Implementation of the Wall Street Reform and Consumer Protection Act

How the Dodd-Frank Act Impacts Every Fortune 500 Company

September 2011
Joseph Engelhard



Superior Washington Intelligence For Investors
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Eight major themes in Dodd-Frank Act

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Regulatory Gaps

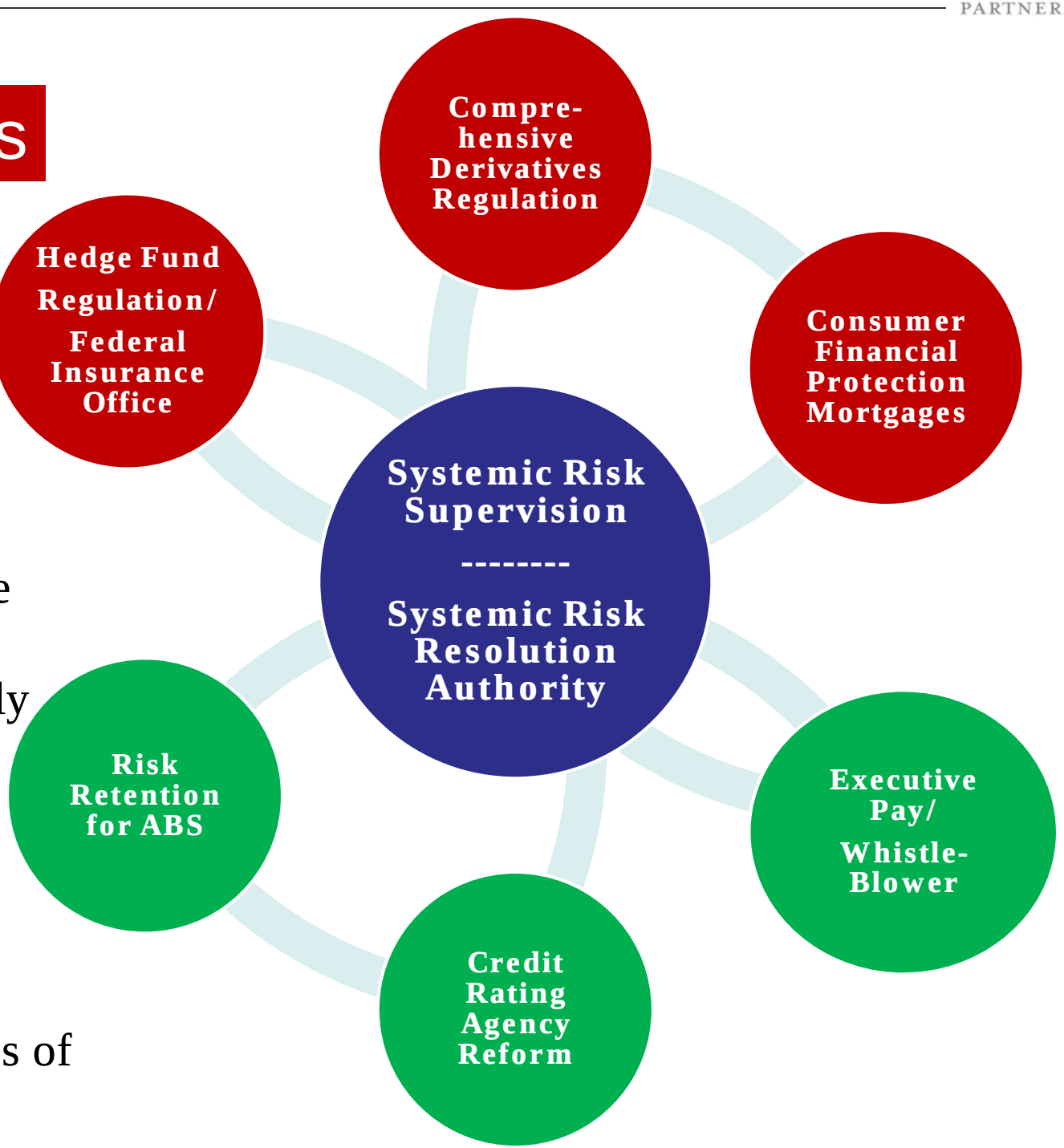
Empower regulators to cover all markets and products

