



The Dodd-Frank Wall Street Reform and Consumer Protection Act: Issues and Summary

Baird Webel, Coordinator
Specialist in Financial Economics

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Summary

Beginning in 2007, U.S. financial conditions deteriorated, leading to the near collapse of the U.S. financial system in September 2008. Major banks, insurers, government-sponsored enterprises, and investment banks either failed or required hundreds of billions in federal support to continue functioning. Households were hit hard by drops in the prices of real estate and financial assets, and by a sharp rise in unemployment. Congress responded to the crisis by enacting the most comprehensive financial reform legislation since the 1930s.

Treasury Secretary Timothy Geithner issued a reform plan in the summer of 2009, which served as a template for legislation in both the House and Senate. House committees reported a number of bills on an issue-by-issue basis, which were then consolidated into a comprehensive bill, the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173). H.R. 4173, as passed by the House on December 11, 2009, contained elements of H.R. 1728, H.R. 2571, H.R. 2609, H.R. 3126, H.R. 3269, H.R. 3817, H.R. 3818, H.R. 3890, and H.R. 3996. On May 20, 2010, the Senate passed H.R. 4173, after substituting the text of Senator Christopher Dodd's bill, the Restoring American Financial Stability Act of 2010 (S. 3217), as amended. Following a conference committee, the House accepted changes to H.R. 4173, now titled the Dodd-Frank Wall Street Reform and Consumer Protection Act, on June 30, 2010, and the Senate followed suit on July 15, 2010. President Obama signed the bill, now P.L. 111-203, on July 21, 2010.

Perhaps the major issue in financial reform has been how to address the systemic fragility that was revealed by the crisis. The Dodd-Frank Act creates a new regulatory umbrella group chaired by the Treasury Secretary—the Financial Stability Oversight Council—with authority to designate certain financial firms as “systemically significant” and subjecting them to increased prudential regulation, including limits on leverage, heightened capital standards, and restrictions on certain forms of risky trading. These firms will also be subject to a special resolution process similar to that used in the past to address failing depository institutions.

Other aspects of financial reform address particular sectors of the financial system or selected classes of market participants. The Dodd-Frank Act consolidates consumer protection responsibilities in a new Bureau of Consumer Financial Protection within the Federal Reserve. The act consolidates bank regulation by merging the Office of Thrift Supervision (OTS) into the Office of the Comptroller of the Currency (OCC). It requires more derivatives to be cleared and traded through regulated exchanges, and it mandates reporting for derivatives that remain in the over-the-counter market. Hedge funds have new reporting and registration requirements. Credit rating agencies are subject to greater disclosure and legal liability provisions, and references to credit ratings will be removed from statute and regulation. A federal office is created to collect insurance information. Executive compensation and securitization reforms attempt to reduce incentives to take excessive risks. Intermediaries who provide investment advice to retail investors and municipalities may be subject to a fiduciary duty. The Federal Reserve's emergency authority is amended and its activities are subject to greater public disclosure and oversight by the Government Accountability Office (GAO).

This report reviews issues related to financial regulation and provides brief descriptions of major provisions of the Dodd-Frank Act. This report will not be updated.

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Introduction

Comprehensive Financial Reform Proposals

The 111th Congress considered several proposals to reorganize financial regulators and to reform the regulation of financial markets and financial institutions. Following House committee markups on various bills addressing specific issues, House Committee on Financial Services Chairman Barney Frank introduced the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), incorporating elements of numerous previous bills.¹ After two days of floor consideration, the House passed H.R. 4173 on December 11, 2009, on a vote of 232-202.

Chairman Christopher Dodd of the Senate Committee on Banking, Housing, and Urban Affairs issued a single comprehensive committee print on November 16, 2009, the Restoring American Financial Stability Act of 2009.² This proposal was revised over the following months and a committee print of the Restoring American Financial Stability Act of 2010³ was issued on March 15, 2010. This bill was amended in committee on March 22, 2010, and was reported as S. 3217 on April 15, 2010. The full Senate took up S. 3217 and amended it several times, finishing consideration on May 20, 2010, when it substituted the text of S. 3217 into H.R. 4173. The Senate then passed its version of H.R. 4173 on a vote of 59-39.

Following a conference committee, the House on June 30, 2010, agreed to the H.R. 4173 conference report—now titled the Dodd-Frank Wall Street Reform and Consumer Protection Act—by a vote of 237-192. The Senate agreed to the report on July 15, 2010, by a vote of 60-39. The legislation was signed into law on July 21, 2010, as P.L. 111-203.

In addition to Chairman Dodd's and Chairman Frank's bills, other proposals were made but not scheduled for markup. For example, House Financial Services Committee Ranking Member Spencer Bachus introduced a comprehensive reform proposal, the Consumer Protection and Regulatory Enhancement Act (H.R. 3310), and offered a similar amendment (H. Amdt. 539) during House consideration of H.R. 4173.⁴ In March 2008, Treasury Secretary Hank Paulson issued a "Blueprint for a Modernized Financial Regulatory Structure."⁵ The Obama Administration released "Financial Regulatory Reform: A New Foundation" in June 2009, and followed this with specific legislative language that provided a base text for congressional consideration.⁶

¹ Initially incorporated bills included H.R. 2609, H.R. 3126, H.R. 3269, H.R. 3817, H.R. 3818, H.R. 3890, and H.R. 3996.

² The Restoring American Financial Stability Act of 2009 committee print is available at http://banking.senate.gov/public/_files/111609FullBillTextofTheRestoringAmericanFinancialStabilityActof2009.pdf.

³ The Restoring American Financial Stability Act of 2010 committee print is available at http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf. The amendment adopted in committee is available at http://banking.senate.gov/public/_files/032310MangersAmendmentAYO10627.pdf.

⁴ See http://republicans.financialservices.house.gov/index.php?option=com_content&task=view&id=601&Itemid=42.

⁵ "Blueprint for a Modernized Financial Regulatory Structure" U.S. Treasury, available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

⁶ Treasury has created websites to track financial intervention and financial reform. See <http://ustreas.gov/initiatives/regulatoryreform/> and <http://www.financialstability.gov>.

This report discusses related major provisions of the enacted version of the Dodd-Frank Act.

Understanding the fabric of financial reform proposals requires some analysis both of the Panic of 2008, as well as of more enduring concerns about risks in the financial system. This report begins with that analysis.

The Panic of September 2008⁷

The financial disruptions that peaked in September 2008 focused policy attention on systemic risk, which had previously been a subject of interest to academics and central bankers, but was not seen as a significant threat to economic stability. The last major systemic risk episode was bank runs in the Great Depression; the main elements of the current bank regulatory regime and federal safety net were put in place to prevent its recurrence. Between the end of the Great Depression and the early 2000s, the financial system weathered numerous shocks, failures, and crashes, with limited spillover into the real economy. Typically, the Federal Reserve (Fed) would announce that it stood ready to provide liquidity to the system, and that proved sufficient to stem panic. The idea that a financial shock could cause the entire system to spin out of control and collapse, and that the flow of credit might stop altogether, seemed to many to be a remote prospect. De facto policy was to rely on the Fed to deal with crises after the fact.

