Financial Regulatory Reform:

The Dodd-Frank Act—
Two Years Later

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Introduction

Two years ago, on July 21, 2010, President Obama signed into law a package of financial regulatory reforms unparalleled in scope and depth since the New Deal. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act or Dodd-Frank Act) was a sweeping reaction to perceived regulatory failings revealed by the most severe financial crisis since the Great Depression. The Dodd-Frank Act was intended to restructure the regulatory framework for the US financial system, with broad and deep implications for the financial services industry where the crisis started. But its impact also was intended to be felt well beyond the financial sector, extending federal regulation into areas of corporate governance applicable to all US public companies.

Despite its broad reach and more than 2,300 pages of text, few provisions of the Dodd-Frank Act took effect in the summer of 2010. Instead, the specifics of the Act were intended to be developed through the federal rulemaking process, as the Act mandated the development and implementation of nearly 400 separate regulations to be enacted by, or coordinated among, nearly a dozen federal departments or agencies. The regulatory agencies bearing the bulk of that responsibility are the Federal Reserve (Fed), Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and newly created Consumer Financial Protection Bureau (CFPB).

To date, the deadlines for more than half of the required rulemakings have expired. Regulators, however, have finalized rules for only one third of those rulemakings with statutory dates, missing the deadlines for the rest. What is more, for some of the missed deadlines, regulators have not even issued proposed versions of the regulations for public comment. Approximately 140 regulations mandated by the Act remain outstanding—having been neither proposed nor finalized. But even with those delays, the last two years have witnessed the promulgation of more than 100 rules and the issuance of many additional proposed regulations for public comment. In addition, the next 16 months promise significant action by the SEC, CFTC, and CFPB in the areas of corporate governance, derivatives, and consumer protection, respectively. And by the end of 2012, many important proposed regulations are expected to be finalized, including the controversial Volcker Rule and other measures aimed at curbing risks at the nation's largest financial institutions.

Systemic Risk

The centerpiece of the Dodd-Frank Act was the establishment of a new framework for monitoring and regulating systemic risk. The recent financial crisis highlighted the vulnerabilities of the financial system to risks taken by individual financial services companies as a result of the highly interconnected nature of the financial sector and, in some instances, a high degree of market concentration. As a direct response, Title I of the Act established the Financial Stability Oversight Council (FSOC) to monitor sources of systemic risk and to promulgate rules that would be implemented by the various financial regulators represented on the FSOC. Among other things, the Act vested in the FSOC the authority to:

- designate—by supermajority vote—certain companies as systemically important financial institutions (SIFIs)
- instruct and enable the Fed to impose measures to regulate certain bank holding companies (with $50 billion or more in assets) and nonbank SIFIs, including measures involving:
  - enhanced capital and leverage requirements
  - additional liquidity provisioning
  - mandatory contingent capital
  - resolution plans (commonly called "living wills")
  - credit exposure reports
  - concentration limits
  - supplemental public disclosures
  - periodic stress testing
  - other risk management protocols
- permit—by supermajority vote—the Fed to order SIFIs to divest assets to avert a "grave threat" to financial stability
- collect information from financial regulators to monitor the financial system
- identify regulatory gaps and other potential threats to financial stability
- facilitate greater coordination and conversation among financial regulators
- resolve disputes among member agencies over a particular entity, product, or activity

Title VIII of the Act additionally authorizes the FSOC to designate for prudential supervision by the Fed, the SEC, or the CFTC, as appropriate, entities that engage in systemically important payment, clearing, or settlement activities—so called "financial market utilities."

Developments to Date

The FSOC got off to a slow start. During its first year, it did not promulgate any material regulations or take any significant actions save for issuance of a final rule describing the characteristics it will use to designate financial market utilities as systemically important. Almost a year later, after evaluating comments from many market participants, it also released its final rule governing the designation of nonbank SIFIs for enhanced prudential supervision. Though this category is quite large and can potentially extend to thrifts and their holding companies, broker-dealers, investment advisers (potentially including managers of hedge funds and private equity funds), investment banks, and other asset management firms, the SIFI designation is limited to companies with assets of more than $50 billion that predominantly engage in financial services. The FSOC has not yet designated any nonbank SIFIs.