Systemic Risks

Regulators can manage macro-prudential risk and resolve systemically important firms

Incentives

Align compensation with long-term results of risk taking



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243 Implementing Regulations
67 One-time and 22 Annual Reports

Estimates of Rulemaking By Agency

Agency	All Rulemaking*	One-Time Reports / Studies	New Periodic Reports
Bureau	24	4	5
CFTC	61	6	2
Council	56	8	4
FDIC	31	3	1
Federal Reserve	54	3	3
FTC	2	0	0
GAO	0	23	2
OCC	17	2	2
OFR	4	1	2
SEC	95	17	5
Treasury	9	1	1
Total**	243	67	22

* This estimate only includes references to explicit rulemakings in the bill, and thus likely represents a significant underestimate.

** The Total count eliminates double counting for joint rulemakings.

Source: Davis Polk

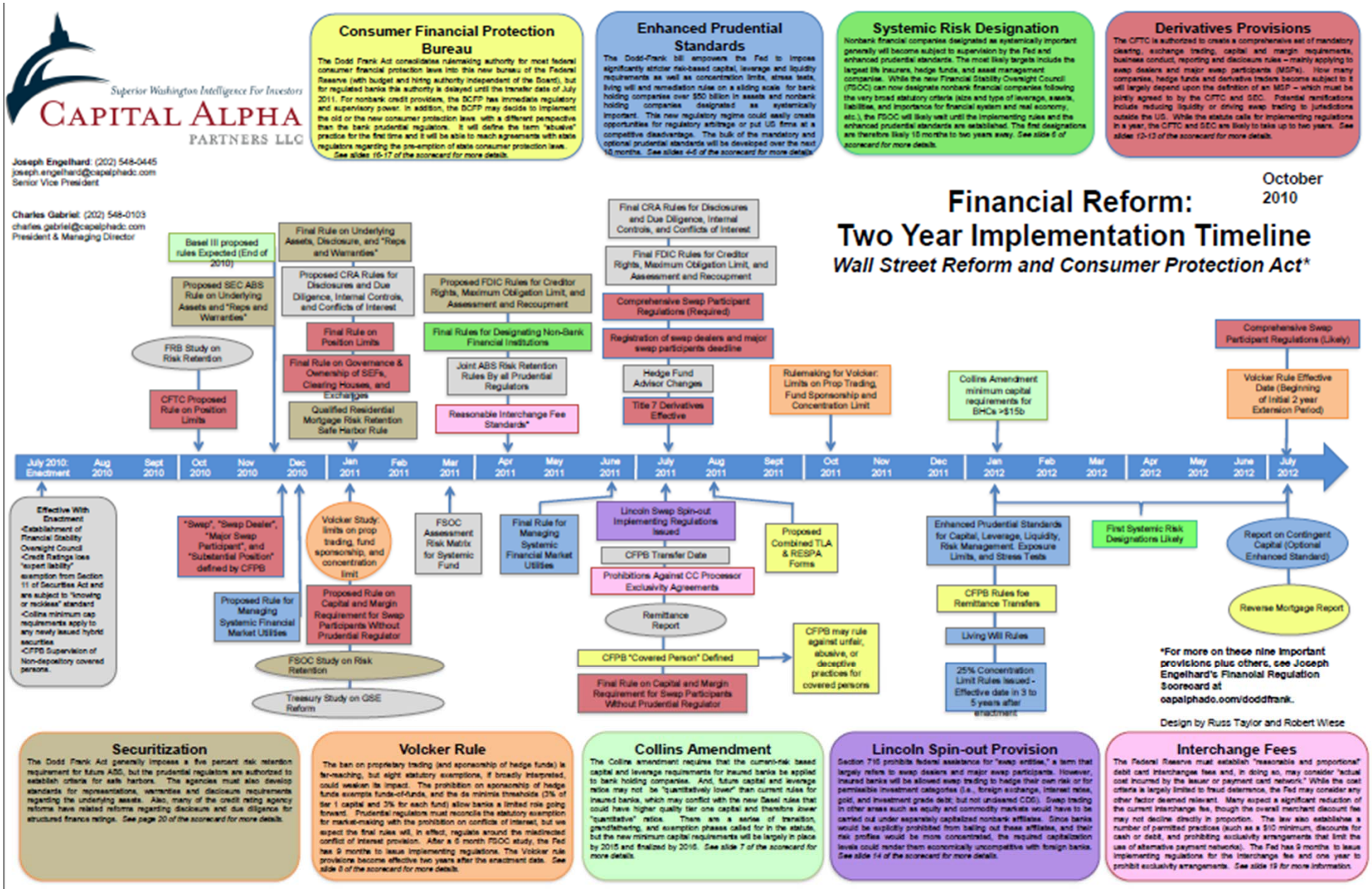
Key Questions

- **Will the new systemic risk regime end or enshrine "too big to fail"?**
- **Will the Volcker rule create regulatory arbitrage for prop trading abroad?**
- **Will trading of equity and commodities swaps to "separately capitalized" affiliates be commercially viable?**
- **Will the new margin requirements on OTC derivatives be a drain on company capital?**
- **Will position limits lower liquidity, raise volatility or push volume abroad?**

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Two Year Dodd Frank Implementation Timeline

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New Systemic Risk Council and Prudential Standards

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Final Version	Likely Impact
Additional Criteria for Systemic Risk Designation of Foreign Financial Companies: 1) Give due regard to the principle of national treatment and equality of competitive opportunity 2) Take into account extent to which foreign company is subject on a consolidated basis to "comparable" home country standards	**European banks** such as DB, CS, and BCS likely to have an advantage in proprietary trading as they will be exempt from the Volcker rule outside of the United States. However, the EU is considering similar heightened prudential standards, particularly in the area of derivatives, and may have more restrictive salary restrictions than in the US.