The events of 2007 and 2008 caused a sharp reassessment of the robustness and the self-stabilizing capacity of the financial system. As Treasury Secretary Timothy Geithner noted in written testimony delivered to the House Financial Services Committee on September 23, 2009, “The job of the financial system . . . is to efficiently allocate savings and risk. Last fall, our financial system failed to do its job, and came precariously close to failing altogether.”⁸

A number of discrete failures in individual markets and institutions led to global financial panic. U.S. financial firms suffered heavy losses in 2007 and 2008, primarily because of declines in the value of mortgage-related assets. During September 2008, Fannie Mae and Freddie Mac were placed in government conservatorship. Merrill Lynch was sold in distress to Bank of America in a deal supported by the Fed and Treasury. The Fed and Treasury failed to find a buyer for Lehman Brothers, which subsequently filed for bankruptcy, disrupting financial markets. A money market mutual fund (the Reserve Primary Fund) that held Lehman-related paper announced losses, triggering a run on other money market funds, and Treasury responded with a guarantee for money market funds. The American International Group (AIG), an insurance conglomerate with a securities subsidiary that specialized in financial derivatives, including credit default swaps, was unable to post collateral related to its derivatives and securities lending activities. The Fed intervened with an \$85 billion loan to prevent bankruptcy and to ensure full payment to AIG’s counterparties. In response to the general panic, Congress approved the \$700 billion Troubled Asset Relief Program (TARP); the Fed introduced several lending facilities to provide liquidity to different parts of the financial system; and the Federal Deposit Insurance Corporation (FDIC) introduced a debt guarantee program for banks. The panic largely subsided through the latter part of 2008, although confidence in the financial system returned very slowly.

⁷ See, for example, “The Panic of 2008,” a speech given by Federal Reserve Governor Kevin Warsh on April 6, 2009, for discussion of aspects of typical financial panics and historical examples, available at <http://www.federalreserve.gov/newsevents/speech/warsh20090406a.htm>.

⁸ Treasury Secretary Timothy F. Geithner, Written Testimony House Financial Services Committee, Financial Regulatory Reform, September 23, 2009, available at <http://www.ustreas.gov/press/releases/tg296.htm>.

It was widely understood that the panic had its roots in the subprime mortgage market, in which years of double-digit housing price increases had fed a bubble mentality and caused lenders to relax their customary prudence. That the housing market would cool, as it began to do in 2006, was not a great surprise. What was generally unexpected was the way losses caused by rising foreclosures and bad loan rippled through the system. Major financial institutions had constructed highly leveraged speculative positions that magnified the subprime shock, so that a setback in a \$1 trillion segment of the U.S. housing market generated many times that amount in financial losses.

Giant financial institutions were shown to be vulnerable to liquidity runs, and many failed or had to be rescued as short-term credit dried up. The value of complex financial instruments created through securitization became completely uncertain, and market participants lost confidence in each others' creditworthiness. Risks that were thought to be unrelated became highly correlated; a negative spiral that showed all financial risk taking to be interconnected and all declines to be self-reinforcing took hold. Doubts about counterparty exposure were magnified by opacity in derivatives markets.

Disruption to the financial system exacerbated recessionary forces already at work in the economy. Asset prices plunged and consumers suffered sharp losses in their retirement and college savings accounts, as well as in the value of their homes. The financial crisis accelerated declines in consumption and business investment, which in turn made banks' problems worse. Overall, the recession proved to be the deepest and longest since the Great Depression.

Against this background, Congress took up financial reform legislation in 2009. The legislation included measures to improve systemic stability, improve policy options for coping with failing financial firms, increase transparency throughout financial markets, and protect consumers and investors. By the time of final passage, the Dodd-Frank Act included provisions that affect virtually every financial market and to amend existing or grant new authority and responsibility to nearly every federal financial regulatory agency.

The Dodd-Frank Act (P.L. 111-203)

Systemic Risk

Policy Issues⁹

Systemic risk refers to sources of instability for the financial system as a whole, often through "contagion" or "spillover" effects that individual firms cannot protect themselves against.¹⁰ Although regulators took systemic risk into account before the crisis, and systemic risk can never be eliminated, analysts have pointed to a number of ostensible weaknesses in the regulatory regime's approach to systemic risk. First, there has been no regulator with overarching responsibility for mitigating systemic risk. Some analysts argue that systemic risk can fester in

⁹ For more information, see CRS Report R40877, *Financial Regulatory Reform: Systemic Risk and the Federal Reserve*, by Marc Labonte.

¹⁰ For an overview of systemic risk, see CRS Report R40417, *Macroprudential Oversight: Monitoring Systemic Risk in the Financial System*, by Darryl E. Getter.

the gaps in the regulatory system where one regulator's jurisdiction ends and another's begins. Second, the crisis revealed that liquidity crises and runs were not just a problem for depository institutions. Third, the crisis revealed that nonbank, highly leveraged firms, such as Lehman Brothers and AIG, could be a source of systemic risk and "too big (or too interconnected) to fail." Finally, there were concerns that the breakdown of different payment, clearing, and settlement (PCS) systems, which are not regulated consistently (or, in some cases, at all), would be another source of systemic risk.

Provisions in the Dodd-Frank Act (Titles I and VIII)

The Dodd-Frank Act does not create a dedicated systemic risk regulator with powers to neutralize sources of systemic risk as they arise. Instead, it creates a Financial Services Oversight Council (FSOC), chaired by the Treasury Secretary and consisting of eight heads of federal regulatory agencies (including the newly created Consumer Financial Protection Bureau) and a presidential appointee with insurance experience. The act creates an Office of Financial Research to support the council. The council is authorized to identify and advise regulators on sources of systemic risk and "regulatory gap" problems, but would have no rulemaking, examination, or enforcement powers of its own. The council is to identify systemically important financial firms regardless of their legal charter, and the Fed will subject them to stricter prudential oversight and regulation, including short-term debt limits, a 10% liability concentration limit, counterparty exposure set at 25% of total capital, risk-based capital requirements (that account for off-balance sheet activities), annual stress tests, and a 15-to-1 leverage limit. The details of this stricter oversight will be determined by the Fed in yet-to-be issued implementing rules. Many large firms are already regulated by the Fed for safety and soundness because they are bank holding companies; the act prevents a firm from changing its charter in order to escape Fed regulation. In addition, the Dodd-Frank Act includes mechanisms by which the Fed would be empowered to curb the growth or reduce the size of large firms to prevent systemic risk.

The Dodd-Frank Act (Section 619) puts limits on commercial banks' proprietary trading activities and investments in hedge funds or private equity firms.¹¹ It also provides for many PCS systems and activities deemed systemically important by the council to be regulated by the Fed, unless those systems are registered with the Securities and Exchange Commission (SEC) or the Commodities Futures Trading Commission (CFTC), in which case the system would be regulated by those entities. Title XI would also allow the FDIC to set up emergency liquidity programs to guarantee the debt of bank holding companies, similar to the 2008 Temporary Liquidity Guarantee Program.

¹¹ For more information, see CRS Report R41298, *The "Volcker Rule:" Proposals to Limit "Speculative" Proprietary Trading by Banks*, by David H. Carpenter and M. Maureen Murphy.

Federal Reserve Emergency Authority and Congressional Oversight

Policy Issues¹²

During the recent financial turmoil, the Fed engaged in unprecedented levels of emergency lending to nonbank financial firms through its authority under Section 13(3) of the Federal Reserve Act. This statute states that “in unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank ... to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange....”¹³

Such loans can be made only if secured to the Fed’s satisfaction and if the targeted borrower is unable to obtain the needed credit through other banking institutions. In addition to the level of lending, the form of the lending has been novel, particularly the creation of three limited liability corporations controlled by the Fed, to which the Fed lent a total of \$72.6 billion to purchase illiquid assets from Bear Stearns and AIG. The Fed’s recent actions under Section 13(3) generated debate in Congress about whether measures were needed to amend the institution’s emergency lending powers.

