# 6 Progress in the Implementation of the Dodd-Frank Act; Council Activities

**The regulatory implementation of the Dodd-Frank Act has included introducing stronger supervision, risk management, and disclosure standards; establishing orderly resolution plans and an orderly liquidation regime to prevent firms from being perceived as too big to fail; regulating the derivatives markets to reduce risk and increase transparency; reforming the securitization markets; enhancing standards for hedge fund advisers; creating the new Federal Insurance Office (FIO); strengthening the oversight program for credit rating agencies; establishing the Office of Financial Research (OFR); consolidating federal banking regulators; and implementing measures to enhance consumer and investor protection.**

**In addition, in its first year, the Council laid the groundwork for determining which nonbank financial companies will be supervised by the Federal Reserve and subject to heightened prudential standards, and for designating systemically important financial market utilities that will be subject to risk management standards. The Council also initiated monitoring of potential risks to U.S. financial stability; fulfilled explicit statutory requirements, including the completion of several studies; served as a forum for discussion and coordination among the member agencies implementing the Dodd-Frank Act; and built its basic organizational framework.**

**The following is a discussion of the significant implementation progress the Council and its member agencies have achieved since enactment of the Dodd-Frank Act.**

## 6.1 Safety and Soundness

### *6.1.1 Capital Adequacy Rules*

In June 2011, the federal banking agencies adopted a rule to implement portions of Section 171 of the Dodd-Frank Act, which is generally referred to as the Collins Amendment. Section 171 addresses several issues regarding financial institutions' capital adequacy.

One issue was to eliminate the possibility that adoption by the largest institutions of advanced Basel II approaches to calculating regulatory capital could result in those institutions holding less capital than that required of smaller banks. Such a result would be inconsistent with the intent of the Dodd-Frank Act, which is that the largest institutions should be subject to heightened capital standards. Accordingly, Section 171 provides that the capital requirements that generally apply to insured banks will serve as a floor for any capital requirements the agencies may establish for banks, depository institution holding companies, and nonbank financial companies supervised by the Federal Reserve.

Section 171 also seeks to ensure that the instruments issued by depository institution holding companies eligible for inclusion in regulatory capital are equivalent or superior to those issued by insured banks. In general, starting January 1, 2013, for certain depository institution holding companies, any regulatory capital deductions required by Section 171 will be phased in incrementally over three years.

### *6.1.2 Resolution Plans and Orderly Liquidation Authority*

#### Resolution Plans

To improve the resolvability of large financial firms and increase stability during times of market stress, Section 165(d) of the Dodd-Frank Act requires nonbank financial companies designated for enhanced supervision by the Federal Reserve and bank holding companies (BHCs) with $50 billion or more in total consolidated assets to prepare and maintain plans for their rapid and orderly resolution under the U.S. Bankruptcy Code; these plans are sometimes referred to as “living wills” ***(see Box I: Addressing Issues Related to Large Complex Financial Institutions)***. These resolution plans are not binding on bankruptcy courts or receivers. The Federal Reserve and the FDIC must review each plan. If they determine that a plan is not credible or would not facilitate an orderly resolution under the U.S. Bankruptcy Code, they may compel the firm to resubmit a conforming plan. If a conforming plan is not forthcoming, the two agencies can take further action, including imposing more stringent capital and liquidity requirements or, in consultation with the Council, ordering a divestiture.

Resolution plans are required to include information such as the following:

- the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;
- descriptions of the company’s ownership structure, assets, liabilities, and contractual obligations; and
- identification of the cross-guarantees tied to different securities, identification of major counterparties, and a process for determining to whom the collateral of the company is pledged.

In April 2011, the FDIC and the Federal Reserve released for public comment a joint proposed rule that would implement the requirement to prepare and maintain resolution plans.