In late 2011, the FDIC and Fed released final rules governing how SIFIs are to create and submit the resolution plans (commonly known as "living wills") that are required under Title I of the Dodd-Frank Act. Each plan must explain how the SIFI can achieve a rapid and orderly resolution in the event of material financial distress. Nine of the largest banks submitted their resolution plans on July 1, 2012. In early 2012, the Fed published a proposed rule to implement the enhanced prudential standards required of SIFIs under Title I (in addition to living wills)—including single counter-party credit limits; a risk committee requirement; leverage limits; and stress testing. In addition, bank regulators recently released proposed rules for public comment suggesting comprehensive revisions to the capital adequacy framework that reflect the implementation of Basel III in the United States.

What to Expect Next

The next 18 months will be the real test of Title I. The FSOC has established much of the groundwork for the new financial stability regime, but has cautiously postponed the more controversial decisions that it must make with respect to the designations of nonbank SIFIs and recommendations for other systemic risk measures not mandated by the Act.

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That will change, but perhaps not immediately. Because the Treasury Secretary (who serves at the pleasure of the President) chairs the FSOC, it is doubtful that any decisions likely to be unpopular with the US business community or the public at large will be made prior to the presidential election this November. Nevertheless, the FSOC is expected to designate the first handful of nonbank SIFIs and financial market utilities before the end of 2012, with more to follow in 2013. For its part, the Fed in 2012-13 will finalize both its prudential requirements for large institutions under the Dodd-Frank Act as well as the specific rules for implementation of Basel III—two developments that promise to have a lasting impact on SIFIs and other financial institutions.

Orderly Liquidation Authority

The Dodd-Frank Act openly acknowledged that some financial firms are going to fail, notwithstanding the provisions of the Act designed to regulate and supervise SIFIs as ongoing entities. During the financial crisis and in its aftermath, a number of policymakers formed the view that the US Bankruptcy Code and the judicial process it entails are ill-suited to govern the resolution of insolvent SIFIs. As a result, the Act established a new mechanism—based largely on the FDIC's longstanding resolution authority for banks—for the liquidation of SIFIs.

This new regime established in Title II of the Act, the Orderly Liquidation Authority (OLA), will preempt the bankruptcy process and permit the FDIC to seize control of the failed entity that is designated as such by the government under a process set forth in the Act. The FDIC will then proceed to liquidate the company, rather than allowing it to reorganize or liquidate itself under the Bankruptcy Code.

Developments to Date

The past two years have witnessed several significant rulemakings with respect to the OLA. These rulemakings have clarified how the OLA will be implemented. In some cases, the rulemakings have clarified provisions of Title II of the Act and expanded on the FDIC's authority as the potential receiver of a failed financial institution. These rulemakings culminated in July 2011 with a final OLA regulation that addresses, among other things:

- the treatment of contingent claims;
- the FDIC's ability to favor certain creditors over others;
- recoupment of compensation;
- provisions affecting secured creditors;
- entities subject to the OLA;
- setoff rights; and
- the claims resolution process.

The final rule has the force and effect of law, and should be interpreted in conjunction with any reading of Title II of the Act.

More recently, the FDIC proposed a rule addressing the agency's ability, as receiver, to enforce certain subsidiary and affiliate contracts in a proceeding under the OLA. The proposed rule would prohibit counterparties of an entity seized by the FDIC, as well as the entity's subsidiaries and affiliates, from exercising "any remedy under a contract simply as a result of the appointment of the receiver and the exercise of its orderly liquidation authorities as long as the receiver complies with the statutory requirements." Additionally, the proposed rule sets forth the scope and effect of the FDIC's authority under the OLA's provisions, clarifies which types of contracts are protected, and details the conditions and requirements to exercise this authority.

What to Expect Next

Notwithstanding these new rules, the OLA has yet to be tested. As such, it remains difficult to predict how an OLA receivership would actually proceed in practice. Moreover, there have been signals from the FDIC that agency officials might consider using the

OLA to effect a reorganization where creditors of the entity are "bailed-in" by converting their claims to equity in the newly reorganized entity—an arguable departure from the original purpose of unwinding and liquidating the failed entity. Perhaps most important, it remains unclear how the OLA and all of its potential variations will affect creditors' day-to-day dealings with financial institutions.

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The Volcker Rule

The Dodd-Frank Act placed a number of substantive restrictions on the activities of banks and other insured depository institutions*—the most controversial (and perhaps the most important) of which is the "Volcker Rule." The Volcker Rule is actually two separate rules: (1) a prohibition on proprietary trading, and (2) a ban on certain private equity and hedge fund activities. These restrictions arose from Congress's view that banks and thrifts had moved too far beyond traditional lending and deposit-taking into other business lines that presented undesirable risks to insured deposits and other aspects of the federal safety net. The Volcker Rule applies to all "banking entities," a term that includes banks, thrifts, holding companies, and their affiliates, as well as foreign banks operating in the United States with access to the discount window of the Federal Reserve System.

