

THE DODD–FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: UNRESOLVED ISSUES OF REGULATORY CULTURE AND MINDSET

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[The Dodd–Frank Act constitutes the most significant reform of financial regulation in the United States since the 1930s. Some of its provisions are bold, particularly in the areas of consumer protection and derivative trading. However, the political challenges for law reformers and regulators in the wake of the global financial crisis are far from over. The Act is inchoate. The full scope and nature of the new financial regulatory system will take several years to evolve as the mandated studies and rule-making are completed and implemented. We argue that the extent to which the reforms achieve their stated objectives will depend most critically on three factors: (i) the competency, integrity and forcefulness of the federal regulators; (ii) the ability and willingness of those regulators to supervise the finance industry on an integrated basis; and (iii) whether a fundamental change in the regulatory culture and mindset is achieved.]

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I INTRODUCTION

The global financial crisis ('GFC') led to widespread calls for regulatory change in the United States ('US') and elsewhere. In June 2009, President Barack Obama introduced a proposal for a 'sweeping overhaul of the [American] financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression.'¹

The *Dodd–Frank Wall Street Reform and Consumer Protection Act* ('*Dodd–Frank Act*')² was signed into law by President Obama on 21 July 2010. The Act is named after two members of Congress: Representative Barney Frank, who proposed the Bill in the House of Representatives on 2 December 2009, and Senator Chris Dodd, the Chairman of the Senate Banking Committee. The long title of the Act states its purposes as being:

- to promote the financial stability of the US by improving accountability and transparency in the financial system;
- to end 'too big to fail';
- to protect the American taxpayer by ending bailouts; and
- to protect consumers from abusive financial services practices.

The purposes of the *Dodd–Frank Act* reflect the major political and public concerns in the US during and in the wake of the GFC:

¹ Barack Obama, 'Remarks by the President on 21st Century Financial Regulatory Reform' (Speech delivered at the White House, 17 June 2009) <http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform>.

² Pub L No 111-203, 124 Stat 1376 (2010).

- the collapse or near collapse of major financial institutions, which had the potential to threaten the global financial system, with devastating economic and other consequences;³
- the spending of massive amounts of taxpayer money to support or bail out collapsing or significantly weakened financial institutions;⁴
- the perceived excessiveness of compensation paid to finance industry executives, particularly those of failed institutions;⁵ and
- the abuse of consumers of mortgage and other credit products, reflected in high levels of home foreclosures and individual indebtedness.⁶

Most of the Act deals with these individual areas of concern.⁷ However, the reforms also address factors that were generally acknowledged as significant underlying causes of the crisis, such as issues relating to the securitisation and derivatives markets and credit rating agencies.

The potential scope of the *Dodd–Frank Act* is immense. The statute is nearly 1000 pages long and it encompasses many aspects of financial reform. One legal practitioner describes it as ‘a profound increase in regulation of the financial services industry’.⁸ However, the Act is inchoate and provides only a broad framework. While some of the reforms came into effect the day following the Act’s passing into law,⁹ the operation of many provisions is delayed or subject to rule-making by the federal regulators. The regulators are required to conduct numerous studies and provide reports and recommendations in order to determine the provisions governing many of the most controversial reforms.¹⁰ Most

³ Title I of the *Dodd–Frank Act* is intended to enhance the stability of the financial system: see *Dodd–Frank Act*, § 115, 124 Stat 1376, 1403–6. The key provisions of tit I are outlined and discussed below in Part III of the article.

⁴ Title II of the *Dodd–Frank Act* provides for an orderly liquidation process that can be used to break up and wind down a financial institution in financial distress without any loss being borne by taxpayers: see *Dodd–Frank Act*, § 203, 124 Stat 1376, 1450–4. The orderly liquidation process is summarised and discussed below in Part III of the article.

⁵ As outlined below in Part VI of the article, the *Dodd–Frank Act* contains provisions that prohibit incentive-based compensation, or that claw back such payments, in specified circumstances. It also provides for management, directors, and third parties of a failed financial company to bear losses consistent with their responsibility: see *Dodd–Frank Act*, §§ 951–6, 124 Stat 1376, 1899–1906.

⁶ Title X of the *Dodd–Frank Act* provides for the establishment of a Bureau of Consumer Financial Protection and reforms to protect financial consumers: see *Dodd–Frank Act*, §§ 1011–12, 124 Stat 1376, 1964–6. These reforms are reviewed below in Part VII of the article.

⁷ As such, the reform is likely to be seen by many parties as ‘post-GFC reform’ or as regulation following a crisis. See, eg, Stephen M Bainbridge, ‘*Dodd–Frank: Quack Federal Corporate Governance Round II*’ (2011) 95 *Minnesota Law Review* 1779. Bainbridge argues that the *Dodd–Frank Act* is a ‘bubble law, enacted in response to a major negative economic event’ and that it represents ‘a populist backlash against corporations and/or markets’: at 1796.

⁸ Eric J Friedman, Executive Partner, in Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, *The Dodd–Frank Act: Commentary and Insights* (12 July 2010) <http://www.skadden.com/Cimages/siteFile/Skadden_Insights_Special_Edition_Dodd-Frank_Act1.pdf>.

⁹ *Dodd–Frank Act*, § 4, 124 Stat 1376, 1390.

¹⁰ For a summary of the mandated rules, studies and reports, see Center for Capital Market Competitiveness, United States Chamber of Commerce, *Dodd–Frank Act of 2010: Summary of Rulemaking, Studies, and Congressional Reports by Title* <<http://chamberpost.typepad.com/files/dodd-frank-summary-sheet.pdf>>. For links to lists of the studies and rule-makings required

of the rule-making is scheduled for completion within 12 months; however, the legislative timetables are proving to be overly ambitious.¹¹ The full scope and nature of the financial regulatory framework may take several years to emerge. Indeed, the efficacy of some of the regulation will only be known at the time of the next major financial crisis.

The importance of the legislation to financial regulation and economic development globally is hard to exaggerate. A significant proportion of the world's financial services are provided in the US or by US-based institutions. Moreover, as the GFC clearly highlighted, the world's financial systems are inextricably interconnected. It is not feasible for a single paper to discuss the Act or critique its provisions comprehensively. Instead, this article provides an overview of the significant reforms and discusses some of the more controversial proposals. The primary aims of the article are to highlight the incomplete nature of the legislation and the essential reliance on federal regulators to draft, implement, supervise and enforce the reforms.

The article initially discusses the financial regulatory structure created by the *Dodd–Frank Act*. The Act provides the primary federal regulators — the Federal Reserve ('Fed'), the US Department of the Treasury ('Treasury'), the Federal Deposit Insurance Corporation ('FDIC'), the Securities and Exchange Commission ('SEC') and the Commodity Futures Trading Commission ('CFTC') — with enlarged powers and functions.¹² However, the regulatory system remains cumbersome. The proposed reforms, far from streamlining the supervisory arrangements governing financial companies, add a layer of complexity to the multi-agency framework.

The article then reviews the legislative reforms under the following categories: supervision of systemically important institutions; financial institutions; financial markets and products; executive compensation; consumer protection; and investor protection. These reviews outline the most important or significant provisions, and are followed by commentary and analysis. The aspirational objectives of the *Dodd–Frank Act* are largely uncontroversial. Critique of the regulation and provisions is more difficult given the inchoate nature of the legislation, the reliance on regulators to complete and manage the reform processes, and the need to assess the reforms using a long-term lens.

to be undertaken by each organisation, see National Economic Research Associates, *Dodd–Frank Rulemakings and Studies*, NERA Economic Consulting <<http://www.nera.com/6911.htm>>.

¹¹ This article provides only minimal commentary on events since the *Dodd–Frank Act* was passed. Ongoing updates on the reform timetables and rule-making processes are available from the regulator websites. See, eg, The Federal Reserve Board, *Dodd–Frank Act Proposals* <<http://www.federalreserve.gov/generalinfo/foia/dfproposals.cfm>>; US Commodity Futures Trading Commission, *Dodd–Frank Act* <<http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm>>; US Securities and Exchange Commission, *Implementing the Dodd–Frank Wall Street Reform and Consumer Protection Act* <<http://www.sec.gov/spotlight/dodd-frank.shtml>>. There are also many third party websites providing commentary on the reform schedules and outcomes.

¹² See US Government Accountability Office, *Financial Regulation: Industry Trends Continue to Challenge the Federal Regulatory Structure* (Report to Congressional Committees, GAO-08-32, October 2007) ('GAO Industry Trends Report') for a detailed outline of the federal regulatory structure prior to the reforms.

We complete the analysis with a discussion of regulatory performance issues, because the success of the legislation relies on the regulators' willingness and ability to manage the reforms as an integrated package, and to work together with a primary focus on the bigger picture. We argue that this requires more than simply legislative change. The real question posed by the reforms is not whether the regulators have sufficient powers to achieve the stated objectives of the Act, but whether they are willing to proactively use these powers to prevent or to mitigate the negative effects of the next financial crisis.¹³

II THE FINANCIAL REGULATORY STRUCTURE

There are many papers that detail the significant financial policy reforms and development of the regulatory framework in the US since the 1930s.¹⁴ In 2009 the US Government Accountability Office ('GAO'), which acts as an independent review agency of Congress, indicated that the

current US financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators — put into place over the past 150 years — that has not kept pace with major developments in financial markets and products ... [R]esponsibilities for overseeing the financial services industry are shared among almost a dozen federal ... regulatory agencies ... and hundreds of state financial regulatory agencies.¹⁵

Hubbard suggests the 'fragmentation of regulators is not the product of careful design — it has evolved by layers of accretion since the Civil War. It has survived largely unchanged, despite repeated unsuccessful efforts at reform.'¹⁶ Kushmeider indicates that '[m]ost observers of the US financial regulatory system would agree that if it did not already exist, no one would invent it.'¹⁷ She suggests that repeated failures to reform the system show 'how sensitive the issues are for the many varied interest groups involved.'¹⁸

The financial regulatory structure in the US prior to the introduction of the *Dodd–Frank Act* has been described as 'functional' — that is, financial products

¹³ See Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (January 2011) xviii, stating that 'we do not accept the view that regulators lacked the power to protect the financial system. They had ample power in many arenas and they chose not to use it.'

¹⁴ See, eg, Rose Marie Kushmeider, 'The US Federal Financial Regulatory System: Restructuring Federal Bank Regulation' (2005) 17(4) *FDIC Banking Review* 1. In the appendix of the paper, Kushmeider provides a summary of 24 major proposals for regulatory restructuring: at 25–9.

¹⁵ GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated US Financial Regulatory System* (Report to Congressional Addressees, GAO-09-216, January 2009) ('GAO Framework Report').

¹⁶ R Glenn Hubbard, 'Finding the Sweet Spot for Effective Regulation' (2009) 6(11) *The Economists' Voice* 1, 4 <<http://www.bepress.com/ev/vol6/iss11/>>. Hubbard argues that the establishment of a systemic risk council is flawed and represents 'fragmentation by another name'.

¹⁷ Kushmeider, above n 14, 1.

¹⁸ *Ibid* 4.

or activities were regulated according to their function.¹⁹ The benefits of this structure were:

- a better understanding of products or activities due to regulator specialisation;
- improved regulatory innovation due to competition among regulators;
- checks and balances between regulators;
- the ability for companies to select the regulator most appropriate for their business; and
- a system that has generally worked well, enabling deep, liquid and efficient markets.²⁰

However, problems with the prevailing agency structure include:

- overlapping jurisdictions making it difficult to hold any one agency accountable for its actions;
- conflicts between state and federal regulators;
- potential regulatory gaps;
- competition between regulators in a race to the bottom for the lowest standards of regulation and enforcement;
- the inability of regulators to manage complex financial institutions or systemic risk;
- difficulties managing consolidated groups; and
- entrenched constituencies.²¹

An International Monetary Fund ('IMF') report in August 2007 indicated that the multiple federal and state regulatory frameworks in the US overseeing the financial market system may limit regulatory effectiveness and slow responses to pressing issues.²² Two months later the GAO reported to Congressional Committees on the federal regulatory system.²³ The GAO report indicated that the regulatory structure was challenged by the developing industry trend of large, complex and internationally active firms whose product offerings spanned the jurisdiction of several agencies.²⁴ It highlighted unresolved issues around duplicative and inconsistent regulation of financial services conglomerates and problems with accountability when agency jurisdiction is not clearly assigned. A GAO report released as testimony before the Committee on Homeland Security and Governmental Affairs of the US Senate in January 2009 reached a stronger

¹⁹ *GAO Industry Trends Report*, above n 12, 9. For a discussion of the characteristics of functional regulation, see *ibid* 9–10.

²⁰ See, eg, *GAO Industry Trends Report*, above n 12, 9–10, 17–18.

²¹ *Ibid* 17–37.

²² IMF, 'United States: 2007 Article IV Consultation — Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion' (Country Report No 07/264, IMF, August 2007) 18. The IMF report in August 2007 was undertaken as part of the regular consultations of member countries under art IV of the IMF *Articles of Agreement*.

²³ *GAO Industry Trends Report*, above n 12, 15.

²⁴ *Ibid*.

conclusion. The summary stated that ‘[a]s the nation finds itself in the midst of one of the worst financial crises ever, the regulatory system increasingly appears to be ill-suited to meet the nation’s needs in the 21st century.’²⁵ The limitations and gaps posed by the fragmented regulatory arrangements were identified as:

- a failure to mitigate systemic risk posed by large and interconnected financial conglomerates;
- difficulties in dealing with significant market participants, such as non-bank mortgage lenders, hedge funds and credit rating agencies;
- challenges posed by new and complex investment products, such as retail mortgage and credit products;
- difficulties in establishing accounting and audit standards that are responsive to financial market developments and global trends; and
- difficulties in coordinating international regulatory efforts.²⁶

The 2009 GAO report did not provide detailed proposals or solutions to address the identified issues; instead it outlined principles that an ideal regulatory framework should reflect. It indicated that the framework should: have clearly defined regulatory goals; be comprehensive; adopt a system-wide focus; be efficient and effective; ensure consistent consumer and investor protection; ensure that regulators are independent with sufficient resources, clout and authority; and enable consistent financial oversight with minimal taxpayer exposure.²⁷

The legislative provisions outlined in the following Parts include reforms with similar regulatory aspirations to those identified by the GAO. Whether the reforms will achieve the desired regulatory framework remains an open question.

III SUPERVISION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

A *Legislative Provisions*

1 *Financial Stability Oversight Council*

President Obama wanted to limit the overall size of individual financial institutions to avoid a concentration of risk in a small number of financial companies and to reinforce the principle that no institution is too big to fail.²⁸ This aspiration is translated into provisions in tit I of the *Dodd–Frank Act* that potentially require systemically important companies to hold minimum levels of risk-based capital beyond those generally applicable under other regulations.²⁹ Bank

²⁵ *GAO Framework Report*, above n 15.

²⁶ *Ibid.*

²⁷ *Ibid.* 48–63.

²⁸ Barack Obama, ‘President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers’ (Press Release, 21 January 2010) <<http://www.whitehouse.gov/briefing-room/statements-and-releases>>.

²⁹ *Dodd–Frank Act*, § 115, 124 Stat 1376, 1403–6.

holding companies with US\$50 billion or more in assets and non-bank financial companies ('NFCs')³⁰ designated as systemically important ('designated NFCs') can be made subject to 'enhanced supervision and prudential' requirements beyond those imposed by other regulations.³¹ Individual regulators are authorised to determine the specific leverage and capital measures.³²

The Fed is also empowered to act in relation to bank holding companies with US\$50 billion or more in assets and designated NFCs that pose a 'grave threat to the financial stability of the United States'.³³ The Fed may: limit these companies' ability to merge, consolidate or affiliate with another company; restrict the financial products they offer; require the termination of their activities; impose conditions on the way they conduct a business activity; and require them to sell or transfer assets.³⁴ In addition, mergers, acquisitions and other business combinations are prohibited if the resulting enlarged company would hold more than 10 per cent of the total consolidated liabilities of all banks and supervised NFCs.³⁵

The reforms extend beyond concern with individual financial institutions to the supervision of systemic risk and financial stability. The Fed remains primarily responsible for systemic risk regulation and supervision. In addition, the *Dodd-Frank Act* establishes a Financial Stability Oversight Council ('FSOC'), which includes representatives from all of the major regulatory bodies,³⁶ to identify risks to the financial stability of the US, to promote market discipline,

³⁰ A non-bank financial company is defined as a company (other than a bank holding company) that is predominantly engaged in financial activities: *ibid* §§ 102(a)(4), (6), 124 Stat 1376, 1391–2.