Provisions in the Dodd-Frank Act (Title XI)

The Dodd-Frank Act includes several provisions related to Federal Reserve lending authority. In particular, this legislation stipulates that, although the Fed may authorize a Federal Reserve Bank to make collateralized loans as part of a broadly available credit facility, it may not authorize a Federal Reserve Bank to lend to only a single and specific individual, partnership, or corporation. When using emergency authority, the Fed will be required to seek approval from the Treasury Secretary. In addition, the Dodd-Frank Act allows the Government Accountability Office (GAO) to audit the Fed’s lending facilities and open market operations for internal controls and risk management, and it calls for a GAO audit of the Fed’s actions during the crisis. The act requires disclosure of Fed borrowers and borrowing terms, with a lag. The act also prohibits firms regulated by the Fed from participating in the selection of directors of the regional Federal Reserve Banks.

Resolution Regime for Failing Firms

Policy Issues¹⁴

Most companies that fail in the United States are resolved in accordance with the bankruptcy code. Depository institutions that hold FDIC-insured deposits are subject to a special resolution regime, called a conservatorship or receivership. Under normal circumstances, bankruptcies are

¹² See CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

¹³ 12 U.S.C. § 343.

¹⁴ See CRS Report R40530, *Insolvency of Systemically Significant Financial Companies (SSFCs): Bankruptcy vs. Conservatorship/Receivership*, by David H. Carpenter.

judicial in nature with no additional public resources available to support the process. The FDIC's conservatorship/receivership regime is a largely nonjudicial, administrative process, requiring the FDIC to resolve depositories such that the total to be expended will cost the Deposit Insurance Fund less than any other possible method. Under limited circumstances, the FDIC may waive this "least-cost resolution" requirement in order to minimize systemic risk.¹⁵ Some believe that the speed and discretion available in the FDIC's conservatorship/receivership regime is a useful model for resolving other types of systemically important financial firms. The collapse of Lehman Brothers (and the near collapse of AIG, Bear Stearns, and others) during the recent financial crisis has focused congressional attention on policy options for resolving systemically significant nondepository financial institutions.¹⁶ Proponents argue that creating a special resolution regime for such firms would make future taxpayer bailouts unnecessary. Opponents argue that it would provide a way for policymakers to provide "backdoor bailouts" to favored creditors and counterparties of failing firms.

Provisions in the Dodd-Frank Act (Title II)

The Dodd-Frank Act establishes a new system for certain financial companies whose resolution under otherwise available law is determined by various federal regulators to pose dangers to the U.S. financial system. This resolution system is modeled after the FDIC's existing receivership regime for depository institutions. Many types of financial companies and their subsidiaries are eligible for this special resolution regime; however, subsidiaries that are insurance companies, certain broker-dealers, and insured depositories are not eligible.

For an eligible financial company to be resolved under the special regime, a group of regulators, including two-thirds of the Federal Reserve Board, must recommend the company for the resolution based on standards delineated by the Dodd-Frank Act. After the recommendation, the Secretary of the Treasury (Secretary), in consultation with the President, must make a determination that the "company is in default or in danger of default;" the company's resolution under otherwise available law would "have serious adverse effects on financial stability of the United States; no viable private sector alternative is available;" and other considerations.¹⁷ A company that disputes the determination by the Secretary will have limited rights to appeal the determination in federal court.

Although the special resolution regime is modeled after the FDIC's receivership power, there are some important distinctions between the two. For instance, the Dodd-Frank Act emphasizes that

creditors and shareholders will bear the losses of the financial company; management responsible for the condition of the financial company will not be retained; and the [FDIC] and other appropriate regulators will take all steps necessary and appropriate to assure that all parties ... having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility.¹⁸

¹⁵ 12 U.S.C. § 1823(c)(4).

¹⁶ For a more in-depth analysis of these resolution regimes, see CRS Report R40530, *Insolvency of Systemically Significant Financial Companies (SSFCs): Bankruptcy vs. Conservatorship/Receivership*, by David H. Carpenter and CRS Report R40928, *Lehman Brothers and IndyMac: Comparing Resolution Regimes*, by David H. Carpenter.

¹⁷ Dodd-Frank Act § 203.

¹⁸ Dodd-Frank Act § 204.

The act also states that “[a]ll financial companies put into receivership under this title shall be liquidated, [and n]o taxpayer funds shall be used to prevent the liquidation of any financial company under this title.”¹⁹

The funding mechanism for resolutions under the Dodd-Frank Act also differs from the conservatorship/receivership regime for depositories. The Orderly Liquidation Fund established by the Dodd-Frank Act will not be prefunded. Instead, the FDIC, upon being appointed receiver of a particular financial company, is authorized to borrow funds from the Treasury subject to explicit caps based on the value of the failed firm’s consolidated assets. If necessary to pay off such obligations to the Treasury, the FDIC would have the authority to assess claimants of the failed institution that received more compensation through the receivership than they would have received had the failed firm been liquidated in bankruptcy, as well as with the power to assess certain large financial institutions (bank holding companies and nonbank financial companies eligible for the special resolution regime that have more than \$50 billion in assets and all nonbank financial institutions supervised by the Fed as systemically significant). The Dodd-Frank Act also imposes a three-year time limit on any receivership with the possibility of up to two one-year extensions.

Securitization and Shadow Banking

Policy Issues²⁰

Shadow banking refers to financial activity either conducted by nonbanks or sponsored by banks off of their balance sheets. Securitization supports the shadow banking system. Securitization is the process of turning mortgages, credit card loans, and other debt into marketable securities. Securitizers acquire and pool many loans from primary lenders and then issue new securities based on the flow of payments through the pool. This process can allow banks to reduce the risk of their retained portfolios. Securitization also finances nonbank lenders specializing in mortgage loans, credit cards, and other loan products, and thus can increase the amount of credit available to businesses and consumers. If the risks of securitized products are adequately managed and understood, securitization can enhance financial stability by shifting financial risk to those most willing and able to bear it.

Securitization risks were not properly managed during the period leading up to the crisis, which contributed to the housing bubble and financial turmoil in a variety of ways. Lenders planning to sell their loans have a reduced stake in the borrower’s long-term capacity to repay the loan. Bank underwriting standards are subject to guidances issued by bank regulators because loans to risky borrowers might be unsafe and unsound for the banks themselves. These guidances, however, do not apply to nonbank mortgage lenders that are funded through securitization (although the Fed has separate authority to regulate lending). Private securitization was especially prevalent in the subprime mortgage market, the nonconforming mortgage market, and in regions where loan defaults have been particularly severe. As loans were made that the lender never expected to hold, mortgage underwriting standards deteriorated.

¹⁹ Dodd-Frank Act § 214.

²⁰ See CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward V. Murphy.

Opaqueness in the shadow banking system also caused problems. When defaults rose among home buyers, the complexity of mortgage-backed securities (MBSs) made it more difficult to identify which firms would suffer the largest losses. Furthermore, a drop in the credit rating of a MBS could require some holders to sell, even though the security was still performing. In addition to holding the securities of nonbank subprime lenders, some banks also sponsored their own mortgage funding facilities off their balance sheets in special purpose vehicles. When the liquidity of MBSs declined, some of these sponsoring banks had to pull the assets of such special purpose vehicles back on to their balance sheets and recognize more losses.

One approach to address incentives in securitization is to require loan securitizers to retain a portion of the long-term default risk. An advantage of this “skin in the game” requirement is that it may help preserve underwriting standards among lenders funded by securitization. Another advantage is that securitizers would share in the risks faced by the investors to whom they market their securities. A possible disadvantage is that if each step of the securitization chain must retain a portion of risk, then relatively little risk may ultimately be shifted out of the financial sector to investors. To the extent that securitization is seen as a device to shift risk to those more willing and able to bear it, concentration of risk in the financial sector may be self-defeating.