Developments to Date

An initial step toward implementing the Volcker Rule came in January 2011 when the FSOC completed a study of the prohibitions as mandated by the Act. Some commenters observed that the FSOC report raised far more questions than it answered, providing little insight into how regulators would implement the Volcker Rule and how affected financial institutions should prepare themselves. Ten months passed before the Fed, FDIC, OCC, and SEC jointly issued the long-awaited proposed rule (which the CFTC subsequently endorsed). The proposed rule, which with commentary spanned more than 300 pages, covered significant ground—further defining key terms such as "banking entity," "proprietary trading," and "covered fund" (for purposes of the private equity and hedge fund restrictions), as well as supplying the specifics for the various exceptions to, and carve-outs from, the Volcker Rule's prohibitions. The complexity of the proposed rule demonstrates the difficulties both regulators and financial institutions will have in distinguishing between illicit proprietary trades and those permitted for purposes of underwriting, market making, and hedging. The proposed rule's restrictions on private equity and hedge fund ownership and sponsorship are arguably even more troublesome—not only because of their complexity but also their breadth. Many investment products and corporate structures having nothing to do with private equity or hedge funds will be prohibited as "covered funds" if the proposed rule is finalized in its present form.

What to Expect Next

The comment period for the proposed rule closed in February 2012, and regulators have announced that they are unable to meet the impending statutorily imposed deadline of July 21. Lawmakers and regulators are pushing for a final rule by the end of the year—though some commentators speculate it may be released as early as August. Regulators recently clarified, however, that financial institutions will have until July 21, 2014 to bring their affected activities into conformance with the rule and that regulators may also extend that period, as appropriate. Until a final rule is promulgated, the financial sector remains in limbo. This is particularly the case with respect to the covered funds prohibition because most investment decisions taken today will remain in effect well beyond 2014. What is more, it is unlikely that any final regulation will answer all of the questions expected to arise as those complex rules are implemented in the United States and beyond.

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* Banking sector reforms are at the heart of Titles III and VI of the Dodd-Frank Act, and many provisions throughout the Act were intended to affect insured depository institutions and their affiliates. Most noteworthy was the Act's elimination of the Office of Thrift Supervision (OTS) and subsequent transfer of various existing OTS powers to the Fed, OCC, and FDIC during 2011. Other important developments include changes to the affiliate transactions provisions of the Federal Reserve Act and the so-called swaps "push-out" rule, which is expected to be implemented in 2013.

Derivatives

The derivatives section of the Dodd-Frank Act was arguably as important to Congress's reforms as the systemic risk framework and the activity restrictions on the banking industry. In the decade preceding the financial crisis, swaps transactions had been virtually unregulated and often took the form of highly customized bilateral agreements. As a result, margin requirements (if any) were not uniform, and when counterparties began failing to meet margin requirements or even declaring insolvency, the possibility of a systemic domino effect became real. Title VII of the Act attempted to resolve the perceived systemic risk and transparency deficiencies of the current over-the-counter (OTC) swaps market by requiring the centralized clearing of all swaps suitable for the clearing process. In addition to their efforts to mandate centralized clearing, the drafters of the Dodd-Frank Act determined that the risk exposure of important players in the swaps market must be regulated. "Swap dealers" and "major participants" were to be subject to capital, margin, and reporting requirements as well as business conduct standards. The Act charged the CFTC and the SEC with joint oversight of the OTC swaps market, with the CFTC regulating swaps, the SEC regulating security-based swaps, and both agencies jointly regulating so-called "mixed" swaps.

Developments to Date

Since enactment of the Dodd-Frank Act, the CFTC and the SEC have issued numerous rules and regulations governing swaps. Generally speaking, the CFTC has made more progress in producing final rules than the SEC, but both agencies have fallen far behind their original rulemaking schedules. By July 2011, most of the final rules and regulations required to implement derivatives reform had not been adopted in the timeframe prescribed by the Act. Thus, the agencies granted a temporary exemption (still in effect) from complying with the provisions of the Commodity Exchange Act (the CEA) and the Securities Exchange Act of 1934 (the Exchange Act) as amended by the Dodd-Frank Act. The two agencies also temporarily exempted compliance with the newly created reference terms for entities involved in derivatives transactions such as "swap dealer," "major swap participant," "security-based swap dealer," "major security-based swap participant," and "eligible contract participant," and terms for instruments such as "swap," "security-based swap," "mixed swap," and "security-based swap agreement." Only recently did the CFTC and SEC finally adopt their joint final rules defining these terms.