³¹ *Ibid* § 165, 124 Stat 1376, 1423–32.

³² *Ibid* § 171, 124 Stat 1376, 1435–8.

³³ *Ibid* §§ 121(a), 165(j), 124 Stat 1376, 1410, 1431.

³⁴ *Ibid* § 121(a), 124 Stat 1376, 1410.

³⁵ *Ibid* § 622, 124 Stat 1376, 1632–4. Section 622(e) requires the Financial Stability Oversight Council to complete a study on the extent to which this size affects financial stability, moral hazard, the efficiency and competitiveness of US financial firms and markets, and the cost and availability of credit and other financial services to households and businesses. This study was completed in January 2011. See Financial Stability Oversight Council, 'Study and Recommendations Regarding Concentration Limits on Large Financial Companies' (January 2011) <<http://www.treasury.gov/initiatives/fsoc/Pages/studies-and-reports.aspx>>. The Council noted that in

the near term, the concentration limit is mostly likely to restrict or otherwise affect acquisitions by four financial institutions — Bank of America Corporation, JP Morgan Chase & Company, Citigroup Inc, and Wells Fargo & Company — because only these four firms, based on current estimates, appear to hold more than 5 per cent of the aggregate liabilities of all financial companies subject to the concentration limit.

³⁶ *Dodd-Frank Act*, § 111, 124 Stat 1376, 1392–4. The FSOC's voting members are the Secretary of the Treasury, the Chairman of the Board of Governors, the Comptroller of the Currency, the Director of the Consumer Bureau, the Chairman of the SEC, the Chairperson of the Corporation, the Chairperson of the CFTC, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board and an independent member. The non-voting members are the Director of the Office of Financial Research, the Director of the Federal Insurance Office, a state insurance commissioner, a state banking supervisor and a state securities commissioner. See also FSOC, *2011 Annual Report* (2011) <<http://www.treasury.gov/initiatives/fsoc/Pages/annual-report.aspx>>, which provides: (i) a review of the US financial system in 2011; (ii) insightful commentary on future challenges and risks; (iii) updates on the implementation of the *Dodd-Frank Act*; and (iv) recommended additional steps to strengthen the financial system.

and to respond to emerging threats.³⁷ The role of the FSOC is to provide advice and to facilitate communication and coordination across the regulatory framework. It is required to define and monitor systemic risk regulation, conduct research, keep abreast of ongoing market developments, and make recommendations on prudential standards and market activity.³⁸

2 Orderly Liquidation Authority

Title II of the *Dodd–Frank Act* creates an Orderly Liquidation Authority (‘OLA’) that empowers the FDIC to serve as a receiver for large interconnected financial companies whose insolvency poses a significant risk to financial stability or is likely to seriously adversely affect the US economy.³⁹ As receiver of a financial company, the FDIC assumes control of the liquidation process with broad powers.⁴⁰

The Act prohibits the use of taxpayers’ funds to prevent a liquidation and provides that taxpayers shall bear no losses from the exercise of any authority by the OLA.⁴¹ All costs are to be recouped from creditors or shareholders of the institution,⁴² from the disposition of assets of the company, or from assessments on other financial companies.⁴³

B Commentary and Analysis

The reforms in titles I and II of the *Dodd–Frank Act* reflect elements of proposals highlighted by scholars. Herring argued in 2009 that ‘supervisors need to place much greater emphasis on increasing the resilience of the system by ensuring that no institution is too big, too complex, or too interconnected to fail.’⁴⁴ He suggested that systemically important institutions should be required to file and update a winding down plan and, where required, supervisors should be empowered to require changes in the size or structure of firms.⁴⁵

Skeel argues that the final reforms single out the largest institutions for special treatment. He suggests that the OLA processes provide ‘unconstrained regulatory discretion’, and that the ‘basic expectations of the rule of law — that the rules will be transparent and knowable in advance ... [—] are subverted by this

³⁷ *Dodd–Frank Act*, § 112(a)(1), 124 Stat 1376, 1394–5.

³⁸ *Ibid* § 112(a)(2), 124 Stat 1376, 1395–6.

³⁹ *Ibid* § 203, 124 Stat 1376, 1450–4. To be placed into receivership under the OLA, a financial company must be a ‘covered financial company’ (defined in § 201(a)(8), 124 Stat 1376, 1443) and a written determination must be made by the Secretary of the Treasury (after a recommendation from the FDIC and the Fed, or in a case involving an insurance company, the Director of the Federal Insurance Office and the Fed) that the company presents systemic risk.

⁴⁰ See *ibid* § 204, 124 Stat 1376, 1454–6. Insurance companies cannot be placed into receivership under the Act and must be liquidated or rehabilitated under state law proceedings: § 203(e), 124 Stat 1376, 1454.

⁴¹ *Ibid* § 214, 124 Stat 1376, 1518.

⁴² *Ibid* § 204(a)(1), 124 Stat 1376, 1454.

⁴³ *Ibid* § 214(b), 124 Stat 1376, 1518.

⁴⁴ Richard J Herring, ‘The Known, the Unknown, and the Unknowable in Financial Policy: An Application to the Subprime Crisis’ (2009) 26 *Yale Journal on Regulation* 391, 404.

⁴⁵ *Ibid*.

framework.⁴⁶ Taylor argues that the OLA institutionalises a harmful bailout process because it is not possible for the FDIC to wind down large and complex financial institutions without disruption. He criticises the significant discretionary powers given to the FDIC and suggests the problems of ‘too big to fail’ and the political and regulatory capture by certain large financial institutions will continue.⁴⁷

Wilmarth concludes that the ‘too big to fail’ policy remains ‘the great unresolved problem of bank supervision’.⁴⁸ He suggests the Act makes meaningful improvements in the regulation of large financial conglomerates. However, it does not solve the ‘too big to fail’ problem because: (i) it relies primarily on capital-based regulation, the same supervisory tool that failed to prevent the 1980s savings and thrift crisis and the GFC; (ii) the efficacy of the supervisory reforms depends on the same federal regulatory agencies that failed to stop excessive risk-taking during both crises; and (iii) the effectiveness of the FSOC is open to question given the history of turf wars and bureaucratic issues that have typically been associated with governmental multi-agency oversight bodies in the US.⁴⁹

The arguments of Skeel, Taylor and Wilmarth are valid. The Fed, the FSOC and the FDIC are given broad discretion to supervise and monitor the largest financial institutions, leaving the door ajar for regulatory abuse or capture.⁵⁰ In practice, the Fed is only likely to use its powers under § 121(a)(4) to break up a systemically important financial institution in extraordinary circumstances.⁵¹ Successful implementation of the OLA provisions will also be difficult, and the skill and competency of the regulators will be significantly challenged. Determinations on the appropriate time to positively intervene and break up or assume control of a company will involve complex, confronting and intensely political

⁴⁶ David Skeel, *The New Financial Deal: Understanding the Dodd–Frank Act and Its (Unintended) Consequences* (John Wiley & Sons, 2011) 9.

⁴⁷ John B Taylor, ‘The Dodd–Frank Financial Fiasco’, *The Wall Street Journal* (online), 1 July 2010 <<http://online.wsj.com/article/SB10001424052748703426004575338732174405398.html>>. See also Jeffrey N Gordon and Christopher Muller, ‘Confronting Financial Crisis: Dodd–Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund’ (2011) 28 *Yale Journal on Regulation* 151; Kenneth Scott, ‘Dodd–Frank: Resolution or Expropriation?’ (Working Paper, Stanford Law School, 25 August 2010). Scott argues that the OLA procedure ‘gives unprecedented power and discretion to an administrative official, going far beyond banking law to the point of posing serious Constitutional problems’: at 1. He is concerned by the lack of due process and judicial overview.

⁴⁸ Arthur E Wilmarth Jr, ‘The Dodd–Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem’ (2011) 89 *Oregon Law Review* 951, 1052.

⁴⁹ *Ibid* 1053–4.

⁵⁰ Notably, Mark McDermott suggests the potential harshness of the provisions may mean that the ‘most salutary effect will be to minimize the circumstances under which it will, in fact, be used.’ He argues that the Act’s broad provisions and the power vested in the FDIC may work best when used as a threat to compel a private solution: Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, above n 8, 102.

⁵¹ Wilmarth, above n 48, 1024–5. Wilmarth highlights that the Fed’s divestiture authority under the *Bank Holding Company Act of 2006*, 12 USC § 1844(e)(1) (2006) has never been successfully used for a major banking organisation. He suggests that given the more stringent procedural and substantive constraints on the Fed’s authority under § 121, the prospects for a Fed-ordered breakup of a systemically important financial institution seem remote at best.

decisions.⁵² If the regulatory agencies take a conservative approach, the break-up or winding down of a large firm may occur too late to avoid another major crisis with potentially significant economic consequences. Conversely, the premature or poorly managed break-up or winding down of an important firm is likely to be very costly politically.

Perhaps the weakest aspect of the reforms in tits I and II is the domestic focus. One of the most important lessons from the GFC is the essential interconnectedness of global financial markets and systems. The GFC was primarily rooted in factors originating in the US, but the drivers of future crises may well arise from elsewhere. Many of the largest financial institutions operate outside of the US and will not be subject to these provisions. Thus, the Fed, the FSOC and the FDIC will need to work closely with global policymakers and regulators to ensure the reforms achieve their purposes.⁵³ The efficacy of the provisions and processes in tits I and II will only be seen fully during the next financial crisis.

IV FINANCIAL INSTITUTIONS

The *Dodd–Frank Act* extends the breadth of the regulatory framework for financial institutions. The primary aims of the extended regulatory oversight are to restrict the scope of activity of some financial institutions as a means of reducing systemic risk and increasing the transparency of capital market trading.

A *Legislative Provisions*

1 *Insurance Companies*

The insurance regulatory framework in the US is generally state-based. However, tit V of the Act creates a Federal Insurance Office within Treasury to monitor all aspects of the insurance sector.⁵⁴ The ability of the FSOC to supervise an insurance company as a designated NFC under the Act's reforms also

⁵² *Dodd–Frank Act*, § 203(b), 124 Stat 1376, 1451 indicates that having received a recommendation, the Secretary in consultation with the President shall appoint the FDIC as receiver of a covered financial company if the Secretary determines that: the financial company is in default or in danger of default; the failure of the financial company would have serious adverse effects on financial stability in the US; no viable private sector alternative is available to prevent the default; the effect on the claims or interests of creditors, counterparties and shareholders of the financial company and other market participants of proceedings under the Act is appropriate, given the impact of any action under the Act on financial stability in the US; and an orderly liquidation would avoid or mitigate such adverse effects.

⁵³ Global discussion and policy development of many of the reform areas in the *Dodd–Frank Act* are continuing. See, eg, G-20, 'Communiqué of Finance Ministers and Central Bank Governors of the G-20' (Communiqué, 14–15 October 2011) [4] <http://www.g20.org/pub_communique.aspx>, where it was stated that

[w]e are more determined than ever to reform the financial sector to better serve the needs of our economies. We reaffirm our commitment to implement fully, consistently and in a non-discriminatory way agreed reforms on OTC derivatives, all Basel agreements on banking regulation within agreed timelines and reducing overreliance on external credit ratings. We endorsed a comprehensive framework to reduce the risks posed by [systemically important financial institutions], including strengthened supervision ...

⁵⁴ *Dodd–Frank Act*, § 502, 124 Stat 1376, 1580–9.

brings the insurance holding company system within the federal regulatory framework.

2 *Depository Institutions*

The Act emphasises the traditional role of banks and saving and loan entities as intermediators between depositors and mortgagors. Section 619 prohibits depository institutions and their affiliates from engaging in proprietary trading; acquiring or retaining an interest in a hedge fund or a private equity fund; or sponsoring such a fund.⁵⁵ These provisions (commonly referred to as the ‘Volcker Rule’, after former Chairman of the Fed, Paul Volcker) apply to proprietary trading and fund activities by US banks in any location.⁵⁶ They also apply to proprietary trading and fund activities of non-US banks in the US, or such activities outside of the US if they involve the offering of securities to US residents.⁵⁷ Designated NFCs are not subject to the Volcker Rule, but they may be required to hold additional capital and quantitative limits may be set in relation to such activities.⁵⁸

‘Proprietary trading’ is broadly defined in the Act as ‘engaging as a principal for the trading account of a banking organisation’ or supervised NFC in

any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the [regulators may determine by rule].⁵⁹

In other words, the Volcker Rule generally prohibits a depository institution buying and selling securities as principal for the entity’s trading account. However, some trading activity is specifically permitted, including:

- trading in government securities;
- trading in connection with underwriting or market-making;
- risk-mitigating hedging;
- trading on behalf of customers;
- investments in small business investment companies;
- trading by a regulated insurance business for the general account of the insurance company; and
- the organising and offering of a private equity or hedge fund.⁶⁰

The Act requires the FSOC to study the Volcker Rule and to make recommendations on its implementation.⁶¹ The FSOC completed this study and reported to

⁵⁵ Ibid § 619, 124 Stat 1376, 1620–31.

⁵⁶ Ibid § 619(d)(1)(H), 124 Stat 1376, 1625.

⁵⁷ Ibid. See also Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, above n 8, 31.

⁵⁸ Ibid § 619(f)(4), 124 Stat 1376, 1629.

⁵⁹ Ibid § 619(h)(4), 124 Stat 1376, 1630.

⁶⁰ Ibid § 619(d), 124 Stat 1376, 1623–6.

⁶¹ Ibid § 619(b)(1), 124 Stat 1376, 1621.

Congress on 18 January 2011.⁶² The FSOC report advocated robust implementation of the Volcker Rule and recommended that the federal regulatory agencies consider taking the following actions:

- 1 Require banking entities to sell or wind down all impermissible proprietary trading desks.
- 2 Require banking entities to implement a robust compliance regime, including public attestation by the [chief executive officer] of the regime’s effectiveness.
- 3 Require banking entities to perform quantitative analysis to detect potentially impermissible proprietary trading without provisions for safe harbors.
- 4 Perform supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading.
- 5 Require banking entities to implement a mechanism that identifies to Agencies which trades are customer-initiated.
- 6 Require divestiture of impermissible proprietary trading positions and impose penalties when warranted.
- 7 Prohibit banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trust, fiduciary or investment advisory customers.
- 8 Prohibit banking entities from engaging in transactions that would allow them to ‘bail out’ a hedge fund or private equity fund.
- 9 Identify ‘similar funds’ that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule.
- 10 Require banking entities to publicly disclose permitted exposure to hedge funds and private equity funds.⁶³

Timothy Geithner, the Treasury Secretary, who leads the FSOC, indicated that ‘[w]e have to be careful to strike the right balance between putting in place new rules that protect consumers and investors and the economy, without stifling the competition and innovation that drives economic growth’.⁶⁴

⁶² FSOC, ‘Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds’ (January 2011) <<http://www.treasury.gov/initiatives/fsoc/Pages/studies-and-reports.aspx>>. The FSOC notes that ‘certain classes of permitted activities — in particular, market making, hedging, underwriting, and other transactions on behalf of customers — often evidence outwardly similar characteristics to proprietary trading, even as they pursue different objectives’: at 18. Notably, the study concludes that ‘[s]upervisory review is likely to be the ultimate lynchpin in effective implementation by Agencies’: at 43.

⁶³ *Ibid* 3.