Required Enhanced Prudential Standards: 1) Risk-based capital requirements and 2) leverage limits (unless either requirement is not appropriate for the company's activities, but Fed must apply other similarly stringent substitute risk controls) 3) Liquidity requirements 4) Overall risk management requirements 5) Early remediation requirements 6) "Living will" resolution plan 7) Credit exposure concentration limit 8) Credit exposure reports 9) Stress tests 10) M&A limit of 10% total financial sector liabilities	**Customization of Enhanced Prudential Standards:** 1) Standards must increase in stringency based on amount and nature of assets, leverage, short-term liabilities, OBS exposure, etc. 2) Fed authorized to differentiate among companies (individually or by category) based on size, capital structure, risk, complexity, type of institution. 3) Fed must adapt required standards as appropriate to predominant line of business for each company. 4) OBS exposures must be included in computing capital requirements Danger of regulatory arbitrage via customization. While the Fed may try to keep rules uniform, the bill intentionally calls for a "tailored" approach - and competitive disadvantages via differentiated standards could result.
Optional Prudential Standards: 1) Contingent capital (long-term debt with preset conversion criteria after Fed Study) 2) Additional public disclosure 3) Short-term debt limits, and 4) Any other prudential standard s deemed appropriate by the Fed to mitigate systemic risk 5) Upon a finding by the Fed, and concurrence by 2/3 of the FSOC, that a particular company or practice imposes a "grave threat" to financial stability, the Fed must take actions to address that threat, ranging from: 1) Imposing conditions upon conduct of that activity 2) Limiting ability to merge or acquire 3) Restrict or terminate ability to offer a product 4) Break-up company or force sale of certain assets	**Considerations for Prudential Regulators:** 1) In establishing the implementing regulations, the FSOC and Fed regulations should "not result in sharp, discontinuous changes in the prudential standards" and regulators should adapt their recommendations "as appropriate in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate." 2) Discretion for FSOC to recommend and Fed to apply prudential standards to companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors.

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Timeline for FSOC and Enhanced Prudential Standards

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July 2010 Enactment

The new FSOC is effective day after enactment.

But, it should take some time for its infrastructure to be formalized (likely 6-9 months) and longer for the new Office of Financial Research at Treasury to be established (9-12 months).

N.B. – Effective date is one-day after enactment unless otherwise specified for entire bill.