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One major concern with derivatives reform has been the extraterritorial reach of Title VII. The Act provides that its swaps provisions shall not apply to activities outside the United States unless they (1) have a direct and significant connection with activities in, or effect on, US commerce; or (2) contravene the CFTC's anti-evasion rules or regulations. Furthermore, the Act provides that no security-based swaps provision shall apply to anyone transacting a business in security-based swaps "without the U.S. jurisdiction," unless they are doing so for the intended purposes of evading US regulation. Yet the Act does not define what constitutes a "U.S. person," nor does it explain what constitutes "activities outside the U.S." or "without the U.S. jurisdiction." In response to a growing demand from market participants for guidance on these provisions, the CFTC recently issued proposed interpretive guidance on the cross-border application of the Title VII provisions administered by that agency. The SEC has stated its intent to issue similar guidance.

What to Expect Next

The SEC recently issued a policy statement outlining the sequencing of compliance dates for final rules applicable to security-based swaps. The agency provided the general order in which various rules would likely be adopted but was careful not to include specific compliance dates for those rules. The CFTC has been silent concerning in what order it intends to proceed with its rulemakings. Now that the rules further defining various entities and instruments are final, compliance with various regulations may be required as early as the fall of 2012. What remains unclear is what portion of the markets will need to migrate to centralized clearing and by when.

Hedge Funds and Private Equity

The Dodd-Frank Act endorsed the longstanding view of the SEC and other policymakers that advisers to private funds should be required to register with a regulatory body and be subject to monitoring on an ongoing basis. To achieve this, Title IV of the Act eliminated the "private adviser" exemption (for advisers to fewer than 15 clients) under the Investment Advisers Act of 1940 (Advisers Act).

The Act resulted in a large portion of the private fund industry being subject to SEC regulation in a way that was unthinkable to fund advisers just a few years ago.

As a result, an adviser to a private fund (which includes most private equity and hedge funds) generally has to register with the SEC unless the adviser falls within a specifically enumerated exemption created by the Act. Secondarily, the Act gave the SEC expanded enforcement powers and the ability to enhance the reporting requirements for registered investment advisers and the private funds they manage. Therefore, the Act resulted in a large portion of the private fund industry being subject to SEC regulation in a way that was unthinkable to fund advisers just a few years ago.

Developments to Date

The Dodd-Frank Act created five new narrow exemptions from registration under the Advisers Act and increased from $25 million to $100 million the threshold amount of assets under management that triggers mandatory SEC registration for state-registered advisers. The new exemptions and the increased threshold were designed to exempt smaller advisers from SEC registration (but subject them to regulation by the States) and to allow the SEC to concentrate on those perceived to have a greater impact on investors and markets.

The new categories of exempt advisers are:

- advisers to venture capital funds;
- foreign private advisers;
- advisers that advise only "small business investment companies";
- family offices; and
- advisers to "mid-size private funds."

In the past two years, the SEC has finalized rules or otherwise provided guidance on the contours of these new exemptions established by the Act.

The SEC also increased reporting requirements under the Advisers Act in response to demands for more transparency in the private fund industry. Specifically, the SEC in 2010 substantially revised Form ADV, the registration form for investment advisers, to include, among other things, more detailed information about an adviser's business and affiliations. Revised Form ADV also now requires a significant amount of information regarding private funds managed by the adviser.

In addition, the CFTC and SEC in October 2011 jointly adopted new rules requiring SEC-registered investment advisers to private funds to periodically file Form PF with the SEC. The timing and types of information that an adviser is required to disclose on Form PF depend on whether the adviser manages private equity funds, hedge funds, or liquidity funds, as well as the size of those funds, but generally the form asks for information regarding fund performance, types of investors, borrowing, liquidity, and portfolio companies. Hedge fund advisers additionally are required to disclose information about strategy, credit risk, use of trading and clearing mechanisms, exposures by asset class, geographical concentration, and portfolio turnover. The SEC has advised that it will examine the information reported on Form PF to ensure it is consistent with that reported on Form ADV. The SEC also has stated that it does not intend to make information filed on Form PF public.

The SEC's required body of rulemakings under the Dodd-Frank Act with respect to the private fund industry is largely complete, and advisers required to register with the SEC as a result of the Act have already done so.

What to Expect Next

The SEC's required body of rulemakings under the Dodd-Frank Act with respect to the private fund industry is largely complete, and advisers required to register with the SEC as a result of the Act have already done so. However, private fund managers are still grappling with the requirements of Form PF, the first filings of which are due in August 2012 for some hedge fund advisers and in April 2013 for most private equity advisers. It also remains to be seen if the SEC will adopt additional compliance rules focused on issues specific to the private fund industry.