⁶⁴ Ian Katz and Rebecca Christie, ‘Volcker Rule Should Be “Robust”, Financial Oversight Panel Says’, *Bloomberg* (online), 18 January 2011 <<http://www.bloomberg.com/news/2011-01-18/volcker-rule-s-implementation-should-be-robust-oversight-council-says.html>>.

3 Hedge Funds and Private Equity Funds

Prior to enactment of the *Dodd–Frank Act*, registered hedge fund advisers were subject to the same disclosure requirements as other registered investment advisers in the US. Moreover, disclosure and risk management practices at hedge funds were acknowledged as having improved over the last decade.⁶⁵ In practice, however, many hedge funds were not registered with the SEC and were not required to report their activities,⁶⁶ because they fell within the safe harbour of reg D under the private offering exemption of § 4(2) of the *Securities Act of 1933*.⁶⁷ Most funds were exempt from registration as investment companies under §§ 3(c)(1) or (7) of the *Investment Company Act of 1940*, as the securities were issued as private placements and either there were less than 100 investors or the securities were offered to ‘qualified purchasers’.⁶⁸ Section 203(b)(3) exempted advisers from registration under the *Investment Advisers Act of 1940* provided there were fewer than 15 clients, no services were offered to the public, and no advice was given to registered investment companies.⁶⁹

The *Dodd–Frank Act* requires hedge funds and private equity funds that were previously exempt under §§ 3(c)(1) or (7) of the *Investment Company Act* to register with the SEC.⁷⁰ In addition, the exemption under § 203(b)(3) of the *Investor Advisers Act* has been repealed.⁷¹ All advisers to private funds, whether registered or not, are required to provide ongoing reports to the SEC.⁷²

4 Credit Rating Agencies

Section 931 of the *Dodd–Frank Act* indicates that Congress found that credit rating agencies are ‘central to capital formation, investor confidence, and the efficient performance of the United States economy’. The rating agencies ‘play a critical “gatekeeper” role in the debt market that is functionally similar to that of securities analysts ... and auditors.’ Their activities are ‘fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers’. Inaccurate ratings on structured financial products ‘contributed significantly to

⁶⁵ For a detailed review of hedge fund regulation and practices prior to the reforms, see GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention is Needed* (Report to Congressional Requesters, GAO-08-200, January 2008) (‘*GAO Hedge Funds*’).

⁶⁶ Lisa C Brice, ‘2010 Financial Reform as It Relates to Hedge Funds’ (Working Paper, 19 July 2010) 3–4 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1679191>.

⁶⁷ 15 USC § 77(d) (2006). The relevant regulation is 17 CFR § 230.506 (2009). There is no limit on the amount of capital raised under r 506 when a company does not market its securities through general solicitation or advertising and the securities are sold only to ‘accredited investors’.

⁶⁸ 15 USC §§ 80a-3(c)(1), (7) (2006).

⁶⁹ 15 USC § 80b-3(3) (2006).

⁷⁰ *Dodd–Frank Act*, § 402, 124 Stat 1376, 1570. Section 408 requires the SEC to provide an exemption from the registration requirements for investment advisers with less than \$150 million in assets under management. This exemption applies only to advisers who act solely as advisers to private funds. The SEC is empowered to require annual reporting from the exempted investment advisers as necessary and appropriate in the public interest or for the protection of investors: *Dodd–Frank Act*, § 408, 124 Stat 1376, 1575.

⁷¹ *Ibid* § 403, 124 Stat 1376, 1571.

⁷² *Ibid* § 404, 124 Stat 1376, 1571–4.

the mismanagement of risks by financial institutions and investors ... Such inaccuracy necessitates increased accountability on the part of credit rating agencies'.⁷³

The Act seeks to minimise conflicts of interest and improve the transparency of credit rating processes by imposing disclosure, reporting and procedural regulation as well as corporate governance processes. Rating agencies must disclose credit rating assumptions, procedures and methodologies; the potential limitations of a rating; information on the uncertainty of a rating; the extent to which third party services have been used in arriving at a rating; an overall assessment of the quality of available and considered information; and information relating to conflicts of interest.⁷⁴ A standardised form must be used to disclose the information to enable comparison.⁷⁵ The SEC is mandated to establish a rule requiring agencies to provide published periodic performance reports that reveal the accuracy of ratings provided over a range of years and for a variety of types of credit ratings.⁷⁶

In addition, the agencies must disclose whether and to what extent external due diligence services have been used.⁷⁷ The findings and conclusions of any third party due diligence reports must be published and the third party must certify and explain the extent of the review performed.⁷⁸

The Act specifically provides for private investor actions against a credit rating agency under the *Securities Exchange Act of 1934*,⁷⁹ in the same manner and to the same extent as apply to statements made by an accounting firm or a securities analyst.⁸⁰ It also alters the pleading standards under the *Private Securities Litigation Reform Act of 1995*⁸¹ so that a complaint need only state facts that give rise to a strong inference that the ratings agency knowingly or recklessly failed to conduct a reasonable investigation of the facts relied on or failed to obtain reasonable verification of the factual elements.⁸²

The Act mandates the SEC to conduct a range of studies on, among other issues:

⁷³ Ibid § 931, 124 Stat 1376, 1872.

⁷⁴ Ibid § 932(a), 124 Stat 1376, 1879–81.

⁷⁵ Ibid § 932(a), 124 Stat 1376, 1879.

⁷⁶ Ibid § 932(a), 124 Stat 1376, 1880. The SEC has issued the following proposed rules: Nationally Recognized Statistical Ratings Organization ('NRSRO') reports of internal controls; technical amendments to NRSRO Rules; transparency of NRSRO ratings performance; credit ratings procedures and methodologies; certification by third parties; and fines and other penalties. The rules are available at SEC, *Implementing Dodd–Frank Wall Street Reform and Consumer Protection Act — Accomplishments* <<http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml>>.

⁷⁷ *Dodd–Frank Act*, § 404, 124 Stat 1376, 1571–4.

⁷⁸ Ibid § 932(a), 124 Stat 1376, 1880.

⁷⁹ 15 USC §§ 78a–78nn (2006).

⁸⁰ *Dodd–Frank Act*, § 933(a), 124 Stat 1376, 1883.

⁸¹ 15 USC § 78u-4(2) (2006).

⁸² *Dodd–Frank Act*, § 933(b)(2), 124 Stat 1376, 1883. On 29 September 2010, the SEC revised reg FD to remove the exemption for entities whose primary business is the issuance of credit ratings: SEC, 'Removal from Regulation FD of the Exemption for Credit Rating Agencies' (Release, Nos 33-9146 and 34-63003, 29 September 2010) <<http://www.sec.gov/rules/final/2010/33-9146.pdf>>.

- the standardisation of terminology used by credit rating agencies;⁸³
- the market stress conditions under which ratings are determined;⁸⁴
- the independence of rating organisations;⁸⁵
- conflict of interest issues faced by rating agencies;⁸⁶ and
- the feasibility of creating an organisation to provide the ratings of structured finance products.⁸⁷

Following the study, a system may be established for the assignment of nationally recognised statistical ratings organisations to determine the credit ratings of structured products should this be in the public interest or necessary to protect investors.⁸⁸

B *Commentary and Analysis*

1 *Volcker Rule*

Prior to the GFC, the concept and practical reality of what constituted a bank, a non-bank financial institution, an insurance company, a hedge fund, a fund manager, a private equity adviser or a broker in the US had become blurred with the advent of large financial conglomerates. Significant areas of activity of many financial institutions, particularly the largest players, did not fit neatly within the jurisdictions of single regulators. Some areas of financial market activity such as private equity and over-the-counter ('OTC') trading were not generally supervised, and some market participants such as credit rating agencies and hedge fund advisers were subject to only minimal regulation and oversight.

The Volcker Rule represents a partial policy reversion to the period between 1933 and 1999, when the US had the Glass–Steagall restrictions in operation. These rules were initially introduced in the *Banking Act of 1933*,⁸⁹ which generally prohibited:

- banks from purchasing securities for their own account;⁹⁰
- deposit-taking institutions from engaging in the 'issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes' or other securities excepting US Treasury bills and other public sector debt;⁹¹

⁸³ *Dodd–Frank Act*, § 939(h), 124 Stat 1376, 1887.

⁸⁴ *Ibid.*

⁸⁵ *Ibid* § 939C, 124 Stat 1376, 1888.

⁸⁶ *Ibid* § 939F, 124 Stat 1376, 1889.

⁸⁷ *Ibid.* On 10 May 2011, the SEC requested public input to assist the study on the rating process for structured finance products: SEC, 'Solicitation of Comment to Assist in Study on Assigned Credit Ratings' (Release, No 34-64456, 10 May 2011) <<http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml>>.

⁸⁸ *Dodd–Frank Act*, § 939F(d), 124 Stat 1376, 1889–90.

⁸⁹ Pub L No 73-66, 48 Stat 162.

⁹⁰ *Ibid* § 16, 48 Stat 162, 184–5. However, commercial banks were permitted to purchase and sell securities on the order of and for the account of customers.

⁹¹ *Ibid* §§ 16, 21, 48 Stat 162, 185, 189.

- banks from affiliating with a company engaged principally in the ‘issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities’;⁹² and
- banks from having interlocking directorships or close officer or employee relationships with a company principally engaged in securities underwriting and distribution.⁹³

These rules to effectively separate the businesses of commercial banking and investment banking were extended in 1956 by the passing of the *Bank Holding Company Act of 1956*.⁹⁴ However, restrictions on the integration of banking and securities businesses were gradually relaxed from the 1970s, until the Glass–Steagall measures were formally repealed by the *Gramm–Leach–Bliley Act*.⁹⁵

Some scholars suggest it is surprising that opposition to the repeal of the Glass–Steagall restrictions was not more intense.⁹⁶ However, market and financial deregulation in the 1980s and 1990s was strongly supported by most policymakers, scholars and members of the judiciary, as well as the finance industry. Most of the theories to support the push for increasing deregulation and ever larger financial conglomerates were economic or efficiency-based. The commonly cited arguments for larger and more integrated global financial institutions (or universal banking as it is sometimes called) were scale and diversification benefits, and the need to enhance efficiency, spread risk and foster innovation. There were critics who warned about the potential concentration of risk.⁹⁷ However, these parties rarely expressed their arguments in compelling economic terms, and when they did so, their voices were generally overwhelmed in the drive for institutional profit, financial sector growth and enhanced competitiveness or dominance on the global financial stage.

The size and scale of financial institutions are not the only factors that have changed significantly since the 1980s. The structure of capital markets and trading patterns have also undergone a series of transformative phases.⁹⁸ Market activity levels have rapidly escalated, particularly trading in derivative instru-

⁹² Ibid § 20, 48 Stat 162, 188.

⁹³ Ibid § 32, 48 Stat 162, 194.

⁹⁴ Pub L No 84-511, 70 Stat 133.

⁹⁵ Pub L No 106-102, § 101, 113 Stat 1338, 1341 (1999).

⁹⁶ See, eg, Emiliios Avgouleas, ‘The Reform of “Too-Big-To-Fail” Bank: A New Regulatory Model for the Institutional Separation of “Casino” from “Utility” Banking’ (Working Paper, The University of Manchester, 14 February 2010) 13 n 26.

⁹⁷ See, eg, Robert E Litan, ‘Evaluating and Controlling the Risks of Financial Product Deregulation’ (1985) 3 *Yale Journal on Regulation* 1. Litan argued at 2 that while
[i]n theory, product diversification would make it possible for banks to reduce the volatility of their earnings ... [t]he freedom to diversify ... could increase instability in the banking system because of the danger that funds raised from insured depositors will be used to support unduly risky investments.

⁹⁸ See Gill North, ‘Structural Developments in Global Capital Markets: Promoting Efficiency or a Risky and Unstable Mathematical Playground?’ (Working Paper, The University of New South Wales, September 2011); Ross Buckley and Gill North, ‘A Financial Transaction Tax: Inefficient or Needed Systemic Reform?’ (2012) 43 *Georgetown Journal of International Law* (forthcoming).

ments.⁹⁹ An increasing proportion of this activity is computer-generated ‘high frequency’ trading.¹⁰⁰ Mary Schapiro, the Chairperson of the SEC, recently testified that

proprietary trading firms play a dominant role by providing liquidity through the use of highly sophisticated trading systems capable of submitting many thousands of orders in a single second. These high frequency trading firms can generate more than a million trades in a single day and now account for more than 50 percent of equity market volume.¹⁰¹

It is never easy, and often not possible, to turn the clock back. Institutions will look for ways to continue intensive principal-based trading under the new regime. The extent to which the Volcker Rule affects trading activity in the US and reduces actual and potential systemic risk will depend on how the provisions are interpreted and enforced by the regulators and judiciary. The regulators are being asked to tread a fine line. The initial step of defining ‘proprietary trading’ is difficult enough. Implementing and monitoring the Volcker Rule across varying markets, assets and institutions, in an environment subject to constant change, will be even more challenging.¹⁰²

The broader impacts of the trading restrictions are uncertain. Ultimately, the Volcker Rule is only likely to be effective if it is adopted as a global strategy. If other major markets fail to adopt and enforce equivalent rules, institutions are likely to take advantage of gaps or weaknesses in the provisions and regulatory frameworks to move their trading to areas where proprietary trading is not restricted or oversight is limited.

⁹⁹ See, eg, Stephan Schulmeister, ‘A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal’ (WIFO Working Paper No 344, Österreichisches Institut für Wirtschaftsforschung [Austrian Institute of Economic Research], October 2009) 5; Zsolt Darvas and Jakob von Weizsäcker, ‘Financial Transaction Tax: Small Is Beautiful’ (PE 429.989, Policy Department, Economic and Scientific Policies, European Parliament, January 2010) 5–8.

¹⁰⁰ Thornton Matheson, ‘Taxing Financial Transactions: Issues and Evidence’ (Working Paper No 11/54, IMF, March 2011) 19; Sony Kapoor, ‘Financial Transaction Taxes: Tools for Progressive Taxation and Improving Market Behaviour’ (Policy Brief, Re-Define, February 2010) 6. Matheson indicates that 10–20 per cent of foreign exchange trading volume, 20 per cent of options trading volume and 40 per cent of futures trading volume in the US is algorithmic or computer-based.

¹⁰¹ Mary L Schapiro, ‘Testimony on US Equity Market Structure by the US Securities and Exchange Commission’ (Testimony before the Subcommittee on Securities, Insurance, and Investment of the US Senate Committee on Banking, Housing, and Urban Affairs and the US Senate Permanent Subcommittee on Investigations, 8 December 2010).

¹⁰² The proposed Volcker Rule implementing prohibitions and restrictions on proprietary trading under *Dodd–Frank Act*, § 619, 124 Stat 1376, 1620 was released by the SEC, FDIC, the Fed and the Office of the Comptroller of the Currency on 12 October 2011: see SEC, ‘SEC Jointly Proposes Prohibitions and Restrictions on Proprietary Trading’ (Press Release, No 204, 12 October 2011) <<http://www.sec.gov/news/press/2011/2011-204.htm>>. Consultation on the proposed Rule is planned until January 2012. For further discussion, see Charles K Whitehead, ‘The Volcker Rule and Evolving Financial Markets’ (2011) 1 *Harvard Business Law Review* 39, 69–72; cf Matthias Rieker, ‘Citigroup’s Vikram Pandit: Volcker Rule May Strike the Right Balance’, *The Wall Street Journal* (online), 12 October 2011 <<http://blogs.wsj.com/deals/2011/10/12/citigroups-vikram-pandit-volcker-rule-may-strike-the-right-balance/>>. Vikram Pandit, the Chief Executive of Citigroup, suggests the proposed Volcker Rule may strike the right balance between speculation and capital. Whitehead suggests the Volcker Rule fails to reflect important shifts in the financial markets. He argues for a narrow definition of proprietary trading and a fluid approach to implementing the Rule.