Implementation of Enhanced Prudential Standards

Required Standards: No deadline for some, including risk-based capital, leverage, liquidity and resolution plan

Concentration Limits: Rules in 18 Months, effective 3 years after enactment with up to 2 year extension

Contingent Capital: Report from FSOC to Congress in two years, standards optional

Short-term Debt Limit: Optional with exemptive authority for those not owning an IDI

Risk Committee: One year for nonbanks. All banks over $10 billion, optional for rest with final rules in 1 yr, effective in 15 months

Stress Tests: Bi-annual for systemically important, bi-annual for banks over $10 B

Leverage Limit: 15-to-1 debt to equity ratio if FSOC determines necessary to mitigate a "grave threat" to systemic risk by a firm

OBS Assets: Included for systemic unless exempted by Fed

Enhanced Public Disclosure: Optional with no specific date for regulations

FSOC Systemic Risk Designation for Nonbanks

Requires 2/3 vote (including Chair)

Nonbank may request a hearing within 30 days of notice

FSOC will set a hearing date within 30 days of request

Final determination within 60 days of hearing

Nonbank must register with the Fed 180 days after final designation

Emergency exception for systemic risk

Annual review for rescission

Safe Harbor – Fed must exempt certain classes via regs updated every 5 yrs

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New Comprehensive Derivatives Regulatory Regime (1 of 2)

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The bill creates a comprehensive regime to regulate all derivatives markets, participants and products. *Within 360 days, the CFTC must establish a new regime that all swap dealers and major swap participants will be subject to, including:*

1) *Rules imposing minimum capital and initial and variation margin on all non-cleared swaps for all nonbanks (prudential regulators will impose for banks under their jurisdiction)*
2) *Business conduct standards including duty to verify counterparties eligibility status, disclosure of risk characteristics such as risks, material incentives, potential conflicts of interest and reporting/public disclosure standards*
3) *Standards for timely confirmation, processing, netting, documentation, valuation and public reporting of all swaps*

Dealers and MSP must register within 365 days, and will be required to meet all of the CFTC requirements, including the above plus: maintaining daily trading records (including for each counterparty that is identifiable with each transaction, a complete audit trail for completer trade reconstruction, and designate a chief compliance officer with established responsibilities.

Final Version	Likely Impact
Mandatory Clearing: In effect, almost all swaps that a clearinghouse wants to clear must be cleared by the CFTC. That requirement will normally only apply when both sides of the deal are swap dealers or major swap participants (MSPs), with a three-part test to determine who are MSPs: 1) If they maintain a substantial net position in outstanding swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating commercial risk (or pension plans mitigating risk associated with the operation of the plan); or 2) If their outstanding swaps create substantial counterparty exposure that could have serious adverse effects on financial stability; or 3) If they are a financial entity that is highly leveraged relative to the amount of capital held and maintain a substantial position in outstanding swaps (other than, for CFTC-regulated swaps but not SEC-regulated SBS, an entity predominantly engaged in providing financing for the purchase of an affiliate's merchandise or manufactured goods). **Public Reporting:** CFTC to issue real-time public reporting requirements, including price and volume (though likely to provide special rules for large block trades, perhaps end-of-day reporting). **Abusive Swaps:** CFTC can ban abusive swaps and deny access to the US financial system of any entity in a foreign country whose regulation of swaps undermines the stability of the U.S. financial system	Broker Dealers would have capital relief from central clearing due to lower risk weightings, but may suffer from higher initial and variation margin as well as smaller spreads due to the real time pricing required in the bill for exchanges. Institutions that are forced to clear swaps for the first time will now become subject to the initial and variation margin requirements of the clearinghouse. The statute provides for the regulators to require clearinghouses to accept non-cash collateral, but it's not clear how this will work in practice. May be an opportunity for brokers to provide a guarantee for clients in return for loans using traditional collateral from the commercial end users. Swaps entered into after enactment, but before 360 day effective date of clearing requirement, are exempt if they are reported as required by CFTC/SEC. (Swaps before enactment date must also report within 180 days to be exempt from clearing requirement.) The statute provides an alternative exemption for commercial end users (but not for MSPs, commodity pools and private funds) as long as the swap is being used as a hedge for commercial risk (and the end user notifies the CFTC how it generally meets its financial obligations regarding swaps) -- then that swap does not need to be cleared (at the option of the end user). But there is some question of how useful this alternative may be given that MSPs are not eligible. Within one-year, the CFTC must issue rules regulating: 1) How clearinghouses must submit each swap (or category or type of swap) to CFTC for approval 2) How CFTC will review and approve such applications 3) Anti-evasion and abuse prevention rules

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New Comprehensive Derivatives Regulatory Regime (2 of 2)