Securitization

The virtual collapse of the asset-backed securities (ABS) markets during the financial crisis—particularly segments based on pooled residential mortgage loans—revealed serious problems in the securitization process. Congressional proponents of the Dodd-Frank Act maintained that the incentives of both mortgage originators and underwriters of securities backed by those mortgages were not fully aligned with the interests of investors who eventually purchased the securities. As a result, the Act directed regulators to prescribe rules seeking to better align the interests of securitizers of ABS with investors and to require more disclosure in the securitization process.

Developments to Date

The SEC has promulgated several rules to implement aspects of the Act aimed at increasing disclosure in the securitization process. First, the SEC eliminated the automatic suspension of filing and reporting requirements for registered ABS issuances under Section 15(d) of the Exchange Act. The SEC now may determine when filing and reporting requirements for a specified class of ABS should be suspended or terminated. Additionally, issuers of registered ABS are now required to conduct a review of pool assets underlying the ABS and to disclose in the prospectus the conclusions of that review. Securitizers of registered and private ABS also are required to publicly report information about fulfilled, unfulfilled, and pending asset repurchase requests on a regular basis.

In accordance with Act's stated goals, the SEC has proposed several rules relating to risk retention, conflicts of interest, and asset-level disclosure. The Act sought to ensure alignment of the interests of ABS originators with those of ABS investors and thus mandated that securitizers of ABS be required to retain a portion of the credit risk of assets backing ABS—giving securitizers "skin in the game." In furtherance of this goal, regulators have proposed a rule that would require securitizers of ABS to retain an economic interest in the credit risk (generally five percent) of any asset transferred to a third party through the issuance of an ABS. The proposed rule would exempt certain "high quality" loans that meet specific criteria, including "qualified residential mortgages," as well as residential mortgages guaranteed by a US government agency. The proposal also prohibits securitizers from transferring the retained risk by hedging or other means. Additionally, in compliance with the Act's mandate to prohibit certain perceived conflicts of interest in the securitization market, the SEC proposed a rule prohibiting certain persons who create and distribute an ABS from engaging in transactions that would involve or result in certain material conflicts of interest with any investor in such ABS for one year after the closing of an ABS transaction.

Before the Act, the SEC had proposed revising Regulation AB by increasing disclosure and reporting for registered ABS, and establishing a new disclosure regime for privately placed ABS that would make Regulation D and Rule 144A unavailable for an ABS offering unless the issuer disclosed the same information that would be provided if the ABS offering was registered. That proposal overlaps in many respects with the Dodd-Frank Act's mandate to adopt rules requiring ABS issuers to disclose in standardized format information regarding the assets backing an ABS in order to standardize and improve transparency of disclosure in the ABS offering process.

With respect to the Act's "skin-in-the game" mandate, regulators have indicated that a final rule on risk retention will be promulgated in early 2013.

What to Expect Next

With respect to the Act's "skin-in-the game" mandate, regulators have indicated that a final rule on risk retention will be promulgated in early 2013. Once the final rule becomes effective, compliance is required within one year for real estate mortgage-backed securities and two years for all other classes of ABS. As for the changes to Regulation AB, the SEC has neither materially modified its prior proposed revisions in light of the Act nor provided guidance on the timing of a final rule. Commentators and market participants appear skeptical that the Act's reforms were necessary to, or will, significantly improve the ABS markets, which are beginning to improve but are far from pre-crisis levels.

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Credit Ratings

In the wake of the financial crisis, the systemic importance of credit rating agencies and their role in capital formation and as gatekeepers in the debt markets became the subject of extended debate. Not surprisingly, specific provisions in the Dodd-Frank Act targeted the credit rating industry and, in particular, the nationally recognized statistical rating organizations (NRSROs).

Developments to Date

Out of the gate, the Act established a new, independent office within the SEC called the Office of Credit Ratings (OCR), with a mandate to promote accuracy of credit ratings and prevent conflicts of interest. The OCR is charged with conducting a review of each NRSRO at least annually to evaluate each organization's compliance with the legislation's governance, management, and operational requirements. Although the OCR was created nearly two years ago, it was only last month that the SEC appointed an official to oversee the office. The staff of the SEC itself undertook the first review of the ten NRSROs and released its initial findings in September 2011. The staff identified troubling issues at each NRSRO, including a lack of internal controls and failure to adequately oversee conflicts of interest, and suggested courses of action to remediate those concerns.