2 *The Hedge Fund Provisions*

The benefits and risks posed by hedge funds and the case for more regulation of the hedge fund industry continue to be hotly debated. No evidence has been found suggesting that hedge funds were a direct cause of the GFC. However, as Eichengreen and Mathieson highlight, each crisis or episode of volatility in financial markets brings the role played by the hedge fund industry in financial market dynamics to the fore.¹⁰³ Hedge funds were implicated in the 1992 currency crisis in Europe. Similarly, there were allegations of large hedge fund transactions in various Asian currency markets in the lead up to, and in the wake of, the Asian financial crisis in 1997. These concerns were compounded by the near collapse of a major hedge fund, Long Term Capital Management, in the US¹⁰⁴ and more recent problems with hedge funds tied to subprime mortgages.

The absolute level of global trading by hedge funds continues to grow, representing an increasing share of total market trading.¹⁰⁵ Many hedge funds trade primarily in derivative instruments, which ‘compounds problems of information and evaluation for bank management and supervisors alike’.¹⁰⁶ These issues are accentuated when considered in the context of a globalised market. It is therefore important that hedge fund activities are encompassed within the regulatory structure to allow supervisors a comprehensive overview of markets.¹⁰⁷

3 *The Rating Agency Provisions*

Some scholars argued prior to the GFC that rating agencies were sufficiently motivated ‘to provide accurate and efficient ratings because their profitability is directly tied to reputation.’¹⁰⁸ Schwarcz concluded that ‘public regulation of ratings agencies [was] an unnecessary and potentially costly policy option.’¹⁰⁹

¹⁰³ Barry Eichengreen and Donald Mathieson, ‘Hedge Funds: What Do We Really Know?’ (Economic Issues No 19, IMF, September 1999) 8–9. See also Nicole M Boyson, Christof W Stahel and René M Stulz, ‘Hedge Fund Contagion and Liquidity Shocks’ (2010) 65 *Journal of Finance* 1789, where it is argued that contagion in the hedge fund industry is linked to liquidity shocks.

¹⁰⁴ Eichengreen and Mathieson, above n 103, 9–10.

¹⁰⁵ Kapoor, above n 100, 7. Kapoor suggests that hedge funds account for 90 per cent of the trading volume in convertible bonds, 55–60 per cent of the transaction in leveraged loans, almost 90 per cent of the trading in distressed debt, and more than 60 per cent of the trading volume in the credit default swap market.

¹⁰⁶ Eichengreen and Mathieson, above n 103, 8; *GAO Hedge Funds*, above n 65, 19. These problems would also arise for investors more generally.

¹⁰⁷ FSOC, *2011 Annual Report*, above n 36, 69. The FSOC report indicates that historically ‘regulators have had little reliable, detailed information regarding the activities of any particular hedge fund or hedge funds in general, which is of concern because of their increased role in the financial system.’ See also International Organization of Securities Commissions, ‘Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation’ (Final Report 08/11, September 2011). The IOSCO report indicates that hedge funds may ‘pose a number of risks to market integrity, investor protection and financial stability.’ These risks are ‘magnified when financial markets are suffering from stress or instability’ because hedge funds often use ‘leverage and ... the concentrated unwinding of their positions could cause major dislocation and potential disorderly pricing of markets.’ The report concludes that these potential risks need to be mitigated through appropriate oversight: at 138–9.

¹⁰⁸ Steven L Schwarcz, ‘Private Ordering of Public Markets: The Rating Agency Paradox’ (2002) 1 *University of Illinois Law Review* 1, 26.

¹⁰⁹ *Ibid* 2.

However, the public listing of a ratings company results in an inherent conflict between the managerial incentive to provide paying clients with their desired ratings, and to thereby increase the level of ratings provided and company profits, and the public interest that requires accurate ratings.

Listokin and Taibleson propose an incentive scheme in which ratings are paid for with the debt rated.¹¹⁰ This proposal is novel and interesting, but is unlikely to be acceptable to the agencies because it would make their financial management very difficult. Hunt argues that the 'incentive problem can be corrected by requiring an agency to disgorge profits on ratings that are revealed to be of low quality by the performance of the product type over time, unless the agency discloses that the ratings are of low quality.'¹¹¹ This approach poses significant implementation issues. It is not clear who would make the ex post facto judgments on the quality of the ratings. There may be a range of factors resulting in poor performance that were not reasonably foreseeable by the rating agencies. Moreover, even when issues associated with the rating quality could be directly linked to the agency, a disgorgement of the agency profit after the event would not assist investors who had suffered damage arising from the poor quality rating.¹¹²

Coffee suggests that analysis of the reforms relating to credit rating agencies requires acknowledgement of '[t]hree simple truths':

First, an 'issuer pays' business model invites the sacrifice of reputational capital in return for high current revenues.

Second, competition is good, except when it is bad. When [credit rating agencies] compete for the favour of issuers, rather than for that of investors, ratings arbitrage results. ...

Third, in a bubbly market, no one, including investors, may have a strong interest in learning the truth.¹¹³

He concludes that '[o]nly a strong and highly motivated watchdog can offset this process of repression and self-delusion.'¹¹⁴ Coffee argues that reform that fails to address the 'issuer pays' business model 'amounts to re-arranging the deck chairs on the Titanic, while ignoring the gaping hole created by the iceberg.'¹¹⁵ He emphasises the importance of getting the regulation right and suggests that it is necessary to encourage a 'subscriber pays' model to compete with the 'issuer pays' model.¹¹⁶ A mandated 'subscriber pays' model is worthy of

¹¹⁰ Yair Listokin and Benjamin Taibleson, 'If You Mistrade, Then You Lose: Improving Credit Rating Accuracy through Incentive Compensation' (2010) 27 *Yale Journal on Regulation* 91.

¹¹¹ John Patrick Hunt, 'Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement' [2009] *Columbia Business Law Review* 109, 112.

¹¹² See John C Coffee Jr, 'Ratings Reform: The Good, the Bad, and the Ugly' (Law Working Paper No 162/2010, European Corporate Governance Institute, September 2010) 28.

¹¹³ *Ibid* 52–3.

¹¹⁴ *Ibid* 53.

¹¹⁵ *Ibid* 58.

¹¹⁶ *Ibid* 33. Coffee defines the 'subscriber pays' model as one that requires institutional investors to obtain their own ratings from a ratings agency not retained by the issuer or underwriter before they purchase the debt securities.

further consideration, as the reforms included in the *Dodd–Frank Act*, which predominantly rely on disclosure rules, may not be adequate to address the strong temptation for agencies to prefer short-term profits over longer-term reputational issues.¹¹⁷

Finally, there are questions around the constitutionality of the provisions enabling private investor actions against credit rating agencies. Litigation against the rating agencies has generally been unsuccessful in the US because the courts have upheld the agencies' claim for protection under the First Amendment of the *United States Constitution*, on the basis that their ratings are statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities.¹¹⁸

V CAPITAL MARKETS AND PRODUCTS

A Legislative Provisions

1 Securitisation

The *Dodd–Frank Act* seeks to enhance the accountability and diligence of parties issuing or originating asset-backed securities ('ABS') by requiring them to retain some of the credit risk (to keep some 'skin in the game'). The retained risk may not be hedged or transferred.¹¹⁹

The required risk retention is a minimum of five per cent.¹²⁰ However, assets that are not subject to the retained risk requirement include securitisation of 'qualified residential mortgages', securitisation of federally guaranteed mortgage loans, and other assets issued or guaranteed by the US and its agencies.¹²¹ These provisions are a good example of the incomplete nature of this legislation, as the definition and standards of a 'qualified' residential mortgage are to be determined by the federal banking agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the Federal Housing Finance Agency.¹²²

An issuer of ABS must disclose asset or loan-level data on the identity of brokers or originators of the assets, the details of the compensation of the broker or originator of the assets backing the security, and the amount of risk retained if

¹¹⁷ Financial Crisis Inquiry Commission, above n 13, 207. The Commission cites a statement by Jerome Fons, a former managing director of Moody's Investor Services, to the FDIC on 22 April 2010 that the

main problem was ... that the firm became so focused, particularly the structured area, on revenues, on market share, and the ambitions of Brian Clarkson, [former President of Moody's Investor Services,] that they willingly looked the other way, [and] traded the firm's reputation for short-term profits.

¹¹⁸ *Ibid* 120.

¹¹⁹ *Dodd–Frank Act*, § 941(b), 124 Stat 1376, 1891. In March 2011, the regulators jointly issued proposed rules regarding risk retention by securitisers of ABS: SEC, 'Agencies Seek Public Comment on Risk Retention Proposal' (Press Release, No 79, 31 March 2011) <<http://www.sec.gov/news/press/2011/2011-79.htm>>.

¹²⁰ *Dodd–Frank Act*, § 941(b), 124 Stat 1376, 1891–2.

¹²¹ *Ibid* § 941(b), 124 Stat 1376, 1894–5.

¹²² *Ibid* § 941(b), 124 Stat 1376, 1895.

this is required for investors to carry out independent due diligence.¹²³ ABS credit ratings must provide a description of the representations, warranties and enforcement mechanisms and how they differ from issuances of similar securities.¹²⁴ Disclosure of fulfilled and unfulfilled repurchase requests is required so that investors can identify underwriting deficiencies.¹²⁵ The Act mandates the SEC to issue rules requiring issuers of ABS to conduct a review of the underlying assets and to disclose the outcome to investors.¹²⁶

2 Derivatives and Swap Trading

Title VII of the Act, entitled ‘Wall Street Transparency and Accountability’, extends regulatory oversight to OTC derivatives and markets. The new regime encompasses commodity swaps, interest rate swaps, total return swaps and credit default swaps. The CFTC is responsible for regulating swaps,¹²⁷ while the SEC is responsible for the regulation of security-based swaps,¹²⁸ with the definitions of ‘swaps’ and ‘security-based swaps’ leaving ambiguities that will need to be resolved.¹²⁹ Foreign exchange products other than spot and exchange-traded contracts will be subject to CFTC-supervised regulation.¹³⁰ Any security-based swap that contains an interest rate, currency or commodity component will be subject to regulation by both the CFTC and SEC, in consultation with the Fed.¹³¹

The purposes of the reforms are to ‘increase regulatory and public transparency, reduce counterparty risk, and enhance the resiliency of the swaps markets.’¹³² The mechanisms adopted to achieve these goals are:

- to require most products to be centrally cleared and traded on exchanges;¹³³
- to subject swap dealers and major participants to capital and margin requirements;¹³⁴ and

¹²³ *Dodd-Frank Act*, § 942(b), 124 Stat 1376, 1897. For comprehensive analysis of loan-level disclosure, see Howell E Jackson, ‘Loan-Level Disclosure in Securitization Transactions: A Problem with Three Dimensions’ (Public Law & Legal Theory Working Paper No 10-40, Harvard Law School, 27 July 2010). Jackson concludes that with a few modest refinements, loan-level disclosures could revolutionise the manner in which mortgage originations in the US are policed: at 23.

¹²⁴ *Dodd-Frank Act*, § 943(1), 124 Stat 1376, 1897. The SEC has adopted new rules relating to representation and warranties in asset-based securities offerings: 17 CFR §§ 229, 232, 240, 249 (2011). See also SEC, ‘Disclosure for Asset-Backed Securities Required by Section 943 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*’ (Release, No 33-9175, 20 January 2011) <<http://www.sec.gov/rules/final/2011/33-9175.pdf>>.

¹²⁵ *Dodd-Frank Act*, § 943(2), 124 Stat 1376, 1897.

¹²⁶ *Ibid* § 945, 124 Stat 1376, 1898.

¹²⁷ *Ibid* § 712, 124 Stat 1376, 1641–6.

¹²⁸ *Ibid* § 764, 124 Stat 1376, 1784–5.

¹²⁹ *Ibid* §§ 721(a)(19), (21), 124 Stat 1376, 1665–6, 1666–70. In April 2011, the SEC and CFTC issued proposed swap definitions for public comment: SEC, ‘SEC Proposes Product Definitions for Swaps’ (Press Release, No 99, 27 April 2011) <<http://www.sec.gov/news/press/2011/2011-99.htm>>.

¹³⁰ *Dodd-Frank Act*, § 721(a)(21), 124 Stat 1376, 1666–8.

¹³¹ *Ibid*.

¹³² FSOC, *2011 Annual Report*, above n 36, 118.

¹³³ *Dodd-Frank Act*, § 723, 124 Stat 1376, 1675–6.

- to require real-time public reporting of transaction and pricing data of cleared and uncleared swaps.¹³⁵

The Act requires the SEC and the CFTC to establish detailed mandatory clearing processes, business conduct standards, and capital and margin requirements. The Act empowers the CFTC and SEC to clear a swap or to require designated swaps to be cleared.¹³⁶ This means that swaps that are subject to mandatory clearing requirements, but which clearing houses determine are not eligible for clearing, will effectively be prohibited. A swap is exempt from the clearing and exchange trading requirements if one of the counterparties is an end user that is hedging commercial risk. However, the exemption only applies to a counterparty that is not a financial entity, that is using swaps to hedge or mitigate commercial risk, and that notifies the SEC as to how it generally satisfies its swap-related financial obligations.¹³⁷ The CFTC and SEC are required to create rules to mitigate conflicts of interests arising from control of clearing houses, exchanges and swap facilities by industry participants.¹³⁸

All swap dealers and major swap participants are subject to risk-based capital requirements.¹³⁹ In addition, the Act provides the CFTC with powers to impose aggregate position limits across markets in order to:

- diminish, eliminate or prevent excessive speculation;
- deter and prevent market manipulation, squeezes and corners;
- ensure sufficient liquidity for bona fide hedgers; and
- ensure that the price discovery function of the underlying market is not disrupted.¹⁴⁰

Similarly, the SEC may establish size limits on individual or aggregate swap positions as a means to prevent fraud and manipulation.¹⁴¹

The SEC is mandated to adopt business conduct standards requiring swap dealers and participants to disclose material risks and characteristics of a swap, material incentives or conflicts of interest, and mark-to-market information.¹⁴² Swap dealers or major participants will be required under the standards to ‘communicate in a fair and balanced manner based on principles of fair dealing

¹³⁴ Ibid § 731(2), 124 Stat 1376, 1705–6.

¹³⁵ Ibid §§ 727, 729, 124 Stat 1376, 1696–7, 1701–3.

¹³⁶ Ibid § 723(a), 124 Stat 1376, 1675–81.

¹³⁷ Ibid § 723(a)(7), 124 Stat 1376, 1679–80.

¹³⁸ Ibid §§ 726, 728, 124 Stat 1376, 1695–6, 1697–701. The SEC has issued a series of proposed rules relating to derivatives: SEC, ‘SEC Proposes Rules for Registration of Securities-Based Swap Dealers and Major Security-Based Swap Participants’ (Press Release, No 205, 12 October 2011) <<http://www.sec.gov/news/press/2011/2011-205.htm>>. The CFTC has also issued a series of proposed and final rules on clearing and trade execution and swap-related regulation: see CFTC, *Dodd–Frank Proposed Rules* <<http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankProposedRules/index.htm>>; CFTC, *Dodd–Frank Final Rules* <<http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankFinalRules/index.htm>>.

¹³⁹ *Dodd–Frank Act*, § 731, 124 Stat 1376, 1705–6.

¹⁴⁰ Ibid § 737, 124 Stat 1376, 1722–6. Rules that limit the size of positions in futures and swaps markets have been finalised by the CFTC: see 17 CFR §§ 150–1.

¹⁴¹ *Dodd–Frank Act*, § 763(h), 124 Stat 1376, 1778.