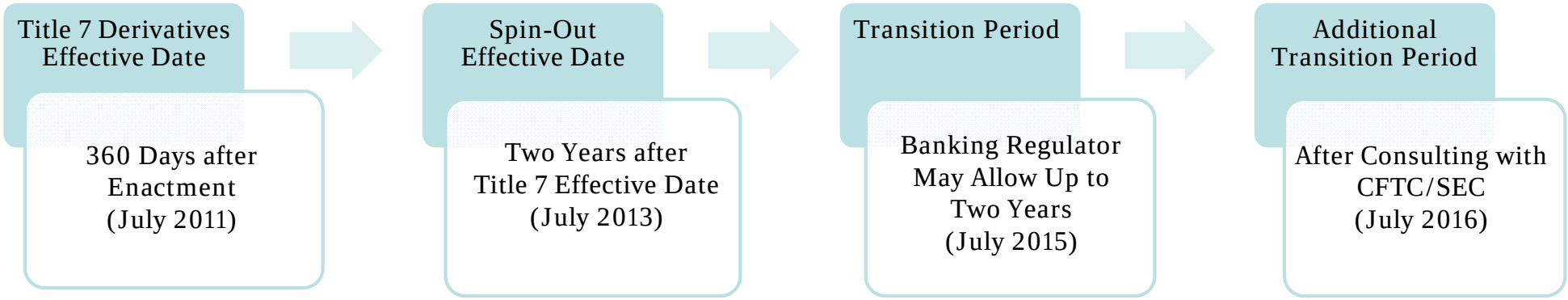
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Final Version	Likely Impact
Mandatory Exchange Trading: Cleared trades must be traded on an exchange or swap execution facility (SEF = a trading system or platform where multiple participants can execute or trade swaps via bid/offer of multiple participants).	Voice originated trades will continue but must be subsequently entered into an electronic system (like a SEF). It's likely that many inter-broker dealers and electronic trade execution companies will register to become regulated as SEFs going forward. Clearinghouses may not discriminate among exchanges, but dealers may steer business through SEFs according to business agreements.
Margin and Capital Requirements: Banking regulators will set margin and capital requirements for banks that are dealers or MSPs; the CFTC, for uncleared swaps of other entities. For cleared swaps, the CFTC must ensure that exchanges set appropriate margin requirements that are "designed for risk management purposes in order to protect the financial integrity of transactions" and the clearing organization itself, but may not set "specific margin amounts."	CFTC must issue regulations establishing capital, initial, and variation margin requirements for uncleared swaps for swap dealers and major swap participants (except for financial entities regulated by federal banking regulators, who will determine the requirements for their regulated entities). CFTC Chairman Gensler has stated that only dealers and MSPs will be subject to the greater initial margin requirements, but in response dealers will likely have to require greater margin of the commercial clients or find other ways to offset the additional costs. Also, netting and coordination issues may develop with multiple clearinghouses. Many will be determined to be systemically important, which could subject them to greater scrutiny and regulation by the FSOC and the Fed, but they will in return receive access to the discount window.
Broker Dealer Fiduciary Duty: Requires an SEC study. If any gaps or overlaps found between broker vs. investment adviser duties, must issue regulations that harmonize the standard of care as investment advisers dealing with retail investors, but without "continuing duty of care" and ability to disclose conflicts.	Brokers will likely face additional suitability and disclosure requirements and more litigation risk due to what in effect will be a fiduciary duty of care, at least during the moment at which a product was sold or service provided. In addition, the bill allows the SEC to prohibit mandatory arbitration, which is likely to be reduced if not eliminated.
Derivatives Position Limits: Authorizes position limits for physical commodities (other than excluded ones) to limit the size of positions, including per person (or group) monthly aggregate limits other than "bona fide" hedge positions. The CFTC is authorized to exempt individual or groups of persons or swaps from the position limit rules. Preexisting swaps are exempt. Exchanges and SEFs must establish and enforce both accountability levels and position limits. Traders must report to the CFTC, with greater reporting requirements for large swap traders.	While the CFTC temporarily postponed its plans to impose an elaborate regime of spot, monthly and aggregate position limits on certain energy swaps, this proposal will now likely be expanded to take into account OTC markets and the other physical commodities subject to mandatory position limits, and industry is pushing for higher limits and adjusted exemptions. It's not clear yet how many adjustment the CFTC will make to its current position limit proposals to take into account the expansion into OTC markets and additional commodities. While concerns about driving liquidity abroad if the regulations are too restrictive are being taken seriously, the earlier proposed position limit framework appears likely to largely remain intact.