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The Dodd-Frank Act mandated that certain federal agencies analyze their existing rules and modify them to remove explicit references to, and direct reliance on, credit ratings. During 2011, the SEC (along with other federal agencies) took steps toward eliminating statutory references to ratings throughout the federal securities regulations. These rulemakings in particular target statutory references to "investment grade" that directly and explicitly reference credit ratings in lieu of an alternative standard of creditworthiness. In line with this mandate, the OCC recently finalized a rule removing the investment grade reference in certain regulations and adopting a new standard of creditworthiness that evaluates a security issuer's capacity to meet financial commitments under the security for the projected life of the asset or exposure. Likewise, the SEC removed credit ratings as one of the eligibility criteria for companies seeking to use "short form" registration in publicly registered issuances.

Many of the reforms of the Dodd-Frank Act addressing credit ratings center on structured finance products. The "issuer-pays" business model of the credit rating agencies was the subject of recurring criticism following the financial crisis and has been highlighted as a pervasive conflict of interest. In response to these concerns, the Act directed the SEC to evaluate the feasibility of establishing a system for assigning NRSROs to determine credit ratings for ABS. In May 2011, the SEC solicited public comments to assist it in shaping its report to Congress due this month. Unless the SEC determines that an alternative system would better serve the public interest and investors, the Act requires the SEC to adopt a system that provides for the creation of a self-regulated board responsible for selecting and assigning NRSROs to rate structured finance products.

Additionally, the SEC still must adopt rules requiring third parties that are retained to conduct due diligence related to ABS to provide, and to certify specified information to the NRSRO that is producing a rating for the ABS, including a description of the due diligence undertaken and the conclusions relating thereto. The proposed amendments also would require NRSROs to disclose whether and to what extent third-party due diligence services were used to formulate the credit rating of an asset-backed security, including a description of the findings and conclusions of the third party service provider. Further, NRSROs are now required to include in any report accompanying a credit rating issued in connection with an ABS offering a description of the representations, warranties, and enforcement mechanisms available to investors, and an explanation of how they differ from those in issuances of similar securities.

The SEC likely will be very active during the next 12 months in finalizing rules in the credit rating industry space.

What to Expect Next

Although the SEC has published a number of proposed rules relating to the NRSRO oversight required by the Act, only a few of these rules have been finalized and implemented to date. Consequently, the SEC likely will be very active during the next 12 months in finalizing rules in the credit rating industry space. Furthermore, it remains to be seen whether these new measures ultimately will be effective at curbing the controversial practices often cited as contributing factors to the financial crisis.

Consumer Protection

Based on the belief held by some policymakers that lax consumer regulation, particularly with respect to retail mortgages, significantly contributed to the crisis, the Dodd-Frank Act dramatically transformed the federal regulation of consumer financial services. A central and controversial aspect of the Act was the establishment of the CFPB to regulate consumer financial products and services. As the first federal agency focused solely on consumer financial protection, the CFPB consolidated and strengthened consumer protection responsibilities previously managed by more than a half dozen federal banking and other regulators. The CFPB was vested with extensive authority to regulate and enforce substantive standards for any person that engages in the offer or sale of a financial product or service to any consumer. In addition to assuming responsibility for the broad panoply of preexisting federal consumer financial services regulations, the CFPB was tasked with protecting consumers from discrimination and "unfair, deceptive, or abusive acts and practices," and has extensive authority over nonbank consumer financial companies. Specifically, the CFPB has examination authority over:

- banks, thrifts, and credit unions with $10 billion or more in assets;
- large nonbank participants in the market; and
- certain types of nonbank providers without regard to size.

Apart from the CFPB at the federal level, the Dodd-Frank Act authorized states to enact stricter substantive protections for consumers and allows state attorneys general to initiate civil actions to enforce the federal consumer financial protection laws.

Developments to Date

Since its official launch in July 2010, the CFPB slowly has filled in its organizational chart, which was capped off by President Obama's controversial recess appointment of the first Director of the CFPB in January 2012. With a Director in place, the CFPB assumed authority under the Act to roll out its nonbank supervision program and began promulgating new, substantive rules rather than simply implementing existing rules that it had inherited from other federal regulators. The CFPB's consumer response center, a critical component of its infrastructure, is now operational as well. The intake center generates detailed analyses of consumer complaints across various industries. Finally, the CFPB published its full supervision and examination manual, which identifies key indicators for determining whether a provider of consumer financial products is complying with federal law. In a diversion from prior regulatory practice, the CFPB has involved enforcement attorneys in routine visitorial examination of banks and nonbanks and thereby increased the adversarial nature of the process.