¹⁴² Ibid § 731(h), 124 Stat 1376, 1707–8.

and good faith'.¹⁴³ When advising special entities such as municipalities and pension plans, swap dealers have a duty to act in the best interests of the special entity.¹⁴⁴

3 *Payment, Clearing and Settlement Activities*

The Act provides for the supervision of systemically important financial market utilities and payment, and of clearing and settlement activities conducted by financial institutions. The CFTC and the SEC are required to enact regulations in consultation with the FSOC and the Fed containing risk management standards for designated utilities and activities.¹⁴⁵ The standards to be considered include:

- risk management policies and procedures;
- margin and collateral requirements;
- participant or counterparty default policies and procedures;
- the ability to complete timely clearing and settlement of financial transactions; and
- capital and financial resource requirements.¹⁴⁶

B *Commentary and Analysis*

The Act does not prohibit or limit specific types of derivative instruments such as the synthetic collateralised debt obligations that attracted much adverse comment in the aftermath of the GFC.¹⁴⁷ Instead, the CFTC and SEC are empowered to report on any instruments that may undermine the stability of a financial market or have adverse consequences for participants in the market.¹⁴⁸ This approach acknowledges that capital markets are constantly evolving, and that to be effective, regulation and regulatory responses must adapt to changing conditions and product innovation. The legislative reforms will only be meaningful if they deter or mitigate the fallout from the next financial crisis, which will almost certainly centre on different products and circumstances than those leading up to the GFC.

The intended effect of the swap-related provisions appears to be to encourage standard or 'vanilla-type' swaps that are cleared through an exchange and clearing house in order to improve systemic oversight. Clearing houses generally

¹⁴³ *Ibid* § 731(h)(3)(C), 124 Stat 1376, 1708.

¹⁴⁴ *Ibid* §§ 731(h)(2), (4), 124 Stat 1376, 1708–9.

¹⁴⁵ *Ibid* § 805(a)(2)(A), 124 Stat 1376, 1809. In March 2011 the SEC issued proposed rules regarding systemically important clearing agencies: SEC, 'Clearing Agency Standards for Operation and Governance' (Release, No 34-64017, 3 March 2011) <<http://www.sec.gov/rules/proposed/2011/34-64017.pdf>>. In July 2011, the SEC, CFTC and the Federal Reserve Board reported to Congress on the framework for designated clearing entity risk management: Board of Governors of the Federal Reserve System, SEC and CFTC, *Risk Management Supervision of Designated Clearing Entities* (2011) <<http://www.sec.gov/news/studies/2011/813study.pdf>>.

¹⁴⁶ *Dodd-Frank Act*, § 805(c), 124 Stat 1376, 1810.

¹⁴⁷ For an outline of collateralised debt obligations and credit default swaps developments prior to the GFC, see FSOC, *2011 Annual Report*, above n 36, 25–7.

¹⁴⁸ *Dodd-Frank Act*, § 714, 124 Stat 1376, 1647.

manage default risk by offsetting transactions, by collection of an upfront margin on trades that serves as a reserve in the event of default by a member, and through the establishment of a guarantee fund to cover losses that exceed the margin collected. On products such as swaps and commodities, the collateral generally includes an ongoing variation margin. The Act adopts aspects of the clearing house risk model by requiring payments from swap counterparties in the OTC markets. The collateral, margin and disclosure requirements are likely to promote greater use of standardised structured products and vehicles and discourage more complex and highly leveraged structures.

Many parties have argued for greater transparency in post-GFC securitisation and derivative markets.¹⁴⁹ Some argue that the reforms do not go far enough. For instance, critics suggest that naked credit default swaps should be banned.¹⁵⁰ Others suggest the provision exceptions may be too broad, and that as a consequence a large portion of the derivative trading may continue unhindered.¹⁵¹ Skeel concludes that despite the ‘substantial uncertainties’ in the legislation, the ‘new framework for clearing derivatives and trading them on exchanges is an unequivocal advance.’¹⁵² We agree. The reforms may improve the operation of markets and enhance long-term economic efficiency. When trades are cleared through clearing houses, the risk of default is independently managed and minimised. The level and overall share of derivative trading through exchanges is likely to increase, facilitating greater market transparency and regulatory scrutiny. Global supervisors need ready and regular access to derivative trading positions to understand capital market developments and to determine systemic risks.

Nevertheless, the difficulties involved in monitoring global system and market risk should not be underestimated. Securities trading in the US is highly fragmented across many exchanges, electronic communication networks and broker-dealers. Orders ‘executed in non-public trading venues such as dark pools and internalising broker-dealers now account for nearly 30 percent of volume’.¹⁵³ The increasing prevalence of high frequency trading through direct access market providers makes it difficult and time-consuming for regulators to identify trades and the traders involved. The reporting of trading activity even within the US ‘often has format, compatibility and clock-synchronization differences’.¹⁵⁴ These issues are significantly compounded when trying to determine global exposures. Regulators are improving their systems and audit trails in an endeav-

¹⁴⁹ See, eg, Hubbard, above n 16, 1; Carlos Tavares, *Short Selling and OTC Derivatives Policy Options* (9 January 2011) VoxEU <<http://www.voxeu.org/index.php?q=node/5996>>.

¹⁵⁰ See, eg, Tavares, above n 149.

¹⁵¹ See, eg, Lynn A Stout, ‘Derivatives and the Legal Origin of the 2008 Credit Crisis’ (2011) 1 *Harvard Business Law Review* 1. Stout argues that the credit crisis was primarily due to the enactment of the *Commodities Futures Modernization Act of 2000*, 7 USC § 1 (2000), which removed long-established legal constraints on speculative trading in OTC derivatives. She is concerned that tit VII of the *Dodd–Frank Act* is subject to possible exemptions that may limit its effectiveness: at 31–5.

¹⁵² Skeel, above n 46, 14.

¹⁵³ Schapiro, ‘Testimony on US Equity Market Structure’, above n 101.

¹⁵⁴ *Ibid.*

our to better monitor trading activity and market developments, but the continuing rapid growth of global trading activity makes this an ongoing challenge.¹⁵⁵

VI EXECUTIVE COMPENSATION

A Legislative Provisions

The *Dodd–Frank Act* reforms seek to address public concerns about compensation paid to company executives, particularly to managers of financial institutions. The Act requires enhanced disclosure of and accountability for compensation paid to executives of listed companies. Shareholders are provided with a non-binding vote on some executive compensation matters including ongoing executive packages and golden parachutes.¹⁵⁶ Companies must explain the basis of the relationship between executive compensation and financial performance,¹⁵⁷ and disclose the ratio of the compensation of the chief executive to employee compensation.¹⁵⁸ In addition, incentive-based compensation paid to executives may be clawed back when financial reporting is found to be materially noncompliant with the securities laws.¹⁵⁹

The more controversial provisions are contained in § 956 of the Act. These provisions require the regulators to enact regulations prohibiting certain incentive-based compensation packages for executives or directors of bank holding companies and other ‘covered financial companies’.¹⁶⁰ The regulators must issue regulations

that prohibit any types of incentive-based payment arrangement ... that the regulators determine encourages inappropriate risks by covered financial institutions —

- (1) by providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or

¹⁵⁵ See Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, ‘Report on OTC Derivatives Data Reporting and Aggregation Requirements’ (Consultative Report, August 2011) 26–7. The report confirms that there is an international effort underway to promote a consistent international framework for the regulation of OTC derivatives transactions based on cooperation between national authorities. This framework includes efforts to aggregate OTC derivatives data.

¹⁵⁶ *Dodd–Frank Act*, § 951, 124 Stat 1376, 1899–1900. New rules concerning shareholder approval of executive compensation and golden parachute compensation under § 951 were adopted by the SEC in January 2011: 17 CFR §§ 229, 240, 249 (2011). See also SEC, ‘Shareholder Approval of Executive Compensation and Golden Parachute Compensation’ (Release, No 33-9178, 25 January 2011) <<http://www.sec.gov/rules/final/2011/33-9178.pdf>>.

¹⁵⁷ *Dodd–Frank Act*, § 953(a), 124 Stat 1376, 1903–4.

¹⁵⁸ *Ibid* § 953(b)(1), 124 Stat 1376, 1904.

¹⁵⁹ *Ibid* § 954, 124 Stat 1376, 1904.

¹⁶⁰ For the definition of ‘covered financial institution’, see *ibid* § 956(e)(2), 124 Stat 1376, 1906. Covered financial institutions with assets of less than US\$1 billion are exempted from these provisions: § 956(f), 124 Stat 1376, 1906.

- (2) that could lead to material financial loss to the covered financial institution.¹⁶¹

The Fed, the FDIC and the Office of the Comptroller of the Currency (‘OCC’), which issued joint guidelines on executive remuneration in June 2010, will monitor compensation paid to bankers in the US. The regulators are also reviewing incentive practices at large financial institutions.¹⁶²

Notably, the Act provides that the employment of management responsible for the financial condition of a failing covered financial company be terminated.¹⁶³ The Act also requires that ‘management, directors, and third parties having responsibility for the condition of the financial company bear losses consistent with their responsibility’.¹⁶⁴

B *Commentary and Analysis*

The legislators clearly want to be seen to give regulators the ability to hold individuals who have presided over the collapse of financial companies personally liable for some of the losses. However, the goals to potentially claw back some of the compensation paid to managers, directors and third parties of failed covered financial companies and to seek reimbursement of some of the losses borne¹⁶⁵ may be difficult to achieve in practice.

The likely outcomes of § 956 of the Act are also uncertain. The section prohibits any incentive-based compensation arrangement that (i) encourages inappropriate risk-taking by providing excessive compensation to staff; or (ii) encourages inappropriate risk-taking that could lead to material financial loss for the institution. Accordingly, incentive-based compensation that is not excessive is still prohibited if it could lead to risks being taken that are sufficient to cause material losses. It will be interesting to see how the final rules define ‘excessive’ compensation and how the regulators will interpret compensation arrangements that (while not necessarily excessive) still encourage material and inappropriate risk-taking.

At a global level, the G-20 Finance Ministers backed away from a joint pledge to cap bank bonuses in 2009.¹⁶⁶ However, on 8 July 2010 the European Parliament passed legislation limiting bonuses at banks, hedge funds and other

¹⁶¹ Ibid § 956(b), 124 Stat 1376, 1905.

¹⁶² On 30 March 2011, the Fed issued a joint proposed rule with the OCC, the FDIC, the Office of Thrift Supervision, the National Credit Union Administration, the SEC and the Federal Housing Finance Agency to prohibit incentive-based compensation arrangements that encourage inappropriate risk-taking by covered financial companies, and to require the disclosure and reporting of certain incentive-based compensation information by covered financial companies: ‘Incentive-Based Compensation Arrangements’ (Release, No 34-64140, 30 March 2011) <<http://www.sec.gov/rules/proposed/2011/34-64140.pdf>>.

¹⁶³ *Dodd–Frank Act*, § 206(4), 124 Stat 1376, 1459.

¹⁶⁴ Ibid § 204(a)(3), 124 Stat 1376, 1454.

¹⁶⁵ See *ibid*.

¹⁶⁶ Ashley Seager and Toby Helm, ‘Brown Wins G20 Battle against Caps on Bank Bonuses’, *The Observer* (online), 6 September 2009 <<http://www.guardian.co.uk/business/2009/sep/06/brown-halts-bonus-caps>>.

financial institutions.¹⁶⁷ The new rules, which took effect from the beginning of 2011, require bonuses to be structured on a long-term basis, with restrictions on upfront cash bonuses, requirements to withhold at least 50 per cent of total bonuses for a period contingent on long-term investment performance, and strict limits on compensation paid to the executives of institutions that were bailed out or supported using taxpayer monies.¹⁶⁸ Some financial institutions are preempting a similar move in the US and are deferring more than 50 per cent of the bonuses awarded.¹⁶⁹

VII CONSUMER PROTECTION

A Legislative Provisions

Title X of the *Dodd–Frank Act*, called the *Consumer Financial Protection Act of 2010*, creates and empowers a new and independent Consumer Financial Protection Bureau (‘CFPB’) to develop consumer protection rules.¹⁷⁰ The purpose of the CFPB is to

seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for [these] products and services are fair, transparent, and competitive.¹⁷¹

The definition of consumer financial products or services is broad, and includes credit cards, mortgages, credit bureaus, debt collection, and any product except insurance that a bank or financial holding company provides to consumers.¹⁷²

The Act provides the CFPB with powers to issue regulations, examine compliance and take enforcement action under federal financial consumer laws.¹⁷³ The CFPB has broad authority over depository institutions with assets in excess of US\$10 billion, financial institutions that broker, originate or service mortgage loans, and other large participants that market consumer financial services.¹⁷⁴

¹⁶⁷ *Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 Amending Directives 2006/48/EC and 2006/49/EC as regards Capital Requirements for the Trading Book and for Re-Securitisations, and the Supervisory Review of Remuneration Policies* [2010] OJ L 329/3 (‘*Directive 2010/76/EU*’). Cf *European Parliament Resolution of 7 July 2010 on Remuneration of Directors of Listed Companies and Remuneration Policies in the Financial Services Sector (2010/2009(INI))* [2011] OJ C 351 E/08.

¹⁶⁸ *Directive 2010/76/EU* [2010] OJ L 329/3. See also Karen Maley, ‘The War on Bank Bonuses’, *Business Spectator* (online), 13 July 2010 <<http://www.businessspectator.com.au/bs.nsf/Article/Banks-Bonus-European-Union-Financial-Crisis-US-pd20100712-7A9S3?OpenDocument>>.

¹⁶⁹ See Jessica Holzer, ‘SEC Puts Forth Bonus Curbs’, *The Wall Street Journal* (New York), 3 March 2011, C2; Justin Baer and Francesco Guerrera, ‘Morgan Stanley Defers 60% of Bonuses’, *Financial Times* (London), 21 January 2011, 15.

¹⁷⁰ *Dodd–Frank Act*, §§ 1011–12, 124 Stat 1376, 1964–6.

¹⁷¹ *Ibid* § 1021(a), 124 Stat 1376, 1979–80.

¹⁷² *Ibid* §§ 1002(5), 1002(15), 124 Stat 1376, 1956, 1957–60.

¹⁷³ *Ibid* §§ 1002(12), 1022(a)–(c), 124 Stat 1376, 1957, 1980–4.

¹⁷⁴ *Ibid* §§ 1024–6, 124 Stat 1376, 1987–95.

The CFPB may prevent these institutions from engaging in unfair, deceptive or abusive practices in the provision of consumer financial products and services.¹⁷⁵

The CFPB encompasses a research unit to monitor trends in the provision of consumer financial products, a unit to focus on consumer education, and a centralised unit to collect and track complaints.¹⁷⁶ The Act also establishes an Office of Fair Lending and Equal Opportunity,¹⁷⁷ an Office of Financial Education,¹⁷⁸ and an Office of Service Member Affairs.¹⁷⁹

The Act aims to significantly strengthen mortgagee rights and protections. Title XIV of the Act, the *Mortgage Reform and Anti-Predatory Lending Act of 2010*, imposes new mortgage underwriting standards, prohibits or restricts specified mortgage lending practices and regulates payments to mortgage loan officers and brokers. Lenders are banned from steering consumers into high-cost, unaffordable loans.¹⁸⁰ Lenders must verify a borrower's ability to repay the mortgage in its entirety by reference to specified factors such as the borrower's credit history, employment status, income and debt-to-income ratio.¹⁸¹ A borrower may raise a violation of these standards as a foreclosure defence.¹⁸² However, there are safe harbour provisions relating to 'qualified mortgages' that meet specified criteria, including points and fees of less than three per cent of the total new loan amount.¹⁸³ In addition, intermediaries of mortgage refinancings must be able to show that borrowers are better off as a result of a refinancing. To better align intermediaries' incentives with those of their clients, compensation payments based on interest rate premiums (commonly referred to as 'yield spread premiums') or other terms of the loans other than the amount of the principal are prohibited.¹⁸⁴ Penalty provisions relating to prepayments of certain loans are also disallowed.¹⁸⁵ Notable enhancements to the mortgage disclosure rules include mandatory notice of resets of the interest rate and negative amortisation occurrences.¹⁸⁶

B *Commentary and Analysis*

The development of consumer credit law in the US has a chequered history that is closely aligned to the property boom and bust cycles and changes in the

¹⁷⁵ Ibid § 1031, 124 Stat 1376, 2005–6.

¹⁷⁶ Ibid § 1013(b), 124 Stat 1376, 1968–70.

¹⁷⁷ Ibid § 1013(c), 124 Stat 1376, 1970.

¹⁷⁸ Ibid § 1013(d), 124 Stat 1376, 1970–2.

