Explaining the Dodd-Frank Act

Center Forward Basics
June 2020

Overview

The Dodd-Frank Wall Street Reform and Consumer Protection Act, more often referred to as Dodd-Frank, was signed by President Barack Obama in July 2010. Dodd-Frank was passed in the aftermath of the "Great Recession" of 2007-2009. The legislation affected nearly every aspect of the U.S. financial system, from the operations of commercial banks, broker dealers and asset managers to the administration of mortgages and credit cards. As we approach the 10th Anniversary of Dodd-Frank's passage, we outline some of Dodd-Frank's major components and effects on the global and domestic market system. Although there is considerable overlap in the regulation of financial institutions, this Basic is focused on the capital markets provisions in the Dodd-Frank Act.

What caused Dodd-Frank?

In response to the 2008 financial crisis, President Barack Obama called for a "sweeping overhaul of the United States financial regulatory system" that would regulate sectors of the financial system such as banks, mortgage lenders, and credit rating industries. President Obama then worked with a Democratic-led Senate and House to draft this massive law that established many new government agencies to oversee parts of the U.S. financial system. The law is named after former Senator Chris Dodd, then-Chairman of the Senate Banking Committee and former Representative Barney Frank, then-Chairman of the House Financial Services Committee. In the final vote, no Republicans voted for the legislation in the House, and only three Republicans did so in the Senate.

Center Forward Basics

Center Forward brings together members of Congress, not-for profits, academic experts, trade associations, corporations and unions to find common ground. Our mission: to give centrist allies the information they need to craft common sense solutions, and provide those allies the support they need to turn those ideas into results.

In order to meet our challenges we need to put aside the partisan bickering that has gridlocked Washington and come together to find common sense solutions.

For more information, please visit www.center-forward.org

What did Dodd-Frank do?

Some of the major capital markets related items in Dodd-Frank include:

- **Financial Stability Oversight Council (FSOC):** identifies emerging threats and regulatory gaps to the financial stability of the U.S. It authorizes the Federal Reserve to regulate systemically important non-bank financial institutions (SIFI) identified by the Council for safety and soundness.
- **The "Volcker Rule":** generally bars banks from proprietary trading and investing in, or owning, hedge and private equity funds for their own profit.
- **Enhanced Prudential Standards and Capital Requirements:** required the Federal Reserve to impose enhanced prudential standards and risk-based capital, liquidity and leverage requirements on large financial institutions.
- **Swaps Regulation:** created a regulatory framework for the regulation of swaps markets giving the CFTC jurisdiction over swaps and the SEC authority over security-based swaps, defined as swaps based on a single security or loan or narrow index of securities.
- **Investor Protections and Securities Regulations:** enhanced investor protection, improved regulation of securities, enhanced corporate governance, improved regulation of credit ratings agencies, enhanced asset-backed securities regulation, and increased enforcement. The act called for the SEC to study the existing standard of care, which led to the eventual adoption of Regulation Best Interest.

Financial Stability

Title I of the Dodd-Frank Act created a process to assist financial regulators in identifying, evaluating, and managing risks to the financial stability of the U.S. economy and financial markets. Specifically, Title I established the Financial Stability Oversight Council (FSOC) and its Office of Financial Research (OFR). The FSOC convenes the heads of federal financial regulations, representatives from state regulatory bodies, and an independent insurance expert to identify risks to the financial stability of the U.S. and make policy recommendations to both member agencies and Congress. The FSOC also has the authority to designate non-bank financial institutions as systemically important. Institutions labeled as systemically important are subject to increased regulation and oversight. The FSOC considers a company to pose a threat to financial stability if a company's financial distress or activities could be transmitted to other firms or markets and cause disruptions to the financial intermediation or other financial market functions. The most commonly used designation activities include leverage and interconnectedness with other systemically important non-bank financial institutions (SIFIs).

The process by which non-bank financial institutions were designated as systemically important had many problems such as being overly opaque and conducted on an ad hoc basis with no clear guidance to explain and justify the decisions. Therefore, in 2017 the U.S. Treasury Department reviewed the FSOC and the non-bank designation process. As a result of this review, the FSOC voted in December 2019 to implement an "activities-based" approach to identify and address potential risks to financial stability. This new approach ensures that FSOC can identify risks to the financial stability of the U.S. and facilitate information-sharing and regulatory coordination among regulations by enhancing greater transparency, due process, and fairness of the designation process.

Improvements to Regulation and the Volcker Rule

The Volcker Rule, Section 619 of the Dodd-Frank Act, prohibits banking entities from engaging in proprietary trading or investing in or sponsoring hedge funds or private equity funds. When the financial regulations implementing the Volcker Rules were enacted in 2013, there were many rules and guidelines that lacked clarity, efficiency, and were inconsistent with its statutory language. As a result of these regulations, there were many unnecessary restrictions of banking and capital markets activities. Overall, the regulations limited banks' ability to promote capital formation, economic growth, and job creation.