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What to Expect Next

While the CFPB has made progress on certain fronts, there is significant uncertainty regarding how it will pursue its regulatory agenda in the future. Over the coming months, consumer financial companies should watch for the CFPB to develop an enforcement record which addresses issues that will resonate with consumers and serves to help the CFPB gain political currency. The CFPB is also expected to issue a number of key rulemakings that will further define the scope of its supervisory powers over larger participants of nonbank markets for consumer financial products. Other rulemakings in the pipeline may serve to illuminate the meaning of "unfair, deceptive, and abusive" acts and practices by prescribing standards that govern covered entities—particularly in the mortgage servicing and origination markets.

Whistleblower Incentives and Protections

The Dodd-Frank Act sought to increase the reporting of securities laws violations by enhancing rewards and protections for whistleblowers. Under the Act, a whistleblower who voluntarily provides "original" information to the SEC that leads to a successful enforcement action resulting in monetary sanctions exceeding $1 million is eligible for a reward of between 10% and 30% of the funds collected as sanctions. Whistleblower protections were also enhanced: a whistleblower may sue a retaliating employer directly in federal court, whereas prior to the Act a whistleblower had to exhaust administrative remedies as an initial step. In addition, the Act clarified that whistleblower protections under the Sarbanes-Oxley Act were to apply to both parent companies and affiliates whose financial information is included in the parent's consolidated financial statements.

Developments to Date

The SEC's final rules implementing the Dodd-Frank mandated whistleblower program became effective in August 2011. The rules are broad, and allow any natural person—regardless of whether he or she is an employee, a third party, or even a culpable participant in the wrongdoing—to qualify for an award. Qualifying whistleblowers are eligible to receive not only 10-30% of monetary sanctions from SEC actions, but 10-30% of sanctions obtained in related actions brought by the Department of Justice (DOJ) and other agencies. The rules also define sanctions broadly to include penalties, prejudgment interest, and disgorgement. This creates the potential for immense awards to whistleblowers. For example, if an individual reports that executives at his or her company are bribing officials in violation of the Foreign Corrupt Practices

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Act, and the company ultimately settles with the SEC and DOJ for $100 million, that individual could be entitled to receive between $10 and $30 million.

The most controversial aspect of the SEC's whistleblower rules was the decision not to include a requirement that whistleblowers first report wrongdoing internally through their employer's corporate compliance programs before going to the SEC. Instead, the SEC included three incentives designed to encourage internal reporting:

- providing "extra credit" for internal reporting in determining the amount of an award;
- giving the whistleblower credit for anything uncovered by the company's internal investigation; and
- reserving a whistleblower's "place in line" for 120 days (*i.e.*, between initial reporting and the subsequent reports to the SEC).

In addition, the strong anti-retaliation measures in the rules, which protect whistleblowers even if they do not ultimately qualify for an award, further serve to encourage internal reporting. The rules also streamline the procedures for reporting securities violations. The SEC's newly created Office of the Whistleblower administers the program with assistance from the SEC's Office of Market Intelligence.

The SEC recently reported that it is receiving about eight tips per day.

The SEC has not yet paid out any awards under the program, but its first award is expected soon. The SEC recently reported that it is receiving about eight tips per day, and that the quality of the tips it is receiving through its new program is "significantly improved," with many complaints including detailed submissions from individuals with first-hand knowledge of alleged wrongdoing, which is permitting the SEC to issue narrow subpoenas targeting the identified conduct. Given the lack of public information available about the program to date, however, and because the SEC has not yet paid out an award under the program, it is too early to draw any meaningful conclusions regarding the identity of whistleblowers and the types of enforcement actions the program is yielding.

What to Expect Next

The coming year will be a defining time for the SEC's whistleblower program. There are many nuances to the whistleblower rules that have not yet been addressed, and the rules give the SEC significant discretion in applying them. Among other things, there is a lack of clarity on how awards will be calculated, how the SEC will treat culpable whistleblowers, the parameters of the relationship between the SEC's whistleblower program and its cooperation initiative, and the extent to which the SEC will permit companies to self-investigate complaints before the SEC initiates investigations. As awards are issued, the answers to these questions will likely come into focus and shape the program. At the same time, because the SEC's whistleblower program creates significant monetary incentives for individuals with knowledge of wrongdoing to come forward, payouts under the program should serve as a further catalyst for additional whistleblowers to come forward.