¹⁷⁹ Ibid § 1013(e), 124 Stat 1376, 1972.

¹⁸⁰ Ibid § 1403, 124 Stat 1376, 2140.

¹⁸¹ Ibid § 1411(a)(2), 124 Stat 1376, 2142–3.

¹⁸² Ibid § 1413, 124 Stat 1376, 2148–9.

¹⁸³ Ibid § 1412, 124 Stat 1376, 2145–8.

¹⁸⁴ Ibid § 1403, 124 Stat 1376, 2139.

¹⁸⁵ Ibid § 1414(a), 124 Stat 1376, 2149.

¹⁸⁶ Ibid §§ 1032(a), 1414, 1418, 1420, 124 Stat 1376, 2006–7, 2150–1, 2153–4, 2155–6.

institutional and product structures.¹⁸⁷ Until the 1970s, savings and loans entities ('SLEs') were the major providers of mortgage credit. However, as the securitisation markets grew, the SLEs lost market share to mortgage companies with access to cheaper funds. Financial deregulation shifted the mortgage industry to a predominantly national system, with mortgages provided on an originate-to-distribute model from mortgagee companies that were generally unregulated.¹⁸⁸

During the 1980s and 1990s, consumer advocates highlighted issues around predatory and high-cost lending and were successful in achieving some policy change.¹⁸⁹ However, there was intense lobbying from the finance industry opposing a strengthening of the consumer protection laws.¹⁹⁰ Continuing problems with predatory lending resulted in a series of federal policy reviews. In 2000, the US Department of Housing and Urban Development and the US Treasury Department issued a report recommending that the Fed use its authority under the *Home Ownership and Equity Protection Act of 1994* ('HOEPA')¹⁹¹ more forcefully to deter predatory practices.¹⁹² However, despite continued reviews and warnings from many quarters about the dangers of subprime loans and the increasing use of complex loan structures, lending regulation at a federal level was not substantially changed.¹⁹³ Conflicts between state and federal regulators increased as federal regulators used their pre-emption powers to override enhancements to state mortgage regulation.¹⁹⁴ In 2007 the legitimacy of the pre-emption authority was tested in the Supreme Court in *Watters v Wachovia*

¹⁸⁷ For a detailed historical outline, see Daniel Immergluck, 'Private Risk, Public Risk: Public Policy, Market Development, and the Mortgage Crisis' (2009) 36 *Fordham Urban Law Journal* 447.

¹⁸⁸ Ibid 465–6. Enactment of the *Alternative Mortgage Transaction Parity Act of 1982*, 12 USC §§ 3801–5 (2006) enabled the mortgage companies that were subject to state-based regulation to opt for supervision by the federal regulator.

¹⁸⁹ See, eg, the *Home Ownership and Equity Protection Act of 1994*, Pub L No 103-325, 108 Stat 2160, 2190, which required greater disclosure of high-priced loans and prohibited some loan practices and terms.

¹⁹⁰ Industry opposition to new regulation governing mortgage lending was most visible at the state level. State legislators were often pressured to repeal or to weaken proposed policy by industry lobbyists arguing that regulation would reduce economic development: see Immergluck, above n 187, 471–5.

¹⁹¹ Pub L No 103-325, §§ 151–8, 108 Stat 2160, 2190–8. See 15 US § 1639(l)(2)(b), which states that '[t]he Board, by regulation or order, shall prohibit acts or practices in connection with ... refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.'

¹⁹² US Department of Treasury and US Department of Housing and Urban Development, *Curbing Predatory Home Mortgage Lending: A Joint Report* (2000).

¹⁹³ Those opposed to stronger regulation argued that the existing lending laws were resulting in suboptimal economic outcomes. For instance, a paper submitted to the OCC relied on an industry-funded report which found that the number of subprime loans had declined in North Carolina as a result of the passing of anti-predatory lending regulation: see, eg, OCC, 'Economic Issues in Predatory Lending' (Working Paper, 30 July 2003) 2.

¹⁹⁴ For instance, in 2003 Eliot Spitzer, the Attorney-General for New York State, threatened to sue the OCC: see Office of the Attorney General (State of New York), 'Statement by Attorney General Eliot Spitzer Regarding the Comptroller of Currency's (OCC) Advisory Letter to National Banks' (Media Release, 1 March 2004) <http://www.ag.ny.gov/media_center/2004/mar/mar01a_04.html>; Eliot Spitzer, 'Predatory Lenders' Partner in Crime', *Washington Post* (Washington DC), 14 February 2008, A25. See also Adam J Levitin, 'Hydraulic Regulation: Regulating Credit Markets Upstream' (2009) 26 *Yale Journal on Regulation* 143.

Bank NA.¹⁹⁵ The Court held that the state regulators could not interfere with the ‘business of banking’ of federally regulated institutions by subjecting national banks or their OCC-licensed operating subsidiaries to state audits and surveillance under rival oversight regimes.¹⁹⁶

The same year the Fed held further hearings on subprime and predatory lending, and proposed increased regulation.¹⁹⁷ An Act containing more substantive protection for consumers was finally passed in Congress in 2008.¹⁹⁸ This Act laid the groundwork for many of the provisions in the subsequent *Dodd–Frank Act*. The conference report accompanying the *Dodd–Frank Act* indicates that the ‘Federal Reserve Board failed to meet its responsibilities under *HOEPA*, despite persistent calls for action.’¹⁹⁹ The Report highlights that

[i]n spite of the rampant abuses in the subprime market and all the damage imposed on consumers by predatory lending — billions of dollars in lost wealth — the [Federal Reserve] Board never implemented a single discretionary rule under *HOEPA* outside of the high cost context. To put it bluntly, the Board has simply not done its job.²⁰⁰

The establishment of an independent and well-resourced consumer protection regime that encompasses research, education, complaints and enforcement arms provides a potentially powerful advocate for consumers. Critics argue that the CFPB has been given too much power.²⁰¹ Others suggest that ‘consumers’

¹⁹⁵ 550 US 1 (2007).

¹⁹⁶ *Ibid* 21 (Ginsburg J for Ginsburg, Kennedy, Souter, Breyer and Alito JJ). The *Dodd–Frank Act* seeks to clarify the role of state authorities and the standards and limits of pre-emption. It enhances the states’ authority to enforce state and federal law against federal banks and other financial institutions in specified circumstances: *Dodd–Frank Act*, § 1042, 124 Stat 1376, 2012–14. The Act confirms that it only pre-empts state law to the extent that state law is ‘inconsistent’ with the Act: § 1041(a), 124 Stat 1376, 2011. It also clarifies the pre-emption standards and the circumstances when state law is deemed to have been pre-empted: § 1044, 124 Stat 1376, 2014–17. See discussion in Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, above n 8, 183–4.

¹⁹⁷ Inter-agency guidance was issued in July 2007: *Statement on Subprime Mortgage Lending*, 72 Fed Reg 37569, 37572 (10 July 2007). This guidance was prompted by concerns about the growing use of adjustable rate mortgages, with low initial payments for an introductory period and a variable rate plus a margin for the remaining term of the loan. These mortgages were being marketed to subprime borrowers and often included high-risk terms and penalty payments.

¹⁹⁸ On 30 July 2008, the Fed published a final rule — 12 CFR § 226 (2008), amending reg Z — implementing the *Truth in Lending Act*, Pub L No 90-321, 82 Stat 146 (1968) (*‘TILA’*) and the *HOEPA*, §§ 151–8, 108 Stat 2160, 2190–8. Further, and on the same day, the US Congress enacted the *Housing and Economic Recovery Act of 2008*, Pub L No 110-289, 122 Stat 2654, which included amendments to the *TILA* known as the *Mortgage Disclosure Improvement Act of 2008: Housing and Economic Recovery Act of 2008*, §§ 2501–3, 122 Stat 2654, 2855–7. The *TILA* requires full disclosures about credit terms and costs: 15 USC § 160. This section provides that

[i]t is the purpose of this [title] to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.

¹⁹⁹ Committee on Banking, Housing, and Urban Affairs, S Rep No 111-176, 111th Congress (2010) 15 (Conf Rep).

²⁰⁰ *Ibid* 27 n 77.

²⁰¹ See, eg, Marco Rubio, US Senator, ‘Time to Hold Obama Accountable on Regulations — Statement for the Record’, *Right Side News* (online), 8 December 2011 <<http://www.rightsidenews.com/2011120915131/us/politics-and-economics/time-to-hold-obama-accountable-on-regulations.html>>. Senator Rubio states that without reform,

interests were woefully underrepresented during the recent crisis' and that the establishment of the CFPB is overdue and a 'step forward'.²⁰²

The creation of a single consumer agency potentially addresses the argument that the prior architecture inevitably led to consumer protection falling through the cracks, taking a back seat to the agencies' primary mission of financial safety and soundness.²⁰³ One of the most tragic outcomes of the GFC in the US has been the large number of people forced from their homes due to mortgage defaults.²⁰⁴ Bar-Gill and Warren concluded in 2008 that '[e]vidence abounds that consumers [were] sold credit products that [were] designed to obscure their risks and to exploit consumer misunderstanding.'²⁰⁵ The evidence indicates that many of the practices adopted for selling financial products and services prior to the GFC had become abusive, and that accountability and enforcement mechanisms across the financial intermediary industry were weak.²⁰⁶ Numerous studies of the mortgage markets by government agencies and independent bodies during the 2000–06 period found that many of the mortgagees sold high interest rate subprime loans would have qualified for lower cost prime market loans.²⁰⁷ In addition, scholarly and policy research found a correlation between unfair credit terms and minority status.²⁰⁸ In 2000, the joint Department of Housing and Urban Development and Department of Treasury National Task Force on Predatory Lending warned:

In some low-income and minority communities, especially where competition is limited, predatory lenders may make loans with interest rates and fees sig-

CFPB's director would serve with unprecedented and unconstitutional amounts of power. The director would have the power to decide what rules are issued in the name of consumer protection, how funds are spent and how its enforcement authority will be used. In short, it empowers a single, unelected person with seemingly endless and unchecked authority.

²⁰² Skeel, above n 46, 14–15. See generally Elizabeth Warren, 'Unsafe at Any Rate' (2007) 5 *Democracy: A Journal of Ideas* 8.

²⁰³ Levitin, above n 194, 155.

²⁰⁴ See Raymond H Brescia, 'The Cost of Inequality: Social Distance, Predatory Conduct, and the Financial Crisis' (2010) 66 *New York University Annual Survey of American Law* 641; Vincent Di Lorenzo, 'The Federal Financial Consumer Protection Agency: A New Era of Protection or More of the Same?' (Legal Studies Research Paper Series No 10-0182, School of Law, St John's University, September 2010) 42. There are approximately 75 million owner-occupied residential properties in the US, of which 70 per cent are mortgaged. Of the 52 million mortgaged properties, one in seven (eight million) are in some stage of the foreclosure process or are at least 30 days delinquent on a mortgage payment. One in five of the mortgaged properties are in a negative equity position: Brescia, above n 204, 651. The incidence of foreclosures are heavily concentrated in low-income communities and communities with predominantly black or Hispanic populations: Di Lorenzo, above n 204, 42.

²⁰⁵ Oren Bar-Gill and Elizabeth Warren, 'Making Credit Safer' (2008) 157 *University of Pennsylvania Law Review* 1, 100.

²⁰⁶ See, eg, *ibid* 93; Levitin, above n 194, 151.

²⁰⁷ Bar-Gill and Warren, above n 205, 38–9, citing studies by the National Training and Information Center, Freddie Mac, Fannie Mae, the Department of Housing and Urban Development and *The Wall Street Journal*.

²⁰⁸ Di Lorenzo, above n 204, 59.

nificantly higher than the prevailing market rates, unrelated to the credit risk posed by the borrower.²⁰⁹

In 2006, research on the Detroit area by the University of Michigan concluded that

even within similar low-income neighbourhoods, black homeowners are significantly more likely to have prepayment penalties or balloon payments attached to their mortgages than non-black homeowners, even after controlling for age, income, gender and credit worthiness.²¹⁰

A series of criminal and civil actions relating to mortgage practices have been settled, or are underway. For instance, Bank of America has reached a US\$2.8 billion settlement with Fannie Mae and Freddie Mac over claims that Countrywide Financial, which Bank of America bought in 2008, routinely provided mortgages to parties who they knew could not afford them.²¹¹ More recently, Citigroup agreed to settle the SEC charges of misleading investors about a US\$1 billion collateralised debt obligation tied to the housing market in which Citigroup bet against investors as the housing market showed signs of distress.²¹²

In 2007, Warren proposed a new federal consumer protection agency to ensure minimum safety standards for all consumer financial products.²¹³ The *Dodd–Frank Act* seeks to provide such safety standards on mortgage products by encouraging the use of qualified or standardised mortgages rather than complex and expensive mortgage structures, and by discouraging the payment of excessive fees. Critics argue the regulation will result in reduced product choice.²¹⁴ However, the provisions as they stand currently do not prevent the design of flexible features into mortgage products. The extent to which mortgagees benefit from sophisticated bells and whistles is debatable in any event.

The new CFPB is a bold reform. However, the practical benefits of the regime to consumers will depend on the CFPB's commitment to fairness in credit markets, the independence of the agency staff, the detailed final rules and

²⁰⁹ US Department of Treasury and US Department of Housing and Urban Development, above n 192, 72.

²¹⁰ Di Lorenzo, above n 204, 59–60, citing Michael S Barr, Jane Dokko and Benjamin J Keys, 'Who Gets Lost in the Subprime Mortgage Fallout? Homeowners in Low and Moderate Income Neighborhoods' (Working Paper, University of Michigan Law School, 1 April 2008) 2. See also Brescia, above n 204, 641–2.

²¹¹ 'Bank of America Settles over Mortgages', *The Sydney Morning Herald* (online), 5 January 2011 <<http://www.smh.com.au/business/bank-of-america-settles-over-mortgages-20110104-19f22.html>>.

²¹² See SEC, 'Citigroup to Pay \$285 million to Settle SEC Charges for Misleading Investors about CDO Tied to Housing Market' (Press Release, No 214, 19 October 2011) <<http://www.sec.gov/news/press/2011/2011-214.htm>>.

²¹³ Warren, above n 202.

²¹⁴ See, eg, Rubio, above n 201:

This bureaucracy holds the sweeping ability to limit choices when it comes to commonly-used financial products such as home equity loans, credit cards and student loans. Simply put, a designation from the CFPB director saying these products are 'abusive' could restrict the availability of credit to consumers and increase the cost of goods or services for all Americans.

consistent enforcement of the measures adopted.²¹⁵ The history of consumer credit law in the US suggests the agency will be heavily pressured by industry to weaken the final rules and to supervise with a light touch.²¹⁶

VIII INVESTOR PROTECTION

A Legislative Provisions

The *Dodd–Frank Act* clarifies the authority of the SEC to establish rules requiring disclosure of certain information to retail clients before they purchase financial products or services.²¹⁷ The Act requires disclosure to be made in documents in a summary format that contain clear and concise information about the investment objectives, strategies, costs and risks, and any compensation or other financial incentive received by the intermediaries.²¹⁸ Rule development to encourage clear, concise and effective marketing and disclosure documentation prior to the sale of financial products and services is a regulatory approach that has been used for many years, arguably with some success, in other jurisdictions.²¹⁹

The most contentious financial intermediary issues were left open by the *Dodd–Frank Act* to further investigation and consultation. The Act requires the SEC to review the duties and standards of care applying to brokers, dealers and investment advisers when providing personalised investment advice and recommendations in connection with the purchase of retail investment products.²²⁰ While the SEC is given the power to establish a fiduciary standard,²²¹ clients may consent to material conflicts of interest if these are adequately disclosed.²²²

²¹⁵ See Brescia, above n 204, 709–10. Brescia argues that ‘robust enforcement of the fair lending laws is necessary. ... [F]or the CFPB to wield this authority in an effective way, it must be staffed by committed, competent and professional bureaucrats who will enforce both the letter and the spirit of the fair lending laws’: at 710.