Provisions in the Dodd-Frank Act (Title IX)

The Dodd-Frank Act generally requires securitizers to retain some of the risk if they issue asset-backed securities. The amount of risk required to be retained depends in part on the quality of the underlying assets. Regulators are instructed to write risk retention rules requiring less than 5% retained risk if the securitized assets meet prescribed underwriting standards. For assets that do not meet these standards, regulators are instructed to require not less than 5% retention of risk. Securitizers are prohibited from hedging the retained credit risk.

The Dodd-Frank Act requires separate risk retention rules for different asset classes that are securitized (residential mortgages, commercial mortgages, auto loans, etc.). The risk retention rules for securitization of nonmortgage assets are to be jointly issued by the SEC and Federal Banking Agencies (FDIC, Office of the Comptroller of the Currency [OCC], and Federal Reserve). The risk retention rules for the securitization of mortgage assets are to be jointly issued by the SEC, the Federal Banking Agencies, the Department of Housing and Urban Development (HUD), and the Federal Housing Finance Agency (FHFA). Regulators are also directed to craft risk retention rules appropriate to collateralized debt obligations (CDOs) and other complex securities if the underlying assets are tranches of other asset-backed securities.

Regulators may also impose retained risk requirements on originators of assets after taking into account the riskiness of the assets, whether securitization markets are causing a decline in prudent underwriting, and the effect on the ability of consumers and businesses to obtain credit on reasonable terms.

In the case of residential mortgages that are securitized, the Dodd-Frank Act allows for a complete exemption from risk retention if all of the mortgages in the securitization meet the standards of a “qualified residential mortgage,” which regulators will define according to certain factors, but which must be no broader than the definition of “qualified mortgage” in Section 1412 of Dodd-Frank. Some of the factors are full documentation of borrowers’ financial resources, debt-to-income ratio limits, and payment shock mitigation. The act also provides an exemption from retained risk requirements for certain Farm Credit Administration loans and related guarantees. Also exempt are loans guaranteed by the United States or an agency of the United

States, as well as municipal securities. Notably, securities guaranteed by Fannie Mae and Freddie Mac are not automatically exempt.

The act requires securitizers to perform due diligence on the underlying assets of the securitization and to disclose the nature of the due diligence. In addition, investors in asset-backed securities are to receive more information about the underlying assets.

Consolidation of Bank Supervision

Policy Issues²¹

Commercial banks and similar institutions are subject to regulatory examination for safety and soundness. Prior to the crisis, depending on their charter, commercial banks, thrifts, and credit unions may have been examined by the OCC, the Office of Thrift Supervision (OTS), the Federal Reserve, the National Credit Union Administration (NCUA), or a state authority. State bank examiners often coordinated through the Conference of State Bank Supervisors. Federal bank examiners often conducted joint rulemaking and coordinated through the Federal Financial Institutions Examinations Council (FFIEC). In addition, some firms engage in bank-like activities, but are not subject to oversight by bank regulators.

The system of multiple bank regulators was believed to have problems, some of which could be mitigated by regulatory consolidation. Multiple regulators may find it challenging to implement consistent enforcement even if they employ joint rulemaking. To the extent that regulations are applied inconsistently, institutions may have an incentive to choose the regulator that they feel will be the weakest or least intrusive. If so, competition among the regulators for covered institutions (regulatory arbitrage) could lead to less effective financial supervision. Among the arguments against consolidation are that regulatory consolidation could change the traditional U.S. dual banking system in ways that put smaller banks at a disadvantage. Another argument for maintaining the current system is that competition among regulators encourages the regulators to monitor each other and alert policymakers if one regulator lowers standards.

During the Dodd-Frank policy debate, there was concern about the Fed's roles in both bank holding company regulation and conducting monetary policy. Some argued that the Fed should concentrate on monetary policy and have fewer regulatory responsibilities, especially if the institution's independence is to be preserved. In contrast, the Fed argued that its bank regulation responsibilities provided it with helpful information for the conduct of monetary policy.

Provisions in the Dodd-Frank Act (Title III)

The Dodd-Frank Act did not effect a complete consolidation of banking agencies, nor did it remove the Fed's bank regulatory responsibilities. Title III eliminates the Office of Thrift Supervision as an independent agency and reassigns its duties to the FDIC, the OCC, and to the Federal Reserve. The Fed will be the holding company level regulator for institutions formerly regulated by OTS. The OCC will be the depository institution level regulator for federally

²¹ See CRS Report R41176, *Federal Financial Services Regulatory Consolidation: Structural Response to the 2007-2009 Financial Crisis*, by Walter W. Eubanks and CRS Report R40249, *Who Regulates Whom? An Overview of U.S. Financial Supervision*, by Mark Jickling and Edward V. Murphy.

chartered thrifts. The FDIC will be the depository institution level regulator for state chartered thrifts. The Fed remains the regulator for state chartered member banks. Title III also expands the assessment base for the FDIC's deposit insurance fund. The new formula will be based upon the total assets of the insured depository minus the average tangible equity of the insured depository. Title VI also creates a three-year moratorium on chartering new credit card banks, industrial loan companies, and trust banks.

Consumer Financial Protection²²

Policy Issues

In the United States, depository institutions—banks, thrifts, and credit unions—have been subject to comprehensive supervision, examination, and enforcement by a number of federal regulators. These regulators have monitored the institutions that they supervise for both safety and soundness and for compliance with other federal laws, including the various federal consumer protection laws. Many nondepository financial companies, such as payday lenders and nonbank mortgage lenders, have been primarily regulated by the states. However, the financial products that these nondepositories offer may still be subject to federal consumer protection laws, such as the Truth in Lending Act (TILA).²³ The Federal Reserve largely has been charged with promulgating the regulations to implement the TILA and most other federal consumer protection laws, and the Federal Trade Commission (FTC) primarily has been responsible for enforcing these laws and regulations against institutions that do not have a primary federal regulator.

In light of this fragmented system, some have proposed legislation to consolidate consumer financial protection functions. These proposals raise policy questions regarding how best to balance safety and soundness regulation with consumer compliance. Although a loan that cannot be repaid is typically bad for both the borrower and the lender, there are some areas in which there can be a conflict between safety and soundness regulation and consumer protection. When a banking activity is profitable, safety and soundness regulators tend to look upon it favorably, because it enables the bank to meet capital requirements and withstand financial shocks. A consumer protection regulator, however, may look at such activity less favorably, especially if the profit is seen to have been gained unfairly at the expense of consumers. Removing consumer compliance authority from the federal bank regulators may weaken the safety and soundness regulation of banks if, for example, the separation results in a less complete picture of bank operations for the prudential regulator. The Fed has argued that its role in consumer protection aids its other authorities, including bank supervision and systemic risk. On the other hand, some, including the Obama Administration, have argued that professional bank examiners are trained “to see the world through the lenses of institutions and markets, not consumers,”²⁴ and separating compliance and safety and soundness into a different agency is the best way to protect both consumers and financial institutions. The extent to which the cost and availability of credit will be affected by a new regulator will depend on exactly what rules it prescribes and how aggressively it and the other regulators enforce consumer protection laws and regulations.

²² See CRS Report R41338, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title X, The Consumer Financial Protection Bureau*, by David H. Carpenter.

