Cover Story

# The Dodd-Frank Reform Bill

## Will It Work?

by
David S. Swayze, Esq.
& Christine P. Schiltz, Esq.
Parkowski, Guerke & Swayze, P.A.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act, which was passed in response to the financial crisis of the fall of 2008, is the most sweeping change to financial regulation since the Great Depression. The full title of the Act states that its purpose is to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."[1]

Essentially, the Act is a sweeping effort to reallocate power from Wall Street to Washington in an attempt to prevent a future financial crisis, and represents a paradigm shift in the financial regulatory environment in this country. Every financial regulatory agency is impacted by the legislation, and new regulatory agencies are created. The key debate surrounding this new legislation is whether the legislation will actually prevent another financial crisis or is it simply a complex and disorganized reaction to the financial crisis that creates unnecessary bureaucracy and does not address many of the activities that gave rise to the crisis. Additionally, there is generally agreement that the full impact of the legislation remains to be seen over the upcoming years as a multitude of regulatory agencies will write rules and regulations to implement various sections of the Act.

## Causes Of The Financial Crisis

In examining the Dodd-Frank legislation, it is important to review those generally accepted causes of the financial crisis to which the Act purportedly responds. First, the growth of the housing bubble from 1997 – 2006 saw home prices in the United States increase by approximately 124%.[2] This housing bubble resulted in homeowners refinancing their homes at lower interest rates, or financing consumer spending through second mortgages. Lower interest rates fueled borrowing. The Federal Reserve continued to lower interest rates to soften the effects of the collapse of the dot-com bubble, the September 2001 terrorist attacks and to combat the perceived risk of deflation.[3] In addition to the easy credit conditions, there is evidence that both government and competitive pressures contributed to an increase in the amount of subprime lending. Both major investment banks and Fannie Mae played a role in the expansion of this higher risk lending.[4] The housing and credit boom gave rise to mortgage-backed securities (MBS) and collateralized debt obligations (CDO). Wall Street investors turned to MBS and CDOs, which were assigned safe ratings by the credit rating agencies. During this time, policymakers did not respond to the increased role played by investments banks and hedge funds, and they were not subject to the same regulations as commercial banks. This country's regulatory framework simply did not keep pace with financial innovation. While there are numerous other factors that analysts argue contributed to the financial crisis, including deregulation, increased over-leveraging and rapid increases in commodities prices, most agree that when the housing and credit bubbles began to burst, the housing and financial assets in the country dramatically declined in value, triggering the cascade of the financial crisis.[5]

## The Dodd-Frank Response

The Dodd-Frank Act contains 2,300 pages and is categorized into sixteen titles. However, this article will focus on six areas of the Act most responsive to the causes of the crisis. First, the Act creates a financial early warning system to encourage financial stability. Two new agencies are created as an arm of the Treasury Department. The first agency is the Financial Stability Oversight Council. It is tasked with monitoring Wall Street's largest companies and other market participants to identify risks to financial stability and respond to those risks and promote market discipline. The Council has broad powers and under certain circumstances may provide for more stringent regulation of financial activity by issuing recommendations to the primary regulatory agency, which that agency is obligated to follow. The second new agency is the Office of Financial Research. This agency is tasked with providing administrative, technical, budget analysis and other services to the Council.

Second, the bill establishes a Consumer Financial Protection Bureau within the Federal Reserve. This agency will have rule making authority as well as authority to enforce existing consumer-oriented regulations that apply to big financial firms, mortgage-related business, and payday and student lenders.

Third, the Act gives federal regulators the authority to seize and liquidate troubled financial firms. The liquidator for most financial institutions will be the Federal Deposit Insurance Corporation. Those institutions who are members of the Securities Investor Protection Corporation fall under that agency's liquidation oversight.

Fourth, the Act eliminates the Office of Thrift Supervision and transfers its powers to other agencies. The thrift charter will remain, although weakened.

Fifth, the Act gives the federal government numerous new regulatory powers over all aspects of the financial industry. It provides enhanced regulation of hedge fund advisors, and it creates a Federal Insurance Office which is tasked with monitoring all aspects of the insurance industry except health insurance, crop insurance and some long-term care insurance. The Act also includes the regulation of many of the investment products that were the subject of several bank failures, including over-the-counter swaps markets and asset-backed securitizations. In addition, complex financial risk swaps known as derivatives will face comprehensive regulation and most will be traded through public clearinghouses. The Act also tightens restrictions on the ability of banks to trade in financial markets with their own funds, proprietary trading is banned, and the Act reduces the ability of banks to count as bank capital certain risky assets. The Act also revises the powers and structure of the Securities Exchange Commission and gives the SEC further powers of enforcement, including the authorization to issue "point-of-sale disclosure" rules as well as a "whistleblower bounty program" similar to that established by the Internal Revenue Service. The SEC is also provided authority to impose regulations requiring a

*(continued on p. 12)*

(continued from p. 11)

fiduciary duty by broker-dealers and investment advisors to their customers.

Finally, the Act contains a number of mortgage reforms and establishes national underwriting standards for residential loans. Banks and other financial institutions must review the income and credit histories of mortgage applicants to ensure they can afford payments. If a consumer is receiving a "high cost mortgage" he or she must obtain pre-loan counseling from a certified counselor.

