ViewPoint: Financial Regulatory Reform

A Review of Legislation and Implementation

6 July 2010

The financial service reform conference committee recently approved the final text of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The 2315-page bill contains 16 titles and touches nearly every part of the financial industry. Asset managers and their clients remained principally outside of the focus of sweeping financial reform though given the length and scope of the bill, it should be expected that various changes will affect the industry over the long term.

The House of Representatives passed the Wall Street Reform and Consumer Protection Act in December 2009, and the Senate passed its version of the bill, Restoring American Financial Stability Act, on May 20, 2010. The Conference Committee established to reconcile the differences between the House and Senate bills voted out the conference bill on Friday, June 25th, along with a last minute change in the "pay-for" on June 29th. The timing for the package to come up for a final vote remains in flux. The House voted 237-192 to pass the bill on June 30th; however, the Senate will not take up the Bill until after the July 4th recess. Given the uncertainty surrounding the makeup of the next Congress and Senator Dodd's (Chairman of the Senate Banking Committee) retirement in November, there is strong incentive to pass the legislation before the August recess. That said, the Senate needs 60 votes and this outcome is not yet certain. Until both houses pass the legislation, it cannot be signed into law.

Congress was also considering a tax-focused bill that would extend certain tax relief and other benefits that have either expired or have fast-approaching sunset clauses. However, the American Jobs and Closing Tax Loopholes Act (often referred to as the "extenders bill") died as the bill did not have sufficient support for passage. The extenders bill would have included provisions relating to defined benefit pension funding relief, taxation of carried interest for hedge fund managers and private equity partnerships, and fee disclosures for 401(k) plans. Instead, the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 addressed pension funding relief.

While a number of the largest issues have been addressed, many facets of the proposed legislation entail further interpretation, studies, and rule making so some uncertainty remains. In addition, a number of issues, such as FNMA and FHLMC, have yet to be addressed. We will continue to engage with legislators and regulators as additional legislation and implementing regulations will be critical to the final outcomes of financial regulatory reform.

Highlights of the Dodd-Frank Bill and Additional Financial Reform Legislation

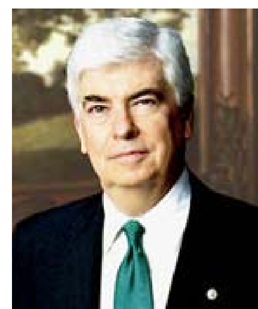
The ongoing reform represents a major overhaul of the financial regulatory environment, covering many areas across financial services. This paper summarizes recent legislation and its potential impacts on investors. We will continue to monitor these issues to fully determine how they might affect investment portfolios, capital markets, and most importantly, our clients.

Volcker rule. This proposal was softened somewhat by excluding customer-driven activity from the definition of proprietary trading. Further, banks will be allowed to invest in private equity and hedge funds that they manage for clients as long as the aggregated investments do not exceed 3% of Tier 1 capital. These changes will be made effective over a period of several years, which will allow the market to adjust more gradually.

Derivatives and foreign exchange. The final version of the reform package includes requirements and incentives for improved transparency, capital and margin requirements, increased standardization of swap contracts, and a favorable move to centralized clearing when possible. These elements of derivatives reform improve protection for all market participants and we view them as generally positive. Within the final text, foreign exchange swaps and related products are defined as "swaps" and therefore are subject to CFTC jurisdiction, however, the bill allows for the Secretary of the Treasury to make a future determination that FX swaps and forwards should not be regulated the same as other derivatives.

Sponsors of the Financial Reform Bill

Barney Frank
Chairman of House Financial Services Committee



Chris Dodd
Chairman of Senate Banking Committee

Opinions expressed are as of July 2010 and are subject to change.

Swap dealers as fiduciaries to pension plans. Although a good faith attempt to strengthen transparency and disclosure requirements, the proposal to apply "fiduciary" status to swap dealers when dealing with pension plans and endowments raised serious concerns for pension plans. In the end, the fiduciary requirement was dropped in favor of "business conduct" rules. These rules are acceptable to dealers, and, as a result, pension plans will continue to have access to swap product. In addition, pension plans are also excluded from the definition of "major swap participant", which is an issue important to many large corporate plans. However, as the legislation requires the posting of margin for swaps that are not cleared, pension plans as end-users are concerned about the impact of this on their cash flow and returns. Senator Dodd has indicated that this can be addressed when regulators implement the new requirements.

Defined benefit pension funding relief. Initially part of the 'extenders bill' which did not pass, instead this provision was signed into law on June 25th by President Obama as part of the "Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010." The terms extended the time period over which an employer is required to fully fund its defined benefit pension plan and it allows corporate and multi-employer defined benefit pension plans to effectively amortize recent investment losses over 9 or 15 years. This is welcome news for many pension plans that had suffered losses during the downturn and can take advantage of these changes.