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Timeline for Derivative Regime and Lincoln "Spin-Out" Provision

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Section 716 prohibits any federal assistance for "swap entities," a term that includes swap dealers and major swap participants (except those MSPs that are insured depository institutions). For this section, a swap dealer is one that "regularly enters into swaps with counterparties as an ordinary course of business for its own account." However, an exclusion is provided in cases where the swap is entered into in connection with originating a loan for that customer.

Insured Depositary Institutions that are swap dealers are excluded from the prohibition on federal assistance if they limit their swap activity to hedging their own risks or to a variety of swaps involving rates or reference assets listed as permissible for investment by a national bank under section 24 of the National Bank Act (other than uncleared credit default swaps). Section 24 permits investments in a wide range of assets, including:

> Loans, promissory notes, drafts, bills of exchange, other extensions of credit, foreign currency, coins, bullion, which includes gold, silver and certain other precious metals; U.S. government and agency securities, certain investment shares in investment companies as long as the assets held by the investment companies are themselves bank permissible, and debt securities that are considered investment securities, generally marketable investment grade debt securities, but also including, to a limited degree, non-investment grade debt securities that the bank reasonably believes will be repaid as to principal and interest and to be reasonably liquid.
>
> *Note: the OCC has the power to add additional assets to the list of permissible banking investments under Section 24.*

The prohibition on federal assistance does not apply if non-permitted swaps are transacted by a non-bank affiliate, but the section 23A and 23B restrictions will apply and the FSOC has the ability to place additional restrictions if deemed necessary to prevent systemic risk (including denial of federal assistance, stricter 23A restrictions, etc.).

Taxpayer funds are prohibited to prevent the receivership of any swap entity (if FDIC insured or systemically important), but once it goes into receivership, then the institutions swap activity becomes subject to regularly applicable law. However, the Lincoln section 716 contains the statement that "taxpayers shall bear no losses for the exercise of any authority under [title 7]."

Federal banking regulators must allow an up to two year transition period to allow banks to divest or cease non-permitted swap activity, and may extend that transition up to one additional year. (There does not appear to be a similar transition period for non banks.)

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Final Version	Likely Impact
Credit Rating Agency: New regulations affect credit rating agencies in a number of ways, the majority of which can be broken down into three categories: (1) provisions to obligate NRSROs to establish internal controls that would help prevent conflicts of interests from arising, (2) provisions to increase transparency in the credit rating process, and (3) provisions to increase liability of NRSROs, which will now be subject to the same "expert" liabilities as registered public accounting firms and securities analysts under the Securities Exchange Act. **Legal Liability:** Removes exemption from expert liability and establishes "knowing and reckless" standard as burden of proof threshold. **Private Right of Action**: Enforcement and penalty provisions of the Securities Exchange Act will now apply to statements made by a credit rating agency in the same manner and to the same extent as they apply to statements made by a registered public accounting firm or a securities analyst under the securities laws. Such statements will not be considered forward-looking statements for the purposes of the Exchange Act's section 21E. **Transparency**: NRSROs must publically disclose information on initial credit ratings and any subsequent changes to allow for accuracy evaluations and comparisons to other NRSROs. *Due Diligence*: The issuer or underwriter of any asset-backed security must make findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter available to the public. *Duty to Report Violations*: NRSROs must report any credible information received from a third on material violations of law to regulatory authorities. **Credit Rating Procedure**: The SEC must prescribe rules to establish certain credit rating procedures and methodologies. Credit ratings must be approved by the board of the NRSRO, and in accordance with the NRSRO's credit rating policies and procedures; NRSROs must ensure that when material changes to credit rating procedures and methodologies (including changes to qualitative and quantitative data and models) are made, that the changes are applied consistently to all credit ratings to which the changed procedures and methodologies apply. The NRSRO must publicly discloses the reason for the change and notify users of credit ratings the version of a procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular credit rating. NRSROs must consider credible (and potentially significant) information about an issuer that it receives from a source other than the issuer or underwriter.	The reduced liability standard will be applied only prospectively, but might nevertheless immediately alter the backdrop in courtrooms, with the risk being that better-armed investor-plaintiffs might more easily reach the discovery phase in lawsuits, perhaps forcing the industry into expensive settlements. Stripping prospectus-related immunity from the agencies (via repeal of Sec. 436g) as well as a mandate for all embedded NRSRO references in federal laws to be reviewed for modification within one year will likely lead to the SEC dropping the requirement that rating be included in a prospectus going forward. While the Franken amendment to compel the creation of a rating agency board to assign the ratings function on newly issued structured finance securities was defanged by allowing for a two-year study to find a better alternative, it would nevertheless direct the SEC to implement the Franken proposal unless it determines an alternative that would better serve the public interest. This seemingly would create open-ended risk and uncertainty for the industry and its stakeholders, in that the SEC would be granted authority to transform the ratings agency business model and sector, if it sees fit to do so, without need for further federal legislation. Nevertheless, given the current resistance to Franken's board or the parallel "roulette" concept within the Obama administration and between House Financial Services and Senate Banking chairmen Barney Frank (D-MA) and Chris Dodd (D-CT), we suspect that the result might be to rely on the implementation of the transparency, governance and conflict of interest provisions largely already required under the bill (barring a very unlikely emergence of consensus by the SEC commissioners around Franken's idea over time).