## Criticism Of The Act

The Dodd-Frank Act started out as a vehicle to address the causes of the financial crisis and serve as a vehicle to subject the complex derivatives markets to federal regulation and public trading. It was also intended to provide federal regulators the tools needed to dismantle failing financial giants. Critics argue that as the bill made its way through Congress, it accumulated hundreds of provisions unrelated to the causes of the financial crisis and failed to address major causes of the mortgage crisis. The largest criticism stems from the omission of Fannie Mae and Freddie Mac from the legislation. These organizations played a major role in financing the housing and mortgage bubble. In 2008, both were placed into conservatorship of the Federal Housing Finance Agency. By that year, they had absorbed most of the subprime mortgages in this country.[6] Yet, nothing in the Act directly addresses reforming these organizations.[7]

Another criticism is that the new legislation creates a new layer of bureaucracy that could have unintended consequences, like limiting credit for consumers and businesses and stifling innovative lending. Others argue that the reform bill fails to address the role of accounting rules that were used to hide mortgage losses.

The bill also adds regulations and rules that have little or nothing to do with the crisis. The new Consumer Financial Protection Bureau will have authority over all financial institutions, including payday lenders, storefront check cashers and student lenders. Regardless of one's impression of these lending institutions, no one has argued that these institutions contributed to the financial crisis.

The bill gives the Federal Reserve Board the authority to limit "swipe" fees that merchants pay for each debit card transaction, although these fees had not the slightest connection to the financial crisis. The bill also gives the SEC authority to empower stockholders to run candidates for corporate boards of directors. Again, these provisions are essentially unrelated to the causes of the crisis.

Finally, as one would expect with a 2,300 page piece of legislation, certain provisions are so wholly unrelated to financial reform that their inclusion is the bill is perplexing at best. For example, HUD is commissioned to study the impact of defective drywall imported from China, while the SEC is mandated to create rules that address potential conflict materials in the Democratic Republic of the Congo. The Act further requires the SEC to report on mine safety. Inclusion of such provisions lends credence to those who criticize the Act as overreaching.

## The Uncertain Future

Enactment of this 2,300 page bill marks only the beginning of a years-long process. According to the law firm of Davis Polk, the legislation requires that regulators create 243 rules, conduct 67 studies and issue 22 periodic reports. (In contrast, Sarbanes-Oxley initiated only 16 new regulations).[8] At the Commodity Futures Trading Commission, 30 teams have been convened to construct a new regulatory system for the over-the-counter derivatives market. The SEC chairman has requested 800 new employees for the agency's new responsibilities and the chairman of the FDIC said her agency will need up to $50 million more budget as well as new hires with experience in investment banking and insurance.[9]

The hallmark of Dodd-Frank is uncertainty. Jurisdictional boundaries between and among regulatory agencies are blurred. The erosion of federal preemption threatens to spawn a plethora of conflicting state laws under the banner of consumer protection that in turn threaten consumer and small business accessibility to credit. The far-reaching dependence in the Act on regulations, as discussed above, rather than on statutory guidance, allows the financial services industry to view the future marketplace only through a glass darkly. The future of Fannie Mae and Freddie Mac, whose losses, when stress-tested by extending the current recession in home prices and sales, might reach twice the $135 billion already invested by the federal government,[10] remains unaddressed pending an Administration recommendation regarding the overhaul of home mortgage financing early next year. The magnitude and duration of enhanced federal oversight of all credit markets is ill-defined. And finally, the inevitable loopholes through which lenders might find some safe harbor to conduct business are not yet discernable. Into this breach the financial services industry must march with uncertain step, and with its omnivorous partner, the federal government, watching all the way.

*DAVID S. SWAYZE joined Parkowski, Guerke & Swayze as a Director in June 2003. He concentrates his practice in the areas of financial services regulation, Delaware trust law and administration, government relations, and legislation, and environmental, administrative and commercial law. He is a former Legal Counsel, Chief of Staff and Executive Assistant to the Governor of Delaware, the former City Solicitor of Wilmington, and the former Chair of the Wilmington Housing Authority. Mr. Swayze is a member of the Administrative Law Section and the Banking Law Committee of the Commercial Law Section of the American Bar Association. He is also a member of The Association of the Bar of the City of New York and the Banking and Environmental Law Committees of the Delaware State Bar Association. Mr. Swayze is admitted to practice in Delaware. He is a 1969 graduate of the University of Pennsylvania Law School, and received his A.B in political science, magna cum laude, from Princeton University.*

*CHRISTINE P. SCHILTZ joined Parkowski, Guerke & Swayze in June 2003, concentrating in insurance and banking law, health care and government relations and regulatory matters. She has represented a variety of clients before the Delaware General Assembly and state administrative agencies. She is a member of the ABA's Business Law and Tort and Insurance Practices sections. She is also a member of the Delaware State Bar Association and recently completed her term on the DSBA's Executive Committee. Ms. Schiltz is a 1993 graduate of the University of Richmond, T.C. Williams School of Law and received her B.A. in history from Wake Forest University.*

**Notes -**

1 - Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, HR 4173).
2 - "CSI: credit crunch" The Economist, October 18, 2007.
3 - " Financial Crisis of 2007 – 2010" Wikipedia.
4 - "Pressure to Take More Risk, Fannie Reached Tipping Point" New York Times, October 4, 2008.
5 - "When a Flow Becomes a Flood" The Economist, January 22, 2009.
6 - "Five Major Defects of the Financial Reform Bill" Becker-Posner Blog maintained by the University of Chicago Law School, July 11, 2010.
7 - "Fannie, Freddie Elicit a Grim Forecast" Wall Street Journal, October 22, 2010.
8 - Editorial, Wall Street Journal, July 17, 2010.
9 - Financial Overhaul is Law, Now Comes the Battle Over its Rules, Bloomberg News, July 21, 2010.
10 - "Fannie, Freddie Elicit a Grim Forecast" Wall Street Journal, October 22, 2010.