²¹⁶ See *ibid* 708–9, where Brescia suggests that
‘[c]ognitive regulatory capture’ of the CFPB by individuals inclined to favor industry interests could, in fact, do more harm than good. Thus, ensuring that the agency is staffed by individuals with independence ... will be an essential first step in guaranteeing the success of the CFPB in carrying out its purposes ...

See also the Sunlight Foundation Reporting Group, *Dodd–Frank Act* <<http://reporting.sunlightfoundation.com/tag/Dodd-Frank>>. The Sunlight Foundation is a non-profit, nonpartisan organisation that states that it is committed to improving access to government information by making it available online. Its website provides an updated record of the meetings between the federal financial agencies and outside representatives relating to *Dodd–Frank Act* reform issues.

²¹⁷ *Dodd–Frank Act*, § 919, 124 Stat 1376, 1837.

²¹⁸ *Ibid*.

²¹⁹ See, eg, Financial Services Authority (UK), ‘Good and Poor Practices in Key Features Documents’ (September 2007) 5–6; Australian Securities and Investments Commission, *Disclosure: Product Disclosure Statements (and Other Disclosure Obligations)*, Regulatory Guide 168, 6 September 2010; Australian Securities and Investments Commission, *Prospectuses: Effective Disclosure for Retail Investors*, Regulatory Guide 228, November 2011.

²²⁰ *Dodd–Frank Act*, § 913, 124 Stat 1376, 1824–30. In January, the SEC reported to Congress: SEC, *Study on Investment Advisers and Broker-Dealers* (January 2011) <<http://www.sec.gov/news/studies/2011/913studyfinal.pdf>>.

²²¹ *Dodd–Frank Act*, § 913(g), 124 Stat 1376, 1828–9. This issue was highlighted by the allegation that Goldman Sachs acted inappropriately when it recommended structured finance products to

The SEC is mandated to study a number of financial intermediary issues, including: how to improve investor access to intermediary registration information;²²³ the need for greater regulatory oversight and enforcement of investment advisers;²²⁴ and whether to establish rules that restrict or prohibit certain sales practices, conflicts of interest, and intermediary compensation schemes that are deemed detrimental to the public interest and investor protection.²²⁵ The GAO is required to study mutual fund marketing,²²⁶ as well as identify and examine potential conflicts of interest within intermediary firms.²²⁷

Regulation to enhance protection for direct investors (that is, investors who invest in securities without intermediary assistance) has also been strengthened. The Act establishes a new Investor Advisory Committee,²²⁸ an Office of the Investor Advocate²²⁹ and a retail investor Ombudsman.²³⁰ The Investor Advisory Committee, which represents retail and institutional investors, will advise and consult with the SEC on:

- regulatory priorities;
- issues relating to the regulation of securities products, trading strategies, and fee structures, and the effectiveness of disclosure;
- initiatives to protect investor interests; and

its clients while simultaneously selling on its own account: see SEC, ‘*Securities and Exchange Commission v Goldman, Sachs & Co and Fabrice Tourre*, 10 Civ 3229 (BJ) (SDNY filed April 16, 2010): The SEC Charges Goldman Sachs with Fraud in Connection with the Structuring and Marketing of a Synthetic CDO’ (Litigation Release, No 21489, 16 April 2010) <<http://www.sec.gov/litigation/litreleases/2010/lr21489.htm>>. As part of a US\$550 million settlement with the SEC in relation to civil charges that it misled clients, Goldman conceded it made a mistake by not disclosing the role of a hedge fund, Paulson & Co, to investors. The firm agreed to toughen oversight of mortgage securities, certain marketing material and employees who create or market such securities. Goldman will pay US\$250 million to investors in the infringing deal and the remaining US\$300 million will be paid to the US government: Susanne Craig and Kara Scannell, ‘Goldman Admits Mistakes in US\$550m SEC Settlement’, *The Australian* (online), 16 July 2010 <<http://www.theaustralian.com.au/business-old/news/goldman-admits-mistakes-in-us550m-sec-settlement/story-e6frg90x-1225892552290>>. Possible criminal prosecutions against the firm and individual employees are still proceeding.

²²² *Dodd–Frank Act*, § 913(g), 124 Stat 1376, 1828–9.

²²³ *Ibid* § 919B(a), 124 Stat 1376, 1838. The SEC completed this study in January 2011: SEC, *Study and Recommendations on Improved Investor Access to Registration Information about Investment Advisers and Broker-Dealers* (January 2011) <<http://www.sec.gov/news/studies/2011/919bstudy.pdf>>.

²²⁴ *Dodd–Frank Act*, § 914, 124 Stat 1376, 1830. On 21 January 2011, the SEC reported to Congress regarding the need for enhanced resources for investment adviser examinations and SEC, *Study on Enhancing Investment Adviser Examinations* (January 2011) <<http://www.sec.gov/news/studies/2011/914studyfinal.pdf>>.

²²⁵ *Dodd–Frank Act*, § 913(g), 124 Stat 1376, 1828–9.

²²⁶ *Ibid* § 918, 124 Stat 1376, 1837. The GAO completed this study in July 2011: GAO, *Mutual Fund Advertising — Improving How Regulators Communicate New Rule Interpretations to Industry Would Further Protect Investors* (July 2011) <<http://www.gao.gov/new.items/d11697.pdf>>.

²²⁷ *Dodd–Frank Act*, § 919A, 124 Stat 1376, 1837–8.

²²⁸ *Ibid* § 911, 124 Stat 1376, 1822–4. In practice, the Investor Advisory Committee was established by Mary Schapiro in 2009 under the *Federal Advisory Committee Act*, 5 USC App (2006). The *Dodd–Frank Act* provides specific statutory authority for the creation of the Committee.

²²⁹ *Dodd–Frank Act*, § 915, 124 Stat 1376, 1830–2.

²³⁰ *Ibid* § 919D, 124 Stat 1376, 1840–1.

- initiatives to promote investor confidence and the integrity of the securities marketplace.²³¹

The Investor Advocate will identify regulatory issues and problems specifically affecting retail investors.²³² The new Ombudsman will act as mediator between retail investors and the SEC.²³³

The SEC enforcement powers have been strengthened. The SEC may pay significant monetary amounts to individuals who provide information that leads to a successful SEC enforcement action.²³⁴ Monetary penalties may be imposed in administrative cease-and-desist proceedings against a person for a violation of securities regulation.²³⁵ In addition, the rules, penalties and standards on aiding and abetting have been significantly enhanced.²³⁶

Finally, the Act tightens the rules on short selling. Monthly public disclosure on short positions is required,²³⁷ and short selling that is deemed to be manipulative is prohibited.²³⁸

B *Commentary and Analysis*

1 *Intermediary Conflicts of Interest*

There are no easy regulatory or practical solutions to deal with financial intermediary conflict issues. Full disclosure of actual or potential conflicts of interest is the most common and reasonable regulatory response. Empirical evidence confirms that clients do not always adequately comprehend or properly assess the effects of intermediary conflict disclosures.²³⁹ However, regulatory options such as prohibiting the selling of products when a conflict exists are not always feasible, practical or beneficial to potential clients.

2 *Intermediary Duty of Care*

The mandated study on financial intermediary duties of care and standards reflects the longstanding debate in the US on the differences in the applicable laws and regulations applying to investment advisers and broker-dealers. Financial advisers are regulated under the *Investment Advisers Act of 1940*,²⁴⁰ while brokerage firms are regulated under the *Securities Exchange Act of*

²³¹ Ibid § 911, 124 Stat 1376, 1822.

²³² Ibid § 915, 124 Stat 1376, 1831.

²³³ Ibid § 919D, 124 Stat 1376, 1840.

²³⁴ Ibid § 922(a), 124 Stat 1376, 1842. The rules adopted to implement a whistleblower incentive and protection program were issued by the SEC in May 2011: see 17 CFR §§ 240, 249. See also SEC, 'Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934' (Release, No 34-64545, 25 May 2011) <<http://www.sec.gov/rules/final/2011/34-64545.pdf>>.

²³⁵ *Dodd-Frank Act*, § 929P(a), 124 Stat 1376, 1862.

²³⁶ Ibid §§ 929M, 929N, 929O, 124 Stat 1376, 1861–2.

²³⁷ Ibid § 929X(a), 124 Stat 1376, 1870.

²³⁸ Ibid § 929X(b), 124 Stat 1376, 1870.

²³⁹ See Levitin, above n 194, 148. See also Australian Securities and Investments Commission, *Licensing: Managing Conflicts of Interest*, Regulatory Guide 181, 30 August 2004.

²⁴⁰ 15 USC §§ 80b-1–80b-21 (2006).

1934²⁴¹ and the rules of the Financial Industry Regulatory Authority ('FINRA'), a self-regulatory authority. Brokers are able to exempt themselves from the investor adviser regulation on the basis that the advice provided is 'solely incidental' to brokerage services.²⁴²

The duties of brokers and advisers were vigorously debated in Congress and at the US Treasury Department during the policy reform processes. The initial draft legislation by the Senate Banking Committee removed the broker-dealer exemption from the *Investment Advisers Act*. However, the Congress was unable to reach consensus on this issue and no change was made to the legislation signed into law.

The SEC was concerned that the regulation applying to the two intermediary groups differed.²⁴³ It argued during the reform review period that all intermediaries providing financial advice should be subject to equivalent regulation and every financial professional should be subject to a uniform standard of conduct.²⁴⁴ It suggested the demarcation between the functions of the two groups of intermediaries is blurred and clients fail to understand the differences between the services provided.²⁴⁵ During the public consultation process, the SEC sought feedback on 14 outlined issues including (i) the potential impact upon retail customers that could result from potential changes in the regulatory requirements or legal standards of care, and (ii) the effectiveness of the enforcement of the intermediary standards of care. The large number of comments received reflected the interest and controversy surrounding this area of law.²⁴⁶ In January 2011, the SEC completed its study on the obligations of brokers, dealers and investment advisers and reported to Congress.²⁴⁷ It recommends establishing a uniform fiduciary standard for the provision of investment advice to retail customers — that is, the standard that currently applies to investment advisers should apply to broker-dealers when they provide retail advice.²⁴⁸

The debates around possible harmonisation of intermediary duties and standards of care are linked to the nature and scope of the fiduciary obligations. All investment advisers in the US are deemed to be in a fiduciary relationship with

²⁴¹ 15 USC §§ 78a–78III (2006).

²⁴² *Investment Advisers Act of 1940*, 15 USC § 80(b)-2(a)(11)(C) (2006).

²⁴³ Mary Schapiro, the Chairman of the SEC, told the Senate Committee on Banking, Housing and Urban Affairs that the services provided by brokers and advisers 'often are virtually identical from the investor's perspective': Mary L Schapiro, 'Testimony Concerning Enhancing Investor Protection and Regulation of the Securities Markets' (Testimony before the US Senate Committee on Banking, Housing and Urban Affairs, 26 March 2009) 8–9.

²⁴⁴ See, eg, Mary L Schapiro, 'Testimony Concerning SEC Oversight: Current State and Agenda' (Testimony before the US House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, 14 July 2009); Elisse B Walter, SEC Commissioner, 'Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?' (Speech delivered at the Mutual Fund Directors Forum Ninth Annual Policy Conference, Washington DC, 5 May 2009).

²⁴⁵ SEC, *Study on Investment Advisers and Broker-Dealers*, above n 220, 99.

²⁴⁶ The comments are available at SEC, *Comments on Study Regarding Obligations of Brokers, Dealers, and Investment Advisers* (4 August 2011) <<http://www.sec.gov/comments/4-606/4-606.shtml>>.

²⁴⁷ SEC, *Study on Investment Advisers and Broker-Dealers*, above n 220.

²⁴⁸ *Ibid* v–vii, 110–39.

their clients and, as such, owe duties of loyalty and care.²⁴⁹ The courts have consistently indicated that the fiduciary standard requires advisers to act continuously in their clients' 'best interest'.²⁵⁰ The adviser recommendations must be suitable to a client's circumstances. While advisers 'may benefit from a transaction with or by a client ... the transaction must be fully disclosed.'²⁵¹ By contrast, the fiduciary obligations that apply to broker-dealers are less clear.²⁵² Laby suggests there is general consensus that a broker with discretionary trading authority over a customer account is subject to fiduciary obligations, whereas a broker without discretionary power is not a fiduciary. However, he notes that this general rule is subject to numerous exceptions, resulting in general confusion in this area of law.²⁵³

The specific client outcomes resulting from the fiduciary obligations applying to the two intermediary groups are difficult to define or explain because of a dearth of case law on broker-dealer duties.²⁵⁴ Laby provides the example of the sale of securities to a client from the firms' own account. He indicates that a broker-dealer can do this, but an investment adviser cannot because of the potential conflict of interest.²⁵⁵ He concludes that 'advice is an essential ingredient of a broker's financial services, rendering the solely incidental exclusion no longer applicable and justifying a fiduciary duty for brokers providing advice.'²⁵⁶

Langevoort agrees the distinctions between the regulatory regimes are becoming untenable,²⁵⁷ but warns there are no easy or comfortable solutions.²⁵⁸ The establishment of a general fiduciary duty for broker-dealers may not improve the current position because fiduciary obligations are by their very nature open-ended.²⁵⁹ He suggests that the SEC needs to provide 'more textured rules that

²⁴⁹ *Securities and Exchange Commission v Capital Gains Research Bureau Inc*, 375 US 180, 191 (Goldberg J for Warren, Black, Clark, Brennan, Stewart, White and Goldberg JJ) (1963).

²⁵⁰ See, eg, *Securities and Exchange Commission v Tambone*, 550 F 3d 106, 146 (Lipez J) (1st Cir, 2008).

²⁵¹ Arthur B Laby, 'Fiduciary Obligations of Broker-Dealers and Investment Advisers' (2010) 55 *Villanova Law Review* 701, 718, citing *Securities and Exchange Commission v Capital Gains Research Bureau Inc*, 375 US 180, 191-2 (Goldberg J for Warren, Black, Clark, Brennan, Stewart, White and Goldberg JJ) (1963).

²⁵² For a detailed outline of this topic, see Laby, 'Fiduciary Obligations of Broker-Dealers and Investment Advisers', above n 251.

²⁵³ *Ibid* 742.

²⁵⁴ *Ibid* 705. Most broker-dealer disputes are handled through arbitration.

²⁵⁵ *Ibid* 702. See also Arthur B Laby, 'Resolving Conflicts of Duty in Fiduciary Relationships' (2005) 54 *American University Law Review* 75.

²⁵⁶ Laby, 'Fiduciary Obligations of Broker-Dealers and Investment Advisers', above n 251, 742.

²⁵⁷ Donald C Langevoort, 'Brokers as Fiduciaries' (2010) 71 *University of Pittsburgh Law Review* 439, 441.

²⁵⁸ *Ibid* 441-2.

²⁵⁹ *Ibid* 456. See also Mercer Bullard, 'The Fiduciary Study: A Triumph of Substance over Form?' (Working Paper, School of Law, University of Mississippi, 30 August 2010) 2. Bullard highlights that the fiduciary duty is inherently principles-based. The conduct standards that apply under a fiduciary duty are revealed through case law.

apply to both brokers and advisers on each of the crucial aspects of the advisory relationship.²⁶⁰

We endorse Langevoort's recommendations. The issue of harmonisation of duties of care across advisers is only a first step. Arguably, the more difficult and significant policy issue concerns the appropriate nature and scope of the intermediary duties on a day-to-day basis. It is not easy to establish a duty of care standard that achieves an appropriate balance between financial intermediaries and clients. Determining what is in a client's best interest at a particular time and on an ongoing basis can be difficult. Intermediaries, their advisers and clients need policy guidance that is as clear as possible on expected behaviour in circumstances that fall within the large 'grey' or uncertain areas. In practice, some clients, whether sophisticated or otherwise, are eager to take on risk during boom times but are quick to pass the blame to an intermediary when things go wrong. Most parties would concur that client compensation is justified when product or advisory disclosure is fraudulent or blatantly misleading. However, what should a fiduciary standard or a 'best interest' duty require from a broker-dealer or a financial advisory intermediary when a client actively seeks riskier products such as margin loans or derivative products during the good times? To what extent are most clients able to theoretically and empirically understand notions of risk, reward and lifestyle flexibility? And should an intermediary determine the appropriateness of the financial products or advice based primarily on the ability of a client to absorb the risk? These are complex issues that policymakers, scholars, lawyers, financial advisers and investors continue to grapple with in all jurisdictions. The protection of investors and consumers is generally a paternalistic endeavour.²⁶¹ Ultimately, policymakers need to carefully consider the extent to which investors and consumers should be accountable for their own interests, actions and decisions.