²³ 15 U.S.C. §§ 1601 *et seq.*

²⁴ U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, June 2009, pg. 56, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

Provisions in the Dodd-Frank Act (Title X)

The Dodd-Frank Act establishes a Bureau of Consumer Financial Protection within the Federal Reserve System to have authority over an array of consumer financial products and services (including deposit taking, mortgages, credit cards and other extensions of credit, loan servicing, check-guaranteeing, collection of consumer report data, debt collection, real estate settlement, money transmitting, financial data processing, among others). It will serve as the primary federal consumer financial protection supervisor and enforcer of federal consumer protection laws over many of the institutions that offer these products and services. The bureau will be required to consult with the prudential regulators when prescribing regulations.

The bureau's authority over financial institutions varies according to the type of company: (1) depository institutions with more than \$10 billion in assets (i.e., "larger depositories"); (2) depository institutions with \$10 billion or less in assets (i.e., "smaller depositories"); and (3) nondepositories. The Dodd-Frank Act explicitly exempts a number of different entities and consumer financial activities from the bureau's supervisory and enforcement authority. Within a year and a half of enactment, primary consumer protection supervisory and enforcement powers over larger depositories that are currently held in those institutions' prudential regulators will be transferred to the bureau.

The bureau will not acquire primary supervisory and enforcement powers over smaller depositories. Instead, these powers will remain with those institutions' primary regulators. The bureau will have some ability to participate in the examination of these smaller depositories, refer potential enforcement actions against smaller depository institutions to their prudential regulators, and require reports directly from these depositories. While the bureau's supervisory and enforcement powers are limited with regard to these smaller depositories, they, along with their larger depository counterparts, generally will be subject to the consumer protection rules prescribed by the bureau.

Regarding nondepository institutions that offer consumer financial products and services, the bureau would only be the primary supervisor and enforcer over entities that

- (1) are engaged in consumer mortgage related activities (i.e., mortgage origination, brokerage, or servicing activities, mortgage modification or foreclosure relief activities);
- (2) are nonmortgage related consumer financial entities that are "larger participant[s] in a market" as determined by the Bureau in regulations and after consultation with the FTC;
- (3) the Bureau has reasonable cause to believe are "engaging, or ha[ve] engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services;"
- (4) provide or offer to provide private student loans; or
- (5) provide or offer to provide a payday loan.²⁵

The bureau's supervisory powers over these covered nondepositories include the authority to require them to register with the bureau, submit to background checks, or adhere to other

²⁵ Dodd-Frank Act § 1024.

measures “to ensure that such persons are legitimate entities and are able to perform their obligations to consumers.”²⁶

The Dodd-Frank Act authorizes the bureau to prescribe rules and issue orders and guidance. The act also transfers to the bureau rulemaking authority for many of the existing federal consumer protection laws (referred to as the “enumerated consumer laws”), including the TILA, Real Estate Settlement Procedures Act, and Home Ownership and Equity Protection Act. As a check on the bureau’s rulemaking powers, the Financial Stability Oversight Council has the ability to set aside a regulation prescribed by the bureau if the regulation “would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk.”

As previously mentioned, the Dodd-Frank Act explicitly exempts some activities and entities from the bureau’s jurisdiction. For instance, the bureau generally will not have any power to regulate insurance activities or to impose interest rate caps on products. The act also significantly limits the bureau’s supervisory, enforcement, and rulemaking powers over a

merchant, retailer, or seller of nonfinancial goods or services ... to the extent that such person (i) extends credit directly to a consumer ... exclusively for the purpose of enabling that consumer to purchase such nonfinancial good or service directly from the merchant, retailer, or seller; (ii) ... collects debt arising from [such] credit ... or (iii) sells or conveys [such] debt ... that is delinquent or otherwise in default.²⁷

The bureau’s authority is further restricted on certain merchants, retailers, and sellers of nonfinancial goods that are also small businesses. It generally does not have supervisory, rulemaking, or enforcement powers over automobile dealers, but the Dodd-Frank Act makes it easier for the FTC to regulate them.²⁸ Other entities for which the act provides certain exemptions include real estate brokers, real estate agents, sellers of manufactured and mobile homes, income tax preparers, and accountants, each to the extent that they are acting in their normal capacity (e.g., a real estate broker would be exempt to the extent that s/he brings parties together to purchase a property). However, the bureau will be able to exert authority over these entities to the extent that they are subject to an enumerated consumer law.

Mortgage Standards

Policy Issues

Beginning around the middle of 2006, residential mortgage delinquency and foreclosure rates began to rise sharply in many regions of the United States. In addition to the negative effects on some homeowners, the increase in nonperforming mortgages contributed to the financial crisis by straining the balance sheets of financial firms that held those mortgages. Although all kinds of mortgages experienced increases in delinquency and foreclosure, many poorly performing mortgages exhibited increasingly complex features, such as adjustable interest rates, or

²⁶ Dodd-Frank Act § 1024.

²⁷ Dodd-Frank Act § 1027(a).

²⁸ The Dodd-Frank Act streamlines the FTC’s rulemaking procedures for declaring trade practices to be unfair or deceptive under the FTC Act, but only with regards to auto dealers. Dodd-Frank Act § 1029. The FTC’s general rulemaking procedures under the FTC Act are not altered by the Dodd-Frank Act. 15 U.S.C. § 57a.

nontraditional mortgage features, such as negative amortization.²⁹ Such nontraditional or complex mortgage features may be appropriate for some borrowers in some circumstances, many were made available more widely than the purposes for which they were originally intended. In addition, some observers view certain mortgage features, such as high prepayment penalties, as predatory. Although not all troubled mortgages exhibited these or similar features, and not all loans that exhibited such features became troubled, some observers point to the widespread use of such mortgage terms as having exacerbated the housing “bubble” and its subsequent collapse.

The role that nonperforming mortgages played in the recent financial crisis have led some to suggest that actions should be taken both to protect consumers from risky mortgage products and to protect the U.S. financial system from experiencing major losses due to troubled mortgages in the future. One possible way to minimize mortgage defaults and foreclosures is to limit or prohibit certain mortgage features that are viewed as especially risky. Another would be to require mortgage lenders to offer consumers basic mortgage products with traditional terms alongside any loan with nontraditional features. Although either of these approaches may reduce the chances of widespread mortgage failures, and might help preserve financial stability, both could also limit consumer choice or prevent borrowers from taking out loans with nontraditional features that may be advantageous given their specific circumstances. Some argue that such approaches could limit financial innovation in mortgage products or reduce competition among lenders.

Provisions in the Dodd-Frank Act (Title XIV)

The Dodd-Frank Act amends the Truth in Lending Act to set minimum standards for certain residential mortgages. Lenders will be required to determine that mortgage borrowers have a reasonable ability to repay the mortgages that they receive, based on the borrowers’ verified income and other factors, subject to regulations promulgated by the Fed. Certain “qualified mortgages” with traditional mortgage terms will be presumed to have met these requirements. The Fed is also directed to issue regulations prohibiting mortgage originators from “steering” consumers to mortgages that (1) those consumers do not have a reasonable ability to repay, (2) exhibit certain features that are determined to be predatory, or (3) meet certain other conditions. It is also directed to issue regulations prohibiting any practices related to residential mortgage lending that it deems to be “abusive, unfair, deceptive, [or] predatory.” The legislation restricts the use of prepayment penalties. Mortgage originators are prohibited from receiving compensation that varies in any way based on the applicable mortgages terms or conditions, other than the principal amount. The legislation also requires increased disclosures to consumers on a range of topics, including disclosures related to how certain features of a mortgage may affect the consumer.

New requirements related to “high-cost mortgages” are included in the legislation, such as limitations on the terms of such mortgages and a requirement that lenders verify that borrowers have received pre-purchase counseling before obtaining such a mortgage. The legislation also imposes additional restrictions on residential mortgage loans and includes additional housing-related provisions that are not discussed in this report.