Defining book value wrappers as swaps. Book value wrappers are used in stable value funds and are highly customized bilateral agreements. Concerns that these products could fall within the definition of a "swap" were addressed by requiring a study of book value wrappers to be carried out over the next 15 months by the U.S. Securities and Exchange Commission (SEC) and U.S. Commodity Futures Trading Commission (CFTC) to determine if they fall within the definition of a swap. Even if the wrappers are determined to be a swap, existing contracts will not be affected and the SEC and the CFTC will still be able to exempt them from the new OTC derivatives provisions. In the interim, book value wrappers will not be defined as a swap transaction until the regulators make their findings and stable value product will be unaffected.

Potential downgrade of financial services firms. The Resolution Authority gives the Federal Deposit Insurance Corporation (FDIC) power to unwind failing financial firms and explicitly bars the use of taxpayer funds to rescue them. As current credit ratings assume some level of government support for these firms, one of the concerns is that there are likely to be rating downgrades now that this support cannot be assumed. However, the rating agencies have stated that any possible downgrade will be determined by, among other things, firm profitability and the macroeconomic backdrop. Ratings agencies have also said that the passing of the bill will not likely have immediate ratings implications, and full evaluation of the legislation and its impact could last through the end of the year and potentially into early 2011, which delays any near-term expectations for rating changes.

Tier 1 capital definition. The Senate provision not to allow Bank Trust Preferreds to count as Tier 1 regulatory capital was modified to allow existing Bank Trust Preferreds to continue to be considered as Tier 1 capital for banks with less than $15 billion in assets. In addition, outstanding issues from banks with more than $15 billion in assets will be phased out over a period of three years beginning in 2013. The grandfathering period will help to reduce the cost of execution and make the transition more manageable; however, the provision will eliminate new issuance going forward, as trust preferreds issued by large banks after May 2010 will no longer be considered Tier 1 capital.

Creditor rights issue. Creditor rights --at least for financial institutions that are determined to be systemically significant-- are being moved out of the purview of bankruptcy courts to the Federal Deposit Insurance Corporation (FDIC) under the new Resolution Authority. The Resolution Authority gives the FDIC power to unwind failing financial firms and explicitly bars the use of public funds to rescue them. Although the FDIC will be permitted to treat different bondholders in the same issue unequally, the proposal to enable the FDIC to impose up to a 10% 'haircut' on secured creditors was reduced to a study of the issue and the automatic stay for qualified financial contracts, including repurchase agreements, was set to one day. In our view, permitting discrimination among bondholders is clearly a negative for capital markets and calls into question long-standing elements of contract law. It is also likely to increase financing costs for many financial companies as investors in bonds demand a premium for this uncertainty.

Securitization and Residential Mortgages. The bill establishes risk retention of 5% tied to securitized loans sold by banks into the secondary market as well as rules for more upfront and ongoing transparency disclosure. The intention is to incent higher quality underwriting in the origination of residential mortgage loans sold into securitizations. As an investor in securitized assets on behalf of our clients, we support the improved disclosure and appropriately crafted risk retention standards. The bill allows for an exemption from such risk retention requirements if the underlying mortgage is a "qualified residential mortgage" and lists five criteria for qualification of QRM status including documentation, residual income, insurance, and credit enhancement. The interpretation of these criteria will determine what exactly qualifies for a QRM and could have a significant impact on future originations.

Outside of the legislative process, Treasury continues to try to address mortgage foreclosures. In early June, Treasury issued a Supplemental Directive, changing three critical aspects of the Home Affordable Modification Program (HAMP) in the areas of principal forgiveness, the treatment of second liens, and implementation details surrounding principal forbearance. We believe the new guidance makes principal forgiveness equivalent to bankruptcy cramdown but without any of the benefits that investors would reap if the borrower were to file for bankruptcy. We continue to object to the HAMP program from an investor perspective as well as raise concerns about its effectiveness in stemming the tide of foreclosures.

Focus on ratings agencies. The ability for issuers to "shop around" and seek the highest ratings has come under tremendous scrutiny in the aftermath of the credit crisis. The reform bill gives broader oversight powers to the SEC and calls for a two year study with a focus on conflicts of interest in the business model where rating agencies earn their revenue from issuers of the securities they rate. The language also establishes a new Office of Credit Ratings within the SEC and calls for new compliance and disclosure requirements for Nationally Recognized Statistical Rating Organizations (NRSRO). These developments are a positive enhancement for the credibility of ratings.

Hedge funds. The legislation requires hedge funds to register with the SEC and report more information to regulators. From the outset of this process, we have endorsed registration and increased manager disclosure as we believe that public disclosure of aggregated anonymous data will provide useful information to market participants. As previously noted, confidentiality of individual manager's positions remains important.