3 *Direct Investor Provisions*

The establishment of an Investor Advisory Committee, an Office of the Investor Advocate, and a retail investor Ombudsman are positive novel developments that other jurisdictions should note. The credibility of the SEC depends to a large extent on its actual and perceived ability to protect investors from exploitation. The cost of these reforms is likely to be low while the potential investor benefits may be significant. Institutional investors tend to have effective representative bodies with established access and relationships at all political and regulatory levels, whereas retail investors often lack sufficient resources, administrative structures, and political and regulatory access to gain an effective voice.

4 *Short Selling Provisions*

The short selling reforms are balanced and in line with global regulatory trends. Many market participants and scholars argue that short selling enhances

²⁶⁰ Langevoort, above n 257, 455.

²⁶¹ See Levitin, above n 194, 148.

market efficiency.²⁶² However, these claims are open to question when the trading is not disclosed or subject to any supervisory oversight.²⁶³ The provisions do not prohibit or significantly restrict short selling activity. Instead, they seek to improve market transparency by requiring disclosure of short positions on a delayed basis, and to enhance market efficiency by banning trading that is not driven by economic fundamentals.

IX REGULATORY PERFORMANCE

Important issues in relation to regulatory capture, competition for regulatory turf and the lack of action by regulators to developments prior to the GFC were not fully debated or resolved during the legislative review processes. Yet the success of the *Dodd–Frank* reforms will depend to a large extent on the competency, integrity and forcefulness of the individual regulators, and their ability and willingness to supervise the finance industry on an integrated basis. The *Dodd–Frank Act* will require proactive, well-informed and coordinated intervention by the regulators to operate effectively.

There are significant risks associated with the inchoate legislative approach and the number and extent of the required studies, reports and rules. The Act requires 60 studies to be completed and 533 rules and 93 Congressional reports to be written.²⁶⁴ The SEC must write 205 of the mandated rules and the CFPB is required to write a further 70. There are multiple stages required before the final rules are established, placing a heavy burden on the regulators.²⁶⁵ As a result of inadequate funding, the SEC is having to reallocate its existing resources to satisfy the requirements under the Act. This threatens the reach and efficacy of the SEC's front-line functions such as enforcement.²⁶⁶ Further, the regulators, particularly the SEC and the CFPB, are entrusted with extensive discretionary powers, leaving the door open to regulatory capture by the very financial institutions that these bodies are supposed to supervise.²⁶⁷

²⁶² See, eg, Pedro A C Saffi and Kari Sigurdsson, 'Price Efficiency and Short Selling' (2011) 24 *Review of Financial Studies* 821.

²⁶³ See Tavares, above n 149.

²⁶⁴ Center for Capital Market Competitiveness, United States Chamber of Commerce, above n 10.

²⁶⁵ The rulemaking procedure generally includes the issuance of a concept release or notice of proposed rulemaking. This is followed by a proposed rule that is released for public comment. Once the final rule is issued, there is generally a phasing-in period to allow industry time to prepare for compliance.

²⁶⁶ Congress initially authorised annual budget increases to the SEC for the next five years, with US\$1.3 billion approved for 2011, stepping up to US\$2.25 billion in 2015: *Dodd–Frank Act*, § 991(c), 124 Stat 1376, 1954. However, this budget deal agreed to in April 2011 between the Administration and House Republicans resulted in significant cost cutting. The SEC received only a small increase in its funding for 2011 and is reallocating resources or using its existing offices to satisfy some of the requirements under the Act. The funding of the CFPB is more flexible. The director of the CFPB determines the amount reasonably necessary to carry out the authorities of the Bureau, up to a funding cap based on a percentage of the total operating expenses of the Fed: *Dodd–Frank Act*, § 1017(a), 124 Stat 1376, 1975.

²⁶⁷ See Skeel, above n 46. Skeel suggests the objectives of the Act are 'right on target'. However, he is concerned by (1) 'government partnership with the largest financial institutions', and (2) 'ad hoc intervention by regulators rather than a more predictable, rules-based response to crises': at 8.

Regulatory capture is a major issue in the US, as in many other countries. The financial services industry ‘has been the single largest contributor to congressional campaigns since 1990.’²⁶⁸ One study indicates that the largest six banks and their industry bodies spent nearly US\$600 million lobbying Congress on the proposed reforms.²⁶⁹ Even the institutions that were bailed out using taxpayer funds paid significant sums to lobbyists.²⁷⁰ Volcker highlights the political difficulties the regulators face. He suggests the response to warnings of destabilising developments in an institution or a market when things are going well will generally be: ‘We know more about banking and finance than you do, get out of my hair, if you don’t get out of my hair I’m going to write [to] my congressman’.²⁷¹

There is little doubt the world has changed since the GFC. However, the extent to which recent events have altered the cultures and mindsets of the regulators in the US (and elsewhere) is not yet clear. Posner argues that prior to the GFC ‘the regulators of financial intermediaries were asleep at the switch.’²⁷² Volcker suggests there was ‘a certain neglect of supervisory responsibilities, certainly not confined to the Federal Reserve, but including the Federal Reserve’.²⁷³ It is easy in hindsight to argue that the regulators should have responded differently. It is more important to understand why the regulators acted the way they did, and what changes in approach are required for the reforms to succeed. The regulatory responses to developments in the home mortgage markets leading up to the GFC suggest that the US regulators need to radically change the framework used to assess the net societal effects of the financial policy they administer.

²⁶⁸ Levitin, above n 194, 160–1.

²⁶⁹ Kevin Connor, ‘Big Bank Takeover: How Too-Big-to-Fail’s Army of Lobbyists has Captured Washington’ (Institute for America’s Future, 11 May 2010) 1 <<http://www.ourfuture.org/files/documents/big-bank-takeover-final.pdf>>.

²⁷⁰ Paul Kiel, *Bailed-Out Companies Spend Millions to Lobby Congress* (22 July 2009) ProPublica <<http://www.propublica.org/article/bailed-out-companies-spend-millions-to-lobby-congress>>.

²⁷¹ Damian Paletta, ‘Ronald Reagan’s Fed Chief Takes Aim at America’s Battered Financial System’, *The Australian* (online), 24 September 2010 <<http://www.theaustralian.com.au/business/news/reagans-fed-chief-takes-aim-americas-battered-financial-system/story-e6frg90x-1225928703094>> (citing Volcker). In practice, it is difficult for regulators to raise the alarm about potentially adverse developments when markets and economies are performing well. Individuals, particularly those with positions and reputations to protect, do not want to be seen to have acted to stop the money rolling in or to be shown in hindsight to have made the wrong call. See Australian Securities and Investments Commission, ‘Securities and Investment Regulation: Beyond the Crisis — Report’ (ASIC Summer School 2010, Melbourne, 1–3 March 2010) 76, where Jane Diplock, the Chairperson of the International Organization of Securities Commissions, expresses the problem thus:

When everybody appears to be making money, and there’s exuberance in the markets, it’s extremely difficult to be the Jeremiah saying: ‘Look, that’s a cliff you’re about to run over’. Nobody wants to hear that message, least of all the politicians whose funds are perhaps being swollen by the very people making all this money.

²⁷² See Richard A Posner, ‘Financial Regulatory Reform: The Politics of Denial’ (2009) 6(11) *The Economists’ Voice* 1, 2 <<http://www.bepress.com/ev/vol6/iss11>>. Posner argues that the main causes of the financial crisis were incompetent monetary policy and the unawareness of regulators of financial intermediaries. He suggests these problems are not cured by the legislative reforms. Posner explains the lack of discussion about regulatory failure as the presence of the politics of denial because the government’s senior economic officials were implicated in the failures.

²⁷³ Paletta, above n 271 (quoting Volcker).

In 1994, Congress passed the *HOEPA* prohibiting identified abusive practices. In addition, Congress granted the Fed the power to prohibit other unfair, deceptive or abusive practices of which it became aware of.²⁷⁴ However, despite the mounting evidence of abusive home credit practices,²⁷⁵ the Fed emphasised educational campaigns to improve consumers' financial literacy and initiated only minor regulatory changes.²⁷⁶ This approach was consistent with the well-established global patterns of increasing deregulation and a strong reliance on markets — a fundamental belief in the ability of markets to deal with themselves, a view that regulatory interference in markets should be kept to a minimum, an emphasis on efficiency and economic factors, and a conviction that consumers should act rationally and look after their own interests. The actions of the Fed were also consistent with the long-standing policy in the US to encourage people to own their own homes. Based on these worldviews, the governors of the Fed saw the growth in the subprime market as a natural and positive development. They were therefore reluctant to interfere, and, even though they acknowledged that abuses were occurring, they determined that the greater economic good or the net societal benefit was served by allowing the lending to continue.²⁷⁷ As late as May 2007, Chairman Bernanke indicated that

²⁷⁴ 15 USC § 45(n) (2006). The 1994 amendment provided that:

The Commission shall have no authority under this section ... to declare unlawful an act or practice on the grounds that such act or practice is unfair unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. In determining whether an act or practice is unfair, the Commission may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.

²⁷⁵ In 2001, the Fed acknowledged increased reports of home purchase loans and refinancings which generally included one or more of the following:

- 1 Making unaffordable loans based on the borrower's home equity without regard to the borrower's ability to repay the obligation;
- 2 inducing a borrower to refinance a loan repeatedly, even though the refinancing may not be in the borrower's interest, and charging high points and fees each time the loan is refinanced, which decreases the consumer's equity in the home; and
- 3 engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower — for example, 'packing' loans with credit insurance without a consumer's consent.

See *Truth in Lending*, 12 CFR § 226 (2001). The Fed also acknowledged evidence of targeting of vulnerable groups. The Fed noted at § 226.32(a):

The reports of actual cases [about predatory lending] are ... widespread enough to indicate that the problem warrants addressing. Homeowners in certain communities — frequently the elderly, minorities, and women — continue to be targeted with offers of high-cost, home-secured credit with onerous loan terms. The loans, which are typically offered by nondepository institutions, carry high up-front fees and may be based solely on the equity in the consumers' homes without regard to their ability to make the scheduled payments. When homeowners have trouble repaying the debt, they are often pressured into refinancing their loans into new unaffordable, high-fee loans that rarely provide economic benefit to the consumers. These refinancings may occur frequently. The loan balances increase primarily due to fees that are financed resulting in reductions in the consumers' equity in their homes and, in some cases, foreclosure may occur. The loan transactions also may involve fraud and other deceptive practices.

²⁷⁶ Di Lorenzo, above n 204, 79.

²⁷⁷ Edmund L Andrews, 'Fed Shrugged as Subprime Crisis Spread', *New York Times* (online), 18 December 2007 <<http://www.nytimes.com/2007/12/18/business/18subprime.html>>.

we believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.

...

Credit market innovations have expanded opportunities for many households. Markets can overshoot, but, ultimately, market forces also work to rein in excesses. For some, the self-correcting pullback may seem too late and too severe. But I believe that, in the long run, markets are better than regulators at allocating credit.²⁷⁸

It was not until 2008 that the Fed significantly strengthened the level of protection provided to consumers by amendments to the *HOEPA* regulation.²⁷⁹ Importantly, these amendments were made using its existing regulatory powers.²⁸⁰

X CONCLUSION

The *Dodd–Frank Act* represents the most substantive reform of financial regulation in the US since the 1930s. It contains some bold legislative changes. The establishment of a well-resourced single consumer protection agency may provide consumers with a regulatory body focused primarily on their interests. The reforms around trading of derivatives are important and may enhance long-term economic outcomes. Likewise, the mere existence of provisions that provide for some of the losses arising from failed companies to be potentially borne by the management and directors may encourage more prudent and cautious behaviour on the part of well-advised executives and directors.

However, the communication, implementation and operational capacities of Congress and the federal regulators over the next few years will be challenged to the limit as the vast array of rules are rolled out. The extent of required rule-making under the Act leaves all parties facing significant uncertainties. The nature and scope of the reforms will only be known once the mandated studies and rule-making are completed and the regulation is fully implemented.

Financial institutions will respond vigorously to the reform agenda. Wall Street lobbying to influence or derail the studies that have been mandated and to water down the implementing regulations will be intense.²⁸¹ New financial products and innovations to minimise the potential adverse effects on institutions seem

²⁷⁸ Ben S Bernanke, 'The Subprime Mortgage Market' (Speech delivered at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, Chicago, 17 May 2007).

²⁷⁹ *Truth in Lending*, 12 CFR § 256 (2008).

²⁸⁰ See Posner, above n 272, 4. Posner concludes that the Fed and the other regulators had the power to avoid the monetary excesses that accelerated the housing boom and to stop questionable lending and trading decisions by financial institutions. See also Financial Crisis Inquiry Commission, above n 13, 187. The Commission, in its conclusion to ch 9, states that '[t]he Federal Reserve failed to recognize the cataclysmic danger posed by the housing bubble to the financial system and refused to take timely action to constrain its growth, believing that it could contain the damage from the bubble's collapse.'

²⁸¹ Paletta, above n 271, where Volcker is quoted as praising the financial reforms, but says the system remains 'at risk because it is subject to future "judgments" of individual regulators who ... [will] be relentlessly lobbied by banks and politicians to soften the rules.'

inevitable. Indeed, the most certain consequence of the reforms is that both regulators and financial institutions in the US are in for a very interesting and demanding few years ahead.

US Treasury Secretary Timothy Geithner recently highlighted the need for the right 'balance between ... rules that protect consumers and investors and the economy, without stifling the competition and innovation that drives economic growth'.²⁸² While few parties would disagree with this aspiration, maintaining such a balance over entire economic cycles is notoriously difficult. The temptation for us all, including policymakers, regulators, financial institutions, other capital market participants and consumers, is to opt for short-term economic gains and to ignore or take insufficient account of longer-term risks and the adverse consequences of inaction.

The success of the reforms over the long-term will depend heavily on regulatory performance. As Robert Shiller suggests, 'It is a good Act but only to the extent that we make it a good Act'.²⁸³ Given the longstanding regulatory struggle around mortgage consumer protection leading up to the GFC, and the reluctance of the federal regulators to use their existing powers and discretion to intervene to mitigate the building excesses and exposures, the key question that arises is whether the regulatory responses will be different the next time around. Have the views of the federal regulators, particularly the Fed, fundamentally changed in relation to the ability of markets to order themselves and the necessity of regulatory oversight and action?²⁸⁴ Has the Fed's conception, application and consideration of the 'net social benefit' test altered since 2007? Are the federal regulators willing to assess and determine economic policy goals using a longer-term lens that better balances the longer term costs and public interest factors with the expected short-term benefits? And are the federal regulators willing to use their previous and new powers and discretion to achieve the stated purposes of the Act? An affirmative response to these questions will require deep changes to the culture and mindset of the US regulatory agencies. Whether these changes are achievable remains the pressing question.

²⁸² Katz and Christie, above n 64 (quoting Geithner).

²⁸³ Amanda White, *Dodd-Frank Act Will Stand or Fall on Right People* (15 September 2010) top1000funds.com <<http://www.top1000funds.com/news/2010/09/15/dodd-frank-act-will-stand-or-fall-on-right-people>> (quoting Shiller).

²⁸⁴ See Gill North and Ross P Buckley, 'A Fundamental Re-Examination of Efficiency in Capital Markets in Light of the Global Financial Crisis' (2010) 33 *University of New South Wales Law Journal* 714.