions. Navigating through political reform can be tricky, so let's stay strong as we stay connected.

With continued confidence,

Banta Asset Management