Carried interest tax. This had been included in the extenders bill which did not pass. The proposal -- to raise the effective tax rate on carried interest paid to individuals who manage private funds from 15% to around 35%, with a formula whereby 75% of income would be taxed as ordinary income and the remainder would be taxed at the 15% capital gains tax rate -- is on hold. It seems likely that a carried interest tax proposal will be resurrected given the need to close the deficit.

Municipal bonds. The SEC recently proposed enhanced disclosure rules for municipal bond issuers. In addition, the reform legislation provides the SEC with broader powers over the municipal market and requires registration for municipal financial advisors, swap advisors, and investment brokers to be administered by the SEC or a designee. In general, there will be greater transparency, more timely information, and stronger reporting requirements for issuers, all of which will benefit investors and should improve the trading and liquidity of municipal bonds.

Consumer financial protection bureau. A bureau is to be created within the Federal Reserve which will monitor and enhance consumer protection laws to ensure that they are comprehensive and strongly enforced. The Bureau will have rule-making authority and enforcement powers applicable to all financial institutions, including depository institutions that offer financial products and services to consumers.

The primary focus of this bureau will be on the extension of credit to consumers, in the form of mortgages, credit cards, or other credit products. The reach of the new agency is limited, with both persons and products registered with the SEC and CFTC excluded. Insurance products are also excluded. Service providers to defined contribution and similar plans (but not the plans or their sponsors) could be in scope but only at the request of Treasury and the Department of Labor. As currently described, the agency will have a negligible impact on the investment management industry and our clients.

Fee disclosure in 401(k) plans. The House version of the "extenders bill" had language related to fee disclosures in 401(k) plans. This language focused on unbundled disclosure versus anticipated regulation from the Department of Labor focusing on bundled fee disclosure. As previously mentioned, this legislation did not pass in the Senate, and therefore it is expected that the Department of Labor's pending disclosure regulations will go forward shortly.

Duties of Brokers and Registered Investment Advisors. The House bill proposed a fiduciary standard for both brokers and registered investment advisors that was intended to harmonize responsibilities when dealing with retail investors. The final language calls for a 12-month study of this issue by the SEC, and the potential for follow-on rulemaking. We believe the business models of both brokers and RIAs, while different, promote investor choice and should be preserved.

State investment advisor registration. The conference report raises the threshold requiring SEC registration by advisors from $25 million to $100 million assets under management. However, any advisor who is not required to register on the federal level must register at the state level, and as a result approximately 25% of advisors will now be required to fulfill state registration requirements. This provision also removes federal registration exemptions previously available to private equity and hedge fund managers. The provision will have a different impact on each advisor depending on the specific rules of the state or states where they register.

National insurance office. Both the House and the Senate versions of the reform bill called for more centralized information on insurance companies. The final version ultimately established a new Federal Insurance Office, housed within the Treasury. It appears the initial goal of this entity is to monitor for systemic risk and collect information. The overall regulatory structure for the industry remains unchanged because the Office does not have regulatory authority, however, the bill also requires a study on how to update and improve insurance regulation within the United States. For now, state-based regulation will remain. Over time, this office may transform into a national insurance regulator with a federal charter that could supersede the current fifty individual state insurance regulatory regimes or might be offered as an optional alternative. While large national insurers who operate in an environment across states and report to up to fifty different regulatory bodies who often have different rules welcome a national alternative, smaller regional insurance companies prefer their current status with a small number of regulatory relationships.

Corporate governance and executive compensation. The reform legislation confirms the SEC's authority over listed companies by giving the Commission power to grant shareholders proxy access to nominate directors as well as require directors to achieve a majority vote in uncontested elections. Additionally, the bill grants shareholders of companies a "say on pay" with a non-binding vote on executive compensation and "golden parachute" on severance payment.

Broker voting of shares. While the bill generally requires shareholders to vote their own shares, it includes exceptions for ETFs and closed-end funds whose shareholders would otherwise bear unnecessary administration costs.

Paying for legislation costs. In some last minute drama, the conference reconvened on June 29th to revise the "pay for" provision of the legislation which had been inserted during the night on June 24th. The revised version eliminated the "assessment" on financial institutions over $50 billion and hedge funds over $10 billion and instead raised FDIC premiums and redeployed Troubled Asset Relief Program (TARP) funds. There is continuing discussion of a new "Bank Tax" or other measure to reduce the deficit and/or contain costs.

Looking Ahead

The language in the reform bill allows for a long phase-in period in which the actual rules will be crafted by regulators and financial institutions will adapt their business models accordingly for the outlined changes. We will continue to keep you apprised of our efforts and of any new developments as the execution of regulatory reform continues.

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