Since regulatory adoption in 2013, many commentators have made suggestions to amend and streamline the final implementing rules in order to eliminate the unintended negative consequences. In the U.S. Treasury Departments 2017 report, Treasury Secretary, Steve Mnuchin encouraged amendments to improve market liquidity. Specifically, the U.S. Treasury Department recommended changes to the statute, regulations and supervision and that certain compliance burdens be eliminated or clarified in order to lessen the impact on market liquidity. Additional recommendations of the 2017 Report are listed here. In May 2018, the Federal Reserve Vice Chairman for Supervision Randal Quarles proposed amending and simplifying the Volcker Rule based on experience implementing the rule. Additionally, regulators finalized these changes on June 25, 2020 and they will be implemented on October 1, 2020. Overall, there is bipartisan consensus in support of reducing the complexity of the Volcker Rule and ensuring that it does not limit the essential functions of the capital markets.

Enhanced Prudential Standards and Increased Supervision

Title XI of the Dodd-Frank Act required the Federal Reserve to impose enhanced supervisory, capital, liquidity and risk-based standards on large domestic and foreign financial institutions ($50 billion or more in assets). The rules included capital planning, and stress testing requirements, enhanced liquidity requirements, risk management, and minimum leverage and risk- based requirements (capital floor) for banks and non-banks regulated by the Federal Reserve. Title XI also created the position of Vice Chairman for Supervision of the Federal Reserve which was filled in 2017 with the appointment of Randal Quarles to the Federal Reserve Board. Since the crisis, the financial industry has built up significant capital to enhance the resiliency of the financial system. With the adoption of numerous conservative prudential regulatory requirements, many of them not required by the Dodd-Frank Act, banks now hold excessive levels of capital and liquidity that are increasingly disconnected from the level of risk they incur. Although these levels have undoubtedly increased resiliency, they come at a cost: the more capital required, the less deployed into the economy. As a result, prudential and market regulators have set out to tailor and improve upon the post-crisis regulatory regime to avoid unintended consequences on the efficient operation of the capital markets.

Swaps Regulation

Title VII imposes comprehensive regulations on the swaps markets, with most regulated by the CFTC and certain swaps defined as securities-based swaps (single name or a narrow index equity swap and single name or narrow index credit default swaps) regulated by the SEC.

- Clearing of standardized OTC derivatives through central clearing counterparties (CCPs),
- Reporting of OTC derivatives transactions to trade repositories,
- Trading of standardized OTC derivatives on electronic trading platforms, and
- Capital requirements and margin requirements for non-centrally cleared swaps.

These reforms culminated in Title VII of the Dodd-Frank Act which imposes a broad regulatory regime administered by the Commodities Futures Trading Commission (CFTC) for swaps and the Securities and Exchange Commission (SEC) for securities-based swaps. The rules resulted in a more resilient derivatives market and allowed market participants to continue to effectively manage risk. Title VII set out requirements for swap and securities-based swap dealers and other market participants, such as swap data repositories (SDRs), designated clearing organizations (DCOs) and swap execution facilities (SEFs). All swaps subject to U.S. regulation are reported to SDRs, sufficiently standardized swaps (which includes the majority of interest rate and credit default swaps) are centrally cleared on DCOs and, where appropriate, traded on SEFs. Additionally, Dodd Frank established initial and variation margin requirements for swaps that are not centrally cleared, which already apply to the vast majority of swaps, further reducing systemic risk. Dodd Frank also established that DCOs can be designated systemically important by the FSOC, which results in additional risk-management standards and potential access to the Federal Reserve discount window.

Investor Protections and Improvements to Securities Regulation

The Act aims to increase investor protection, improve corporate governance; improve the regulation of credit rating agencies; improve the asset-backed securitization process; and increase regulatory enforcement and remedies. It requires the SEC to conduct studies on the regulation of brokers, dealers and investment advisors, including on the existing standards of care applicable to brokers, dealers and investment advisers that provide investment recommendations to retail investors.

In June 2019, the SEC adopted Regulation Best Interest. Reg BI which requires broker-dealers to act in the best interest of their retail customers when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. The SEC also finalized a Form CRS Relationship Summary and interpretive guidance for Broker-Dealers and Investment Advisers and an interpretation regarding the standard of conduct for Investment Advisers. Reg BI has a compliance date of June 30, 2020.

Conclusion

Since its passage in 2010, the Dodd-Frank Act has strengthened the financial system, increased communication and coordination between federal agencies and the financial sector. Additionally, the U.S. financial system has grown even stronger because of the many changes made as a result of the U.S. Treasury Department recommendations. The financial system has passed its first real test since the 2008 financial crisis: a recession resulting from the COVID-19 pandemic. Currently, banks are a source of strength for the economy and are well capitalized. Therefore, they have been in positions to lend to both large and small businesses. Overall, the capital markets proved to be resilient and have performed well during times of unprecedented volatility.

Links to Other Resources

- Columbia Law School Blog - Sullivan & Cromwell Discusses FSOC Changes to Nonbank SIFI-Designation Guidance
- CRS Report - The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and the Federal Reserve
- CRS Report - Financial Stability Oversight Council (FSOC): Structure and Activities
- The Federal Reserve - Federal Reserve Board formalizes previously announced one-year conformance period extension for certain Volcker rule legacy fund investments
- The Federal Reserve - Volcker Rule Overview
- The Federal Reserve - Dodd-Frank Act Stress Test 2019: Supervisory Stress Test Results
- SIFMA - Fixing the Volcker Rule
- SIFMA - OTC Derivatives
- U.S. Treasury Department - A Financial System That Creates Economic Opportunities: Banks and Credit Unions