#### Orderly Liquidation Authority

The financial crisis demonstrated that for certain BHCs or other financial companies near failure during a time of severe market stress, there may be only two options in the absence of a credible orderly liquidation authority: emergency public funding or bankruptcy. Neither of these options can accomplish the efficient and effective resolution of such a firm in a way that both limits the systemic impact and imposes costs on private investors rather than taxpayers. Title II of the Dodd-Frank Act created an orderly liquidation authority (OLA) that authorizes the government to address the potential failure of a BHC or other financial company when the stability of the financial system is at risk. The OLA is modeled on the resolution provisions of the Federal Deposit Insurance Act. After being appointed receiver under the processes described below, the FDIC is authorized to transfer to a third party assets or liabilities of a company subject to the OLA.[1] The FDIC may also establish a temporary bridge financial company to hold any part of the company’s business with going-concern value until it can be sold to a third party at fair value or otherwise liquidated in an orderly fashion.

To help ensure that taxpayers do not cover the costs of liquidation, all funds expended by the FDIC must be recovered through the disposition of the failed company’s assets, assessments on the creditors that stand to benefit from the process because of additional payments made to such creditors in certain limited circumstances, or assessments on large financial firms. In addition, under certain circumstances, senior executives and directors of a company subject to the OLA may be prohibited from participating in the conduct of the affairs of any financial company and be subject to recoupment by the FDIC of compensation received in the two years before the failure.

On the recommendation of two-thirds of the Board of Governors of the Federal Reserve and two-thirds of the board of the FDIC (or, depending on the nature of the financial company, two-thirds of

1 In the case of a failing insurance company, the company is resolved under the relevant state’s liquidation or rehabilitation process rather than under the FDIC’s receivership process. Special procedures also apply to the resolution of failing financial companies that are broker-dealers.

the Board of Governors of the Federal Reserve and either two-thirds of the members of the SEC or the approval of the Director of the FIO, in consultation with the FDIC) and in consultation with the President, the Dodd-Frank Act authorizes the Treasury Secretary to appoint the FDIC as receiver of certain financial companies if the Treasury Secretary makes certain findings. The required findings include a determination that the failure of the financial company and its resolution under otherwise applicable insolvency law would have serious adverse effects on financial stability in the United States; that no viable private sector alternative is available to prevent the default of the financial company; and that the use of the OLA would avoid or mitigate the adverse effects that would result from resolving the financial company under otherwise applicable insolvency law.

The OLA is a remedy of last resort, to be used only if the other tools provided by the Dodd-Frank Act—including the increased informational and supervisory powers—are unable to stave off a failure that could threaten financial stability. In particular, it is expected that the mere knowledge of the consequences of resolution under the OLA, including the understanding that financial assistance is no longer an option, would encourage a troubled financial company to find an acquirer or a strategic partner on its own well in advance of failure.

Title II of the Dodd-Frank Act authorizes the FDIC, in consultation with the Council, to adopt rules to implement the OLA process. The FDIC adopted a final rule to implement the OLA after notice and comment. As discussed more fully below, these rules seek to clarify procedural and substantive matters under the OLA. The FDIC intends to propose additional rules to implement the OLA, including rules governing receivership termination, receivership purchaser eligibility requirements, and record-retention requirements. The FDIC and SEC, after consultation with the Securities Investor Protection Corporation, will jointly propose rules governing the orderly resolution of certain broker-dealers.

The first OLA rule the FDIC adopted was an interim final rule that addressed OLA procedures, including payment of similarly situated creditors (which includes the treatment of holders of long-term senior debt); honoring personal services contracts; recognition of contingent claims; treatment of any remaining shareholder value in the case of a financial company subject to FDIC receivership (a covered financial company) that is a subsidiary of an insurance company; and limitations on liens that the FDIC may take on the assets of a covered financial company that is (1) an insurance company or (2) a covered subsidiary of an insurance company (other than an insured depository institution, an insurance company, or certain broker-dealers).