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Regulations Designed to Affect Market Incentives

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Final Version	Likely Impact
Risk Retention: Federal banking agencies and the SEC must jointly establish risk retention requirements for asset-backed securities, with 5% as the base level. Under certain circumstances, however, regulators are authorized to lower the risk requirement below 5%: 1) RMBS: If the originator meets certain underwriting standards established by Federal banking agencies on a class-by-class basis 2) CMBS: Regulators to establish criteria that may allow substitutes such as warranties and repurchase obligations. Federal banking regulators and the SEC will allocate risk retention obligations between a securitizer and originator. **Exemptions**: Farm credit system institutions and other federal programs (e.g. VA, SBA, and Ag/Farm Credit loans) are exempt (but not Fannie and Freddie). Regulators may jointly adopt/issue further exemptions to this provision.	Landrieu amendment provides a safe-harbor for RMBS that meet safe mortgage underwriting standards to be issued by the prudential regulators. For CMBS, Crapo amendment allows regulatory alternatives to risk retention, including underwriting standards and controls, or via stronger representations and warranties. PMI: The private mortgage insurance industry could find additional impetus from regulatory-driven insurance requirements, but statute will require the industry to prove that PMI reduces the impact on the default of MBS before regulators can approve it as an enhancement mechanism. Because FHA is exempt and not FNM and FRMC, that is a signal that legislators and regulators are trying to wean themselves from reliance on FNM and FRMC as tools to keep the housing finance industry alive in the short-term.
Executive Compensation: Nonbinding shareholder vote on executive compensation at least every three years, and on termination payment whenever a merger is recommended. Federal banking regulators in nine months prescribe rules to prohibit incentive-based payments that encourage inappropriate risks and require them to report their incentive-based compensation arrangements. SEC must direct exchanges to enforce claw back policies on incentive-based compensation triggered by a restatement due to material noncompliance with financial reporting requirements (to the restated levels).	While non-binding, the annual high-level scrutiny of compensation regimes for high level executives will result in pressure to keep compensation costs lower, and more importantly, to structure them in a way that does not create incentives for short-term profits at the expense of long-term results. Financial companies will face the additional scrutiny of regulators and they must follow the standards in the Federal Deposit Insurance Act.
Hedge Fund SEC Registration: $100M minimum threshold for registration, but only $25M if would not be subject to registration and examinations in home state or if would become subject to registration with 15 or more states. Various exemptions available to advisers to solely private funds with <$150M AUM, venture capital, SBICs, family offices and foreign advisors with <15 clients and no US place of business). The SEC will be authorized to require reporting on range of financial information, such as AUM, trading strategy, risk management practices, etc.	Generally speaking, the hedge fund advisor changes become effective 12 months after enactment, so July of 2011 would be the deadline. Any adviser to a fund over $100 would have to register (with exception of venture capital fund – to be defined by SEC), and funds under that amount may in some cases be prohibited from SEC registration and have to register at the state level (any funds near that amount should check with counsel).

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