Corporate Governance and Executive Compensation

In response to the financial crisis, Congress in the Dodd-Frank Act sought to focus on ways to enhance corporate accountability to shareholders and investor protection overall. The governance provisions of the Act were intended broadly to apply to all US public companies, not just financial institutions.

Developments to Date

Public companies still have not felt the full impact of the Dodd-Frank Act's corporate governance reforms as the SEC has continued its relatively slow pace promulgating and implementing the rules required under the Act. Nevertheless, the SEC has to date fully implemented rules in several significant areas required by the Act.

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Effective February 2010, the SEC finalized rules on board leadership disclosures, mandating that companies disclose in annual proxy statements the rationale for separating or combining the chairman and CEO positions. About a year later, in January 2011, the SEC adopted final "say on pay" rules, which require companies to seek non-binding shareholder advisory votes on (a) executive compensation arrangements at least once every three years, (b) how often a say on pay vote should be held, and (c) certain golden parachute arrangements. Then, in December 2011, the SEC adopted final rules implementing disclosure requirements for mining companies relating to mine safety and health.

The Act additionally required the SEC to direct the stock exchanges to prohibit member brokers from voting customer shares without first receiving voting instructions from the beneficial owner regarding director elections, executive compensation, and any other "significant matter" as determined by the SEC. Broker discretionary voting has been eliminated with respect to uncontested director elections, share compensation plans, other executive compensation matters and, effective January 2012, corporate governance matters (for example, to de-stagger the board, adopt majority voting for director elections, eliminate supermajority voting requirements, provide for the use of consents, provide rights to call a special meeting, and adopt certain types of anti-takeover provision overrides).

Mandatory proxy access has been put on hold at the SEC (at least for now).

The SEC also adopted final rules in August 2010 requiring certain eligible shareholder-proposed nominees to be included in the company's own proxy solicitation materials ("mandatory proxy access"). The US Court of Appeals struck down those rules in July 2011 on the grounds that the SEC failed to adequately consider the rules' effect on "efficiency, competition, and capital formation." Mandatory proxy access has been put on hold at the SEC (at least for now).

What to Expect Next

While the SEC has clarified corporate governance rules in certain respects, there remains uncertainty regarding rules that are yet to be proposed and/or adopted. For example, in June 2012, the SEC adopted final rules directing the stock exchanges to require that compensation committee members of listed companies meet heightened independence standards; be authorized to retain, compensate, and oversee advisers to the committee; and consider the independence of those advisers. New disclosures relating to compensation consultant conflicts of interest must be included in proxy statements for meetings at which directors are to be elected occurring on or after January 1, 2013. Each exchange is required to propose relevant listing standards by early fall 2012, which none of the exchanges has done yet, and the SEC must approve those standards by mid-2013.

In addition, about six months after the Act was passed, the SEC proposed rules to require disclosures relating to certain "conflict minerals," and payments made to the US or any foreign government by resource extracting companies. By the end of summer 2012, the SEC will consider whether to adopt final rules relating to these issues.

In other areas, the SEC has not yet begun rulemaking as required by the Dodd-Frank Act. For instance, the Act required the SEC to develop rules requiring disclosure in annual proxy statements of the relationship between executive compensation actually paid and the company's financial performance, as well as disclosure comparing the CEO's compensation to that of the company's other employees. The SEC has not proposed any such rules to date. Nor has the SEC proposed rules instructing the stock exchanges to require that listed companies develop, implement, and disclose a "clawback" policy with respect to executive compensation. The SEC also has not yet proposed rules requiring companies to disclose in their annual proxy statements whether any employee or director is permitted to hedge against losses on their company stock. It is unclear when the SEC intends to begin the rulemaking process with respect to these matters.

Conclusion

Considerable regulatory progress has been made in the last two years since passage of the Dodd-Frank Act, with federal agencies finalizing well over 100 rules. Much remains to be done, however, as almost 150 proposed rules have yet to be finally implemented, and nearly 150 more have yet to be proposed. Bank regulators, in particular, have almost 50 regulations to promulgate that have not yet been proposed, and the SEC, CFTC, and other agencies also are required to develop expansive new rules and revise existing regulations. Key areas in which significant regulation is expected in the next 18 months include bank regulation, corporate governance, consumer protection, and mortgage reform. SIFI designation will also start soon, and some may be controversial. Regulators such as the CFPB and SEC may step up their investigation and enforcement activities.

In short, the Dodd-Frank Act has effected considerable change during the first two years of its implementation. But the Act is far from being fully implemented and its overall impact on the US financial system remains uncertain.

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