In March 2011, the FDIC issued a proposed rule for public comment. This rule provides clarity regarding the implementation of the OLA and helps ensure that the OLA process reflects the Dodd-Frank Act's mandate of transparency in the liquidation of covered financial companies. Among the significant issues addressed in this rule are the priority for the payment of claims, the process for the determination of claims by the receiver, and the process for seeking a judicial review of any claims disallowed in whole or in part.

The FDIC issued a final rule in July 2011 that amends and makes final the interim final rule and the proposed rule issued in March 2011. The final rule establishes a more comprehensive framework for the implementation of the OLA and provides greater transparency to the process for the orderly liquidation of covered financial companies under the Dodd-Frank Act. The rule also includes specific provisions setting forth the priority of payments to creditors, and the administrative claims process and the processes for resolving contingent and secured claims.

### Secured Creditor Haircut Study

The Dodd-Frank Act requires the Council to study, and issue a report regarding, the importance of maximizing U.S. taxpayer protections and promoting market discipline with respect to the treatment of fully secured creditors in the use of the OLA. The Council approved the report for submission to Congress on July 18, 2011. The report is discussed further in Section 6.4.

## 6.2 Financial Infrastructure, Markets, and Oversight

### *6.2.1 Over-the-Counter Derivatives Reform*

A lack of transparency in pricing or market exposures of derivatives and a lack of regulatory oversight created risks that contributed to the vulnerabilities of the financial system's largest institutions. Title VII of the Dodd-Frank Act establishes a comprehensive regulatory framework for the over-the-counter (OTC) derivatives marketplace. The regulatory structure for derivatives set forth in the Dodd-Frank Act is intended to promote exchange trading and centralized clearing of swaps and security-based swaps, helping increase regulatory and public transparency, reduce counterparty risk, and enhance the resiliency of the swaps markets. The reforms under Title VII should also enhance investor protection by increasing disclosure, helping mitigate conflicts of interest involving swaps and security-based swaps, and establishing comparable standards for initial and variation margin posted to swap dealers in connection with noncleared swaps.

The CFTC and SEC have proposed numerous rules pursuant to the standard public notice and comment process, and have engaged in extensive public outreach and interagency coordination, including the following:

- public roundtables with agency staff, market participants, and other concerned members of the public;
- meetings involving staff from multiple regulators, both domestic and international; and
- agency staff meetings with members of the public.

To facilitate the establishment of OTC derivatives markets that are more transparent, efficient, accessible, fair, and competitive than the previous, unregulated markets, the SEC and CFTC have proposed (or will propose) rules that govern the following:

- the operation of swap and security-based swap trading platforms (exchanges and swap and security-based swap execution facilities);
- conflicts of interest relating to, and the operation of, clearinghouses;
- reporting requirements to swap and security-based swap data repositories for swap and security-based swap dealers, major swap and security-based swap market participants, and swap and security-based swap counterparties; and
- business conduct standards and other regulatory requirements for swaps and security-based swap dealers and major swap and security-based swap market participants.

The SEC and CFTC have also jointly proposed rules further defining the terms "swap," "security-based swap," "security-based swap agreement," "swap dealer," "security-based swap dealer," "major swap participant," and "major security-based swap participant," as well as rules regarding "mixed swaps" and books and records for "security-based swap agreements."

In addition, the CFTC and the federal banking agencies issued proposed rules on capital and margin requirements for swap and security-based swap dealers and major swap and security-based swap market participants. The proposed rules would impose initial margin and variation margin requirements for uncleared swaps held by entities under each agency's jurisdiction. With respect to capital requirements, the federal banking agencies' existing regulatory capital rules take into account and address the unique risks arising from derivatives transactions and would apply to transactions in swaps and security-based swaps. The CFTC has proposed capital requirements for entities under its jurisdiction.

The FDIC, the OCC, and the Federal Reserve have proposed rules to permit entities under their respective jurisdictions to engage in certain retail off-exchange foreign currency transactions, including foreign currency futures, options on futures, and options and functionally or economically similar transactions such as "rolling spot" trades that are similar to futures contracts. The proposed rules establish requirements in six areas: disclosure, recordkeeping, capital and margin, reporting, business conduct, and documentation. Traditional spot and forward contracts are not covered under the rules.

The SEC and the CFTC are considering the structural and systems changes market participants will have to make to satisfy the new derivatives regulatory framework. The agencies are also considering a phased-in approach to implementing the new rules. This approach is intended to mitigate operational risk associated with structural and systems changes, and to provide an opportunity for market participants to raise any concerns they have as they design and implement the required systems.

### *6.2.2 Financial Market Utilities*

Financial market utilities (FMUs) manage or operate multilateral systems for the purpose of transferring, clearing, or settling financial transactions. FMUs are critical components of the U.S. financial system and the broader economy. Financial institutions, corporations, governments, and individuals rely on FMUs directly or indirectly to discharge a variety of financial and economic transactions. The market infrastructure supporting the millions of financial transactions that occur every day encompasses everything from smaller-value retail payment systems, such as credit and debit card networks, to large-value payment, clearing, and settlement systems for financial market transactions, such as central counterparties, securities, foreign exchange settlement systems, and funds transfer systems.

Title VIII of the Dodd-Frank Act establishes a new supervisory framework for systemically important FMUs. It authorizes the Council to designate an FMU as systemically important if the failure of or a disruption to the FMU's operations could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system. As discussed further in Section 6.4, the Council approved a final rule outlining the criteria, processes, and procedures for the designation of FMUs at its July 18, 2011 meeting.

The Federal Reserve, CFTC, and SEC, in consultation with each other and with the Council, have published proposed rules regarding risk management standards for designated FMUs subject to their respective supervisory authority. Final rules on risk management standards for designated FMUs are expected in 2011.

Section 813 of Title VIII requires the CFTC and SEC to coordinate with the Federal Reserve to jointly develop risk management supervision programs for designated clearing entities (DCEs)—FMUs that are either registered derivatives clearing organizations or registered clearing agencies. The agencies transmitted a joint report to Congress on July 21, 2011 containing recommendations for improving consistency of the DCE oversight programs of the CFTC and SEC; promoting robust risk management by DCEs and oversight by their regulators; and improving regulators' ability to monitor the potential effects of DCEs' risk management on financial stability.

### *6.2.3 Securitization*

#### Risk Retention

Properly structured securitization provides economic benefits that lower the cost of credit to households and businesses. However, when incentives are not properly aligned and the origination process lacks discipline, securitization can result in harm to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process. To address this weakness and promote prudent lending, Section 941 of the Dodd-Frank Act requires federal agencies jointly to adopt so-called "skin in the game" rules that require a securitizer to retain credit risk for loans that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party. In March 2011, the OCC, Federal Reserve, FDIC, SEC, FHFA, and the Department of Housing and Urban Development jointly proposed rules to implement this risk retention requirement. The Chairperson of the Council coordinated the rulemaking effort.

The proposed rules would require securitizers of ABS to retain at least 5 percent of the credit risk of the assets underlying the securities. Securitizers would not be permitted to transfer or hedge that credit risk. The proposed rule provides exemptions for qualified residential mortgages and ABS collateralized exclusively by commercial loans, commercial mortgages, or automobile loans that meet certain underwriting standards. The definition of "qualified residential mortgages,"

which represent a portion but not all of the market for mortgage loans, is an important aspect of the proposed rule: it would take into account, among other things, the borrower's ability to repay and credit history, the loan-to-value ratio of the loan, the form of valuation used in underwriting the loan, the type of mortgage, and owner-occupancy status. In crafting the proposed rule, the agencies sought to ensure that the amount of credit risk retained is meaningful while reducing the potential for negative effects on the availability and cost of credit to consumers and businesses.

#### Issuer Review and Representation, Warranty Disclosure, Conflicts

Other provisions of the Dodd-Frank Act require SEC rulemaking for ABS. Pursuant to Section 943 of the Dodd-Frank Act, the SEC adopted final rules in January 2011. These rules require securitizers to disclose the history of repurchase requests received for assets that are believed to have violated representations and warranties, and repurchases made relating to their outstanding ABS. Pursuant to Section 945, the SEC adopted final rules in January 2011 requiring an asset-backed issuer in a transaction registered under the Securities Act of 1933 to perform a review of the assets underlying the ABS and disclose the nature of such review. At a minimum, the review must be designed and effected to provide reasonable assurance that the prospectus disclosure on the assets is accurate in all material respects.

### *6.2.4 Hedge Fund Adviser Registration and Oversight*

Title IV of the Dodd-Frank Act closes a regulatory gap by making numerous changes to the registration, reporting, and recordkeeping requirements of the Investment Advisers Act of 1940 (Advisers Act). These provisions are intended to provide the SEC with oversight authority over previously unregistered investment advisers to hedge funds and private equity funds, and the authority to require recordkeeping and reporting by advisers to venture capital funds.

In June 2011, the SEC adopted a rule that would facilitate the registration of advisers to hedge funds and private equity funds with the SEC. To enhance the SEC's ability to oversee these advisers, the SEC will require them to provide additional information about the private funds they manage, including information about the amount of assets held by the fund and identification of fund service providers, including auditors, prime brokers, custodians, administrators, and marketers. In addition, the SEC will require all advisers to provide further information about an adviser's clients, employees, and advisory activities.

The SEC also adopted rules relating to several new exemptions from the investment adviser registration requirements for advisers that exclusively advise venture capital funds; advisers solely to private funds with less than $150 million in assets under management in the United States; and foreign private advisers with less than $25 million in assets under management in the United States. Although advisers are relieved from SEC registration, they may be subject to a registration requirement with the appropriate state securities regulator.

Section 404 of the Dodd-Frank Act also authorizes the SEC to collect data from investment advisers about their private funds to enable the Council to assess systemic risk. In January 2011, the SEC proposed a rule under this authority that would require registered investment advisers to a private fund to report certain systemic risk information to the SEC. Private fund advisers that are also registered with the CFTC as commodity pool operators or commodity trading advisers would satisfy systemic risk reporting requirements of the CFTC by filing with the SEC.

### *6.2.5 Insurance*

#### Establishment of the FIO

The financial crisis highlighted the lack of expertise within the federal government regarding the insurance industry. In response, the Dodd-Frank Act established the FIO to provide expertise regarding the insurance business, marketplace and regulatory environment. The following are among the FIO's authorities:

- to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;

- to monitor the extent to which traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance, except health insurance;
- to recommend that the Council designate an insurer as a nonbank financial company that should be subject to supervision by the Federal Reserve;
- to coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters; and
- to recommend and approve the resolution of certain troubled insurance companies under the OLA.

The FIO is led by a Director who serves in an advisory capacity as a nonvoting member of the Council. The states remain the primary functional regulators, and the FIO will consult with the states regarding insurance matters of national and international importance.

### 6.2.6 Credit Ratings

Following the onset of the financial crisis, it became apparent that credit rating agencies had systematically underestimated the risks of many RMBS, CDOs, and other structured finance instruments. Faulty assumptions underlying rating methodologies and the subsequent reevaluations by credit rating agencies led to a significant number of downgrades of these securities. The number and severity of these negative ratings actions caused investors to lose confidence in the accuracy of the ratings of a wide range of securitized products, thereby contributing to the market turmoil and revealing the extent to which investors and others had become overly reliant on credit ratings. The Dodd-Frank Act includes two sections that remove references to credit ratings in certain statutes and direct federal agencies to remove any references to or requirements of reliance on credit ratings from regulations.

Subtitle C of Title IX of the Dodd-Frank Act strengthened the SEC's oversight authority regarding, and mandated a number of rulemakings in connection with the SEC's oversight and regulation of, credit rating agencies registered as nationally recognized statistical rating organizