

Q&A on the Dodd-Frank Wall Street Reform and Consumer Protection Act

What is the status of the Dodd-Frank Act?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (HR 4173) was signed into law by President Obama on 21 July. This law is considered the most significant overhaul of financial regulation in the US since the 1930s.

Why is the financial regulatory reform law significant?

In response to the financial crisis, Congress moved to address a number of identified weaknesses and gaps in the US financial regulatory framework. Reform efforts quickly focused on the abuses by a few on Wall Street and the perceived lack of strong oversight and foresight of problems by regulators. The result of nearly 18 months of Congressional deliberations is a law that provides federal regulators with a mechanism to resolve failing non-bank financial institutions and the authority to address regulatory gaps; increases transparency in the OTC derivatives market; imposes risk-retention standards in the securitization process; and provides new levels of consumer protection for financial products.

While central elements of the law are focused on the regulation of the financial services sector, it also includes provisions affecting every public company, including enhanced Securities and Exchange Commission (SEC) enforcement authority and additional corporate governance requirements. Although the regulation of the accounting profession will remain largely unchanged, a number of provisions will have a particular impact.

This document provides high-level observations on provisions within the financial regulatory reform law that affect the financial services sector, the broader corporate community and the accounting profession.

What is the expected impact of the law on the financial services sector, capital markets and the economy?

Although the provisions of greatest concern to the financial services industry ultimately were somewhat relaxed (e.g., strict interpretations of the Volcker Rule, derivatives restrictions), the final law can be expected to have a significant impact on the business and funding models, products and services, and governance and risk management practices of financial institutions. Substantial uncertainty remains as to the capital, leverage and liquidity requirements to be imposed on large, complex firms, OTC derivatives dealers and significant swaps participants, with attendant implications for profitability.

Large, complex institutions and newly regulated ones, such as hedge funds and private equity funds, will face new and enhanced regulatory reporting requirements. This will challenge systems and data infrastructures at many firms.

Finally, expectations that the largest non-bank and bank holding companies supervised by the Federal Reserve will have to develop recovery and resolution plans ("living wills") will mean renewed focus on legal entity-level financial and operational concerns in what are often very complex global legal structures.

More broadly, there remain questions as to what these substantial new requirements will mean for the capital markets and for credit availability. Some aspects of the law are directed at strengthening transparency and accountability for issuers of financial instruments, which is a constructive development.

However, the impact of more stringent capital, leverage, liquidity and compliance requirements on credit availability in what remains a fragile economic recovery is unclear. The law includes somewhat extended transition periods for some of its more far-reaching provisions. Additionally, although much of the US law remains consistent with the global goals set out by G20 leaders, the extent and pace of US reforms as compared to initiatives in other jurisdictions could pose appreciable challenges to multinational financial firms as they respond to different regulatory demands around the world and could raise competitive concerns.

What key provisions impact the financial services sector?

- ▶ **Financial Stability Oversight Council (FSOC) (Sec. 111)** – The new 10-member FSOC, composed of existing regulators, is charged with monitoring and addressing system-wide risks. Among its duties, the FSOC may recommend stricter liquidity, capital and leverage requirements. It may develop rules for large, complex financial firms that are judged to threaten the financial system, including firms that have not heretofore been supervised and regulated as bank holding companies. In extreme cases, it has the power to break up financial firms.
- ▶ **Liquidation authority (Sec. 165)** – Requires large, complex financial companies to periodically submit "living wills" outlining how they would wind down operations in a quick and orderly manner in the event of material financial distress or an economic failure. The law also creates a process allowing the FDIC, at the direction of the Treasury Secretary, to liquidate non-bank financial firms on the verge of collapse in an orderly fashion. Before such a company could be placed into the liquidation process, the FDIC, the Treasury Department and the Federal Reserve would have to agree that such action was necessary to protect the financial system.
- ▶ **Risk committees (Sec. 165 (h))** – Requires publicly traded non-bank financial institutions supervised by the Federal Reserve and large publicly traded bank holding companies to establish a board-level risk committee. This applies only to certain financial institutions, not public companies generally.
- ▶ **Bureau for Consumer Financial Protection (BCFP) (Sec. 1011)** – The new independent bureau, housed within the Federal Reserve, will have authority over all credit, savings and payment products provided to consumers, including credit cards and mortgage lending but not products subject to securities or insurance regulations. The BCFP has rule-making authority over a host of entities, but its enforcement and examination reach will generally be limited to banks, thrifts and credit unions with more than \$10 billion in assets. Bank regulators will continue examining consumer practices at smaller financial institutions. While some services offered by the accounting profession are referenced in the list of activities to be regulated by the BCFP, the law includes an exemption for CPAs and accounting firms in recognition of existing profession regulatory structures.
- ▶ **Volcker Rule (Sec. 619)** – Limitations are imposed on proprietary trading and investments in hedge funds and private equity funds by banking entities subject to *de minimis* limits allowing bank investments in hedge funds and private equity funds of no more than 3% of their Tier 1 capital in all such funds combined and 3% of any one fund's total ownership interest. Transactions and relationships among a fund advised by a banking company, or any affiliate of the company and any entity within the group, would be significantly constrained. Under a separate provision modifying the Volcker Rule, underwriters or sponsors of asset-backed securities would be prohibited from engaging in any transaction for one year, such as shorting the securities, that would result in a material conflict of interest with investors in that security, although hedging would be permitted.
- ▶ **Derivatives reform (Sec. 721)** – Most derivatives will now have to be cleared and traded on exchanges. Banks may continue engaging in principal transactions involving interest-rate, foreign-exchange, gold, silver and investment-grade credit default swaps, subject to Volcker Rule limitations on proprietary trading. However, with respect to commodities, most other metals, energy and equities, banks will have to shift certain of their swaps operations to a separately capitalized affiliate within the holding company.
- ▶ **Credit rating agencies (CRA) (Sec. 931)** – The credit rating agencies were subject to increased scrutiny given their role in the subprime mortgage crisis. In order to reduce corporate and consumer reliance on them, most references to CRAs will be removed from federal rules. Rating agencies will not only be subject to increased liability, but claims can be brought against them for "recklessly" failing to review "key information" in

developing a rating (including external information). With the nullification of Section 436(g) of the 1933 Act, CRAs will now be subject to liability under the Act.

The SEC will have the right to “deregister” a CRA firm, require ratings analysts to pass qualifying exams and prevent issuers of structured products from shopping for the best rating. The SEC must also study the CRA “issuer pays” business model over the next two years. Should it determine that a change in business model would be in the best interest of investors, the SEC is directed to establish a system to assign issuers of debt products to a randomly selected CRA, unless an alternate approach is identified.

- ▶ **Interchange restrictions** (Sec. 1075) – While initially much broader in scope, the final law directs the Federal Reserve to ensure that debit-swipe fees are “reasonable and proportional” to the cost of processing transactions. The provision exempts lenders with less than \$10 billion in assets.
- ▶ **Private pools of capital** (Sec. 401) – Most advisors to hedge funds and private equity funds with more than \$100 million in assets under management will be required to register with the SEC and be subject to SEC regulatory oversight (venture capital funds will be exempt, with a definition of such funds to be provided by the SEC within a year of enactment). However, advisors with less than \$150 million in assets under management in the US whose only clients are private funds will remain exempt from registration, subject to record-keeping and reporting requirements to be established by the SEC. Organizations that are required to register will need to establish a formal compliance policy and framework that encompasses (1) the treatment of conflicts; (2) the hiring of a chief compliance officer; and (3) testing, reporting and inspections by the SEC. Advisors to smaller funds may also be subject to record-keeping and reporting requirements.

What are the key corporate governance and SEC provisions that impact public companies?

- ▶ **Proxy access** (Sec. 971) – Gives the SEC authority to issue proxy access rules to enable shareholder nomination of directors and allows the SEC to exempt small businesses from this requirement. The SEC issued a proposed proxy access rule last year but has been awaiting the clear legal authority that this law provides prior to moving ahead with a final rule. The SEC is already in the process of moving forward with the proxy access rules for public comment.
- ▶ **Independent compensation committees** (Sec. 952) – Requires that members of a listed company’s compensation committee be independent under a definition established by its exchange. The provision also requires the committee to select consultants, legal counsel or other advisors only after taking into account independence factors established by the SEC. These provisions build on existing New York Stock Exchange listing requirements and SEC rules issued in December 2009.
- ▶ **Executive compensation/“say-on-pay”** (Sec. 951) – Every six years, a shareholder resolution will determine whether a non-binding, say-on-pay vote occurs every one, two or three years. The law also gives shareholders a non-binding vote on golden parachutes in connection with a shareholder vote on an acquisition, merger or proposed sale of the company. Additionally, the law requires institutional investment managers to disclose, at least annually, how they voted on both items.
- ▶ **Enhanced compensation disclosures** (Sec. 953) – Provides the SEC with statutory authority to clarify disclosure rules relating to compensation, including a chart that compares executive compensation to stock performance over a five-year period. Requires companies to disclose the following in their annual proxy statement: (1) median of annual total compensation of all employees other than the CEO; (2) annual total compensation of the CEO; and (3) the ratio of these two amounts.
- ▶ **Clawback** (Sec. 954) – Requires issuers to adopt and implement a “clawback” policy to recover incentive-based compensation from current or former executives during a three-year “look back” period. The policy must be applied if the company has to issue an accounting restatement based on erroneous data due to material non-compliance with any financial reporting requirement under the securities laws, regardless of whether the executive was involved in the misconduct that led to the restatement. Companies will also be required to disclose their incentive-based compensation policies. These requirements expand on a previously existing clawback provision included in the Sarbanes-Oxley Act.
- ▶ **Broker voting** (Sec. 957) – Provides the SEC with statutory authority to prohibit a broker that is not the beneficial owner of a company’s shares (i.e., shares held on behalf

of retail investors) from voting on the election of board members, executive compensation or other significant matters (as determined by the SEC), unless the beneficial owner has provided the broker with voting instructions

- ▶ **Disclosure of board leadership structure** (Sec. 972) – Provides the SEC with statutory authority to issue rules requiring companies to disclose the reasons why they chose the same person, or different people, to serve as their chairman and chief executive officer in the annual proxy. Because the SEC issued disclosure requirements in this area in December, further rule-making is not anticipated in the near term.
- ▶ **Section 404(b)** (Sec. 989G) – Non-accelerated issuers (those with \$75 million or less in market capitalization) are permanently exempted from Section 404(b) of the Sarbanes-Oxley Act, which requires an auditor to attest to management’s disclosures regarding the effectiveness of an issuer’s internal controls over financial reporting. Additional provisions require the Government Accountability Office (GAO) and the SEC to study whether additional changes to, or a broader exemption from, Section 404(b) should be instituted.
- ▶ **Whistleblower financial rewards** (Sec. 922) – Creates an SEC program to encourage reporting of securities violations. Provides rewards of up to 30% of funds recovered for information leading to a successful SEC enforcement action resulting in over \$1 million in sanctions. Individuals working at regulatory and enforcement agencies, those who obtain information through the performance of a financial audit, or anyone convicted of a criminal violation related to the underlying act are ineligible for the reward. Employers are prohibited from retaliating against whistleblowers.
- ▶ **Aiding and abetting for recklessness** (Sec. 929O) – Allows the SEC to bring enforcement cases against persons who “recklessly” aid and abet violations of the securities laws (previous law required “knowing” violations).
- ▶ **Aiding and abetting study** (Sec. 929Z) – Requires the GAO to study the impact of authorizing private rights of action against persons who aid or abet others in violations of the federal securities laws.
- ▶ **Extraterritorial reach of US courts for antifraud cases brought by the SEC or DOJ** (Sec. 929P (b)) – Defines the jurisdiction of US courts over antifraud cases brought by the SEC or the Department of Justice (DOJ) where much of the activity occurs outside the US. This previously had been a matter of case law. The law sets the standard so that US jurisdiction in these types of cases exists if “significant steps in furtherance of the violation” are taken in the US.
- ▶ **Collateral bars** (Sec. 925) – The SEC is given the authority to bar an individual who has violated federal securities laws from becoming associated with any regulated financial services entity, regardless of the area in which the violation occurred (e.g., a person associated with an investment adviser could be barred from becoming associated with a broker-dealer).
- ▶ **Nationwide service of subpoenas** (Sec. 929E) – Allows the SEC to serve a subpoena for the attendance of a witness or production of documents anywhere in the US in civil SEC actions filed in federal courts.
- ▶ **SEC funding** (Sec. 991) – The SEC is permitted to use fee collections to establish a reserve fund of up to \$100 million, which can be used to fund special projects. In addition, the SEC may submit its annual budget directly to Congress without requiring the prior approval of the White House.

What key provisions will have a direct impact on the accounting profession?

- ▶ **Broker/Dealer auditor oversight** (Sec. 982) – The PCAOB’s standard-setting, inspection and enforcement authority is extended over audit firms that audit broker/dealers. The Board’s authority relative to broker/dealer audits had been limited to requiring audit firm registration.
- ▶ **PCAOB information-sharing with foreign authorities** (Sec. 981) – The PCAOB is authorized to share information with foreign audit oversight authorities. This will facilitate PCAOB cooperation with its foreign counterparts and PCAOB inspections of non-US firms.

What comes next?

Much of the debate now shifts from the halls of Congress to the offices of federal regulatory agencies (e.g., the Federal Reserve Board, the SEC, the CFTC, the FDIC and the new BCFP). Congress delegated many of the implementation details to the regulators, and that process will take place over the next 6 to 18 months. The impact will be staggered, as rule-making will be spread over a two-year period, if not longer. While the effective date for final rules varies, many of the provisions, such as the Volcker Rule, provide for a transition period to allow affected companies time to meet new requirements. The extended time frame in which much of this law will be implemented allows for renewed efforts by affected parties to influence the shape and scope of the rules being written.

As part of the law, Congress included requirements for over 60 different studies and 100 reports by the various oversight agencies. As these studies are likely to produce legislative recommendations and potentially new regulations, financial regulatory reform will remain an ongoing process for the next few years.

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