²⁹ See CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward V. Murphy.

Derivatives

Policy Issues³⁰

Derivatives are financial contracts whose value is linked to some underlying price or variable. Derivatives are traded both on organized exchanges with central clearing houses that guarantee payment on all contracts, and in a previously unregulated over-the-counter (OTC) market, where credit risk is borne by the individual counterparties. The CFTC regulates commodity futures and options on futures, whereas the SEC regulates options on securities.

The Commodity Futures Modernization Act of 2000 (CFMA)³¹ largely exempted swaps and other derivatives in the OTC market from regulation. The collapse of AIG in 2008 illustrated the risks of large OTC derivatives positions that are not backed by collateral or margin (as a central clearing house would require). If AIG had been required to post margin on its credit default swap contracts, it would not have been able to build such a large position, which may have reduced the threat to systemic stability and resulting a costly taxpayer bailout. Such disruptions in markets for financial derivatives during the recent crisis led to calls for changes in derivatives regulation, particularly in the OTC market. Further, opacity in the OTC market made it difficult for policymakers and market participants to gauge firms' risk exposures, arguably exacerbating the panic.

Derivatives reform focused on requiring the OTC markets to adopt features of the regulated markets, including mandatory clearing through derivatives clearing organizations, trading on exchanges or exchange-like facilities, registration of certain market participants, and the like.

Provisions in the Dodd-Frank Act (Titles VII and XVI)

The Dodd-Frank Act mandates centralized clearing and exchange-trading of many OTC derivatives, but provides exemptions for certain market participants.³² The act creates a process by which federal regulators (either the CFTC or the SEC) will determine which types of swaps and security-based swaps will be subject to the clearing requirement. It also requires reporting of all swaps and security-based swaps, including those that are not subject to or are exempt from the clearing requirement, to regulated entities or to regulators themselves. The act requires regulators to impose capital requirements on swap dealers, security-based swap dealers, major swap participants, and major security-based swaps participants. The CFTC is to regulate "swaps," which include contracts based on interest rates, currencies, physical commodities, some credit default swaps, whereas the SEC will have authority over "security-based swaps," including other credit default swaps and equity swaps.³³ Both agencies will be given the power to promulgate rules to prevent the evasion of the clearing requirements created by the act.

³⁰ For more information, see CRS Report R40965, *Key Issues in Derivatives Reform*, by Rena S. Miller.

³¹ P.L. 106-554, 114 Stat. 2763.

³² Dodd-Frank Act § 723 (swaps) and § 763 (security-based swaps (SBS)).

³³ Contracts with a large number of underlying securities will be swaps; contracts based on single securities or narrow-based security indexes will be security-based swaps.

In general, swaps and security-based swaps that must be cleared must also be traded on an exchange or exchange-like facility that provides price transparency. The regulators are given considerable discretion to define the forms of trading that will meet this requirement.

The Dodd-Frank Act includes an exemption from the clearing requirement, if desired, if at least one party to the trade is an “end user,”³⁴ defined as parties that are not financial entities³⁵ and are using the swaps to hedge or mitigate commercial risk. An exempted party must inform the CFTC or SEC (depending on the contract) on how they generally meet their financial obligations when entering into noncleared swaps or security-based swaps.

Section 716, a widely debated section of the act, prohibits federal assistance to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity.³⁶ Swaps entities are defined as swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants that are registered under either the CEA or the Exchange Act. However, swap entities do not include any major swap participant or major security-based swap participant that is an insured depository institution. This exemption appears to address concerns that under previous language large commercial banks would have been unable to hedge their risk without becoming ineligible for federal assistance, including access to the Federal Reserve’s discount window or any other Fed credit facility and FDIC insurance.

Depository institutions will be able to act as swap dealers in limited circumstances, such as when they are permitted to deal in the underlying interest, but not with regard to credit default swaps. Furthermore, depository institutions are permitted to establish an affiliate that is a swap entity as long as it is supervised by the Fed and comports with Sections 23A and 23B of the Federal Reserve Act.

Credit Rating Agencies

Policy Issues³⁷

Credit rating agencies provide investors with an evaluation of the creditworthiness of bonds issued by a wide spectrum of entities, including corporations, sovereign nations, and municipalities. The grading of the creditworthiness is typically displayed in a letter hierarchical format: for example, AAA being the safest, with lower grades representing a greater risk. Credit rating agencies are typically paid by the issuers of the securities being rated by the agencies, which could be seen as a conflict of interest. In exchange for adhering to various reporting requirements, the SEC provides interested credit rating agencies with a Nationally Recognized

³⁴ Dodd-Frank Act § 723 (Swaps) and § 763 (SBS).

³⁵ Financial entities are defined, for the purposes of these subsections, as swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, commodity pools, private funds, employee benefit plans, and persons predominantly engaged in activities that are in the business of banking or are financial in nature. The CFTC and SEC are given the power to exempt small banks, savings associations, farm credit system institutions, and credit unions from the definition of financial entities. § 723 (Swaps) and § 763 (SBS) of the Dodd-Frank Act.

³⁶ Dodd-Frank Act § 716.

³⁷ See CRS Report R40613, *Credit Rating Agencies and Their Regulation*, by Gary Shorter and Michael V. Seitzinger.

Statistical Rating Organization (NRSRO) designation. The designation is particularly important because a variety of state and federal laws and regulations have referenced NRSRO ratings.³⁸

In recent years, credit rating agencies have come under increased public scrutiny following several alleged performance failures. For instance, during the recent housing boom cycle the three dominant agencies (Fitch, Moody's, and Standard & Poor's) initially rated many mortgage-backed securities as AAA, before sharply downgrading the securities as the subprime mortgage market collapsed, resulting in heavy losses for investors that relied on these ratings. In some circumstances, downgrades forced financial firms to sell or hold more capital against the security, thereby exacerbating liquidity and deleveraging problems. The perceived agency failings have led to a focus on strengthening the accountability of credit rating agencies and reducing potential conflicts of interest that may compromise the integrity of their ratings.

Provisions in the Dodd-Frank Act (Title IX)

The Dodd-Frank Act contains provisions that enhance SEC regulation; impose new reporting, disclosure, and examination requirements on NRSROs; establish new standards of legal liability, create a new mechanism to prevent issuers of structured finance securities from choosing the agency that will perform the initial rating; and require removal of references to NRSRO ratings from federal statutes and regulations.

The act establishes an Office of Credit Ratings in the SEC to examine NRSROs and issue related regulations, including rules requiring that each credit rating be accompanied by extensive disclosures about the assumptions and methodologies underlying the rating. To permit users of ratings to compare NRSRO performance, the SEC will publish information on initial credit ratings and on subsequent changes to such ratings. After notice and opportunity for a hearing, the SEC will be permitted to temporarily suspend or permanently revoke an NRSRO's registration for a particular class of securities if it determines that the NRSRO lacks adequate financial and managerial resources for producing ratings with integrity.

Under the Dodd-Frank Act, NRSROs will be subject to the same standards of accountability as are statements made by registered public accounting firms and securities analysts. The act also permits investors to bring private rights of action against NRSROs for a knowing or reckless failure to conduct a reasonable investigation while performing a credit rating. The act requires the SEC to promulgate rules designed to prevent the sales and marketing considerations of an NRSRO from influencing the ratings that it produces and gives it the authority to revoke or suspend the registration of NRSROs that violated such rules.

The Dodd-Frank Act removes the references to credit ratings in selected sections in specific federal financial statutes.³⁹ Federal regulatory agencies will also be required to review and remove references to NRSRO ratings. The act also directs the SEC to conduct a study that would result in it establishing a system under which the initial rating assignments for structured finance securities would be made on a random or semirandom basis.

³⁸ See CRS Report RS22519, *Credit Rating Agency Reform Act of 2006*, by Michael V. Seitzinger.

³⁹ As an example, federally-insured thrifts were prohibited from owning bonds rated below investment grade by an NRSRO.

Investor Protection

Policy Issues

The multi-billion dollar Madoff Ponzi scheme raised concerns over the effectiveness of the SEC's efforts to protect investors. Madoff's operation was a registered broker-dealer subject to both SEC and Financial Industry Regulatory Authority (FINRA, the self regulatory organization for broker-dealers) oversight, as well as a registered investment adviser subject to SEC oversight. Reform initiatives seek to improve the SEC's performance by providing it with more funding and by amending the regulation of investment advisers and others.

Under prior law, broker-dealers were required to make recommendations "suitable" to their customers, while investment advisers have a fiduciary duty to act in the customers' best interests, without regard to their own compensation, and with an affirmative duty to disclose any potential conflicts of interest. The services provided by broker-dealers and investment advisers, however, often overlap—both can provide investment advice and there are some concerns that customers may falsely assume that the person advising them is committed to acting in their best interests.

Provisions in the Dodd-Frank Act (Title IX)

The Dodd-Frank Act gives the SEC the authority to impose a fiduciary duty on broker-dealers who offer personalized investment advice about securities to a retail customer following a study.

The SEC collects fees from securities transactions and registration fees, which go to an account available to congressional appropriators. The SEC's budget has often been much less than the annual fees that it collects and there has been interest in permitting the agency to be self-funded as is the case with the federal banking regulators. Under the Dodd-Frank Act, some fees will be available to appropriators to fund the SEC, while others will go to the Treasury General Fund. The SEC's budget will remain subject to the congressional appropriations process, but it will submit its budget request directly to Congress, without changes by the Administration. In addition, the Dodd-Frank Act authorizes increased funding levels for FY2011 to FY2015, subject to appropriations, which would result in almost a doubling of SEC funding. It also enables the SEC to access up to \$100 million annually from a "Reserve Fund" for what the SEC "determines is necessary to carry out the functions of the agency,"⁴⁰ funded from the agency's fee collections.

The act creates an Office of Investor Advocate within the SEC. The Investor Advocate will assist retail investors in resolving significant problems they may have with the commission or with self-regulatory organizations; identify areas in which investors would benefit from changes in regulations; and identify problems that investors have with financial service providers and investment products.

The Dodd-Frank Act also establishes an Investor Advisory Committee within the SEC, whose purpose is to advise and consult with the SEC on regulatory priorities; issues relating to the regulation of securities products, trading strategies, fee structures, and the effectiveness of disclosure; initiatives to protect investor interest; and initiatives to promote investor confidence and the integrity of the securities marketplace. The committee will include an Investor Advocate,

⁴⁰ Dodd-Frank Act § 991.

a representative of the state securities commissions, senior citizen advocates, and persons representing the interests of individual equity and debt investors, and of institutional investors.

Previously, publicly traded corporations with a market value of less than \$75 million (known as nonaccelerated filers) enjoyed a temporary exemption from Section 404(b) of the Sarbanes-Oxley Act of 2002, which requires publicly traded companies to audit their internal accounting controls (a process aimed at ensuring the reliability of a firm's financial reporting).⁴¹ In 2009, the SEC adopted rules to remove the small company exemption, for the fiscal year ending on or after June 15, 2010. The Dodd-Frank Act effectively reverses that SEC rulemaking, making the exemption permanent.

The Dodd-Frank Act creates a new class of SEC registrant, the “municipal advisor.” Intermediaries who provide financial advice to municipalities will be required to register with the SEC, abide by rules written by the Municipal Securities Rulemaking Board (MSRB), and will have a fiduciary duty to their clients. The MSRB membership will be reconstituted, so that board members who are independent of the municipal securities industry constitute a majority.

Hedge Funds

Policy Issues⁴²

Hedge funds are not explicitly defined in federal securities law. They are generally described as privately organized, pooled investment vehicles not available to the public whose primary investors are wealthy individuals or institutions. Some hedge funds can also be distinguished from other investment funds by their pronounced use of leverage and their use of trading strategies based on short selling. The funds have a significant capital market presence. According to some estimates, they have been responsible for about one-fifth of the daily trading on the New York Stock Exchange and have over a trillion dollars in assets.

Hedge funds can provide benefits to financial markets by enhancing liquidity and efficiency and by reallocating financial risk. Some potential risks were revealed in 1998 when the hedge fund Long-Term Capital Management (LTCM) teetered on the brink of collapse. Concerns over the systemic implications of LTCM's collapse resulted in the New York Fed engineering a multi-billion dollar rescue of the fund. Hedge fund failures did not play a prominent role in precipitating or spreading the recent financial crisis, however.

Under the “private adviser” exemption, hedge fund managers, who do not hold themselves to be investment advisers and who have fewer than 15 clients, have been exempted from registering with the SEC as investment advisers under the Investment Advisers Act (IAA).⁴³ Although some hedge fund managers registered voluntarily, it has been argued that the absence of comprehensive hedge fund data that would accompany mandatory fund registration, could deprive regulators of

⁴¹ See CRS Report RS22482, *Section 404 of the Sarbanes-Oxley Act of 2002 (Management Assessment of Internal Controls): Current Regulation and Congressional Concerns*, by Michael V. Seitzinger.

⁴² See CRS Report R40783, *Hedge Funds: Legal History and the Dodd-Frank Act*, by Kathleen Ann Ruane and Michael V. Seitzinger and CRS Report R40783, *Hedge Funds: Legal History and the Dodd-Frank Act*, by Kathleen Ann Ruane and Michael V. Seitzinger.

⁴³ 15 U.S.C. § 80b-1 *et seq.*

potentially critical information on the size and nature of the funds and the risks that they may or may not pose to the economy.

Provisions in the Dodd-Frank Act (Title IV)

The Dodd-Frank Act eliminates the “private adviser” exemption in the IAA, generally requiring advisers to private funds such as hedge funds with more than \$150 million in assets under management to register with the SEC and to provide such information about their investment portfolios and strategies as the SEC and the FSOC deem necessary to monitor systemic risk. Advisers to venture capital funds and family offices (but not private equity funds) will be exempt from the registration requirement. The Dodd-Frank Act also raises the asset threshold for SEC registration from \$25 million to \$100 million. Smaller advisers will generally register with the states, although SEC registration is required if an adviser’s home state does not regulate advisers or if an adviser is registered to do business in more than 15 states.

Executive Compensation and Corporate Governance

Policy Issues⁴⁴

The financial crisis led to policy concerns about a possible link between excessive financial firm risk taking and executive compensation practices. Beginning in 2008, the Troubled Asset Relief Program subjected recipients to various executive pay restrictions and corporate governance requirements. In the fall of 2009, as part of its safety and soundness regulatory oversight of banks, the Fed proposed to review bank pay structures to identify any compensation arrangements that provide incentives to take excessive.⁴⁵ In June 2010, final guidance was issued. These initiatives are significantly premised on the widely held belief that large financial firm incentive pay structures significantly contributed to excessive risk taking. However, at least one major academic study has raised questions concerning the premise.⁴⁶

Provisions in the Dodd-Frank Act (Title IX)

Under the Dodd-Frank Act, at least once every three years, public company shareholders will be able to cast a nonbinding vote to approve executive compensation and where applicable, executive golden parachutes, known generally as “say on pay.” The SEC will be permitted to adopt exemptions for small public companies. The act also authorizes the SEC to promulgate rules that would allow shareholders to nominate candidates for a public company’s board through the company’s proxy materials, a process called proxy access. The SEC may exempt small companies from these provisions.

⁴⁴ See CRS Report RS22583, *Executive Compensation: SEC Regulations and Congressional Proposals*, by Michael V. Seitzinger.

⁴⁵ See CRS Report R40540, *Executive Compensation Limits in Selected Federal Laws*, by Michael V. Seitzinger and Carol A. Pettit.

⁴⁶ Rudiger Fahlenbrach, Rene Stulz, and Rene M. Bank, “CEO Incentives and the Credit Crisis,” *Charles A. Dice Center Working Paper No. 2009-13*, July 27, 2009, available at SSRN: <http://ssrn.com/abstract=1439859>.

The Dodd-Frank Act also requires the SEC to amend its rules to require additional disclosure on the relationship between executive compensation and corporate financial performance with respect to such metrics as changes in the value of an issuer's stock and dividend distributions. The SEC must issue rules prohibiting stock exchanges from listing the stock of any company that does not adopt an executive incentive pay "clawback" policy. Specifically, when there is an accounting restatement from material noncompliance with federal financial disclosure laws, a company is required to recover incentive-based compensation awarded to current or former executives based on the erroneous disclosures during three years preceding the restatement.

The Dodd-Frank Act also directs federal financial regulators to jointly adopt guidance requiring applicable financial institutions (including depository institutions, broker-dealers, credit unions, investment advisers, Fannie Mae, and Freddie Mac) with more than \$1 billion in assets to prohibit incentive-based pay arrangements for executives, employees, directors, or principal shareholders deemed to be excessive, or that could lead to material financial loss at the financial institution.

Insurance⁴⁷

Policy Issues

Under the McCarran-Ferguson Act of 1945,⁴⁸ insurance regulation is generally left to the individual states. For several years prior to the financial crisis, some Members of Congress have introduced legislation to federalize insurance regulation along the lines of the dual regulation of the banking sector, although none of this legislation has reached the committee markup stage.⁴⁹

The financial crisis, particularly the involvement of insurance giant AIG and the smaller monoline bond insurers, changed the tenor of the debate around insurance regulation, with increased emphasis on the systemic importance of some insurance companies. Although it could be argued that insurer involvement in the financial crisis demonstrated the need for full-scale federal regulation of insurance, the financial regulatory reform proposals in the 111th Congress generally have not included language implementing such a system. Instead, such proposals have tended to include the creation of a somewhat narrower federal office focusing on gathering information on insurance and setting policy on international insurance issues. Provisions on consumer protection, investor protection, and systemic risk provisions also have the potential to affect insurance, though insurance has been largely exempted from these aspects of the legislation as well.

Provisions in the Dodd-Frank Act (Title V)

The Dodd-Frank Act creates a new Federal Insurance Office within the Treasury Department. In addition to gathering information and advising on insurance issues, this office would have limited preemptive power over state insurance laws and regulations. This preemption is limited to cases in which the state measures result in less favorable treatment of non-U.S. insurers and in which the case is covered by an existing international agreement. Insurers are exempted from oversight

⁴⁷ See CRS Report R41018, *Insurance and Financial Regulatory Reform in the 111th Congress*, by Baird Webel.

⁴⁸ 15 U.S.C. § 1011 *et seq.*

⁴⁹ See CRS Report R40771, *Insurance Regulation: Issues, Background, and Legislation in the 111th Congress*, by Baird Webel.

by the act's new Bureau of Consumer Financial Protection. Under the act, systemically significant insurers could be subject to identification by the Financial Stability Oversight Council, regulation by the Federal Reserve and resolution by the special authority created by the act, although resolution of state-chartered insurance companies would continue to occur under the state insurer insolvency regimes. In addition, the Dodd-Frank Act streamlines the state regulation of surplus lines insurance and reinsurance.⁵⁰

Miscellaneous Provisions in the Dodd-Frank Act

The Dodd-Frank Act contains several miscellaneous provisions in various titles of the legislation, including the following:

- *Section 1075: Interchange Fees.* This section authorizes the Federal Reserve to prescribe regulations regarding interchange transaction fees with respect to electronic debit transactions. The amount of such interchange fees must be reasonable and proportional to the costs incurred by the debit card issuer in the transaction. This provision applies to all banks that have \$10 billion or more in assets.
- *Title III, Subtitle C: Federal Deposit Insurance Corporation.* This subtitle reforms deposit insurance by altering the assessment base, placing a floor on reserve ratios, and permanently increasing the insured deposit limit to \$250,000.
- *Title XII: Improving Access to Mainstream Financial Institutions.* This title includes provisions to expand access to the banking system for families with low and moderate incomes by (1) authorizing a program to help such individuals open low-cost checking or savings accounts at banks or credit unions; and (2) creating a pool of capital to enable community development financial institutions to provide small, local, retail loan programs as alternatives to “pay day” or automobile title loans in local communities.
- *Title XIII: The TARP Pay it Back Act.* This title reduces the amount authorized to be outstanding under the TARP to \$475 billion; it was originally \$700 billion. It will also prohibit the Treasury from using repaid TARP funds to make new TARP investments.
- *Title XV: Miscellaneous Provisions.* This title requires the Administration to assess proposed loans by the International Monetary Fund to middle-income nations. If it determines that the loan recipient's public debt exceeds its annual gross domestic product, it will have to oppose the loan unless it can certify to Congress that the loan is likely to be repaid. The act also stipulates that entities responsible for production processes or manufactured output that depend on minerals originating in the Democratic Republic of Congo and adjoining countries will be required to provide disclosures to the SEC on the measures taken to exercise due diligence with respect to the source and chain of custody of the materials, and products manufactured from them. In addition, companies will be required to disclose (1) payments to foreign governments for mineral extraction rights, and (2) information regarding mine safety violations.

⁵⁰ See CRS Report RS22506, *Surplus Lines Insurance: Background and Current Legislation*, by Baird Webel.

Author Contact Information

Baird Webel, Coordinator
Specialist in Financial Economics
bwebel@crs.loc.gov, 7-0652

David H. Carpenter
Legislative Attorney
dcarpenter@crs.loc.gov, 7-9118

Katie Jones
Analyst in Housing Policy
kmjones@crs.loc.gov, 7-4162

Marc Labonte
Specialist in Macroeconomic Policy
mlabonte@crs.loc.gov, 7-0640

Rena S. Miller
Analyst in Financial Economics
rsmiller@crs.loc.gov, 7-0826

Edward V. Murphy
Specialist in Financial Economics
tmurphy@crs.loc.gov, 7-6201

Kathleen Ann Ruane
Legislative Attorney
kruane@crs.loc.gov, 7-9135

Gary Shorter
Specialist in Financial Economics
gshorter@crs.loc.gov, 7-7772

CRS Contacts for Areas Covered by Report

Issue Area	Name and Telephone Number
Systemic Risk	Marc Labonte, 7-0640
Federal Reserve	Marc Labonte, 7-0640
Resolution Regimes	David Carpenter, 7-9118
Securitization and Shadow Banking	Edward V. Murphy, 7-6201
Bank Supervision	Maureen Murphy, 7-6971
Financial Consumer Protection	David Carpenter, 7-9118
Derivatives	Mark Jicking, 7-7784
Credit Rating Agencies	Gary Shorter, 7-7772
Insurance	Baird Webel, 7-0652
Investor Protection	Michael Seitzinger, 7-7895
Hedge Funds	Kathleen Ruane, 7-9135
Executive Compensation	Gary Shorter, 7-7772
Mortgage Standards	Katie Jones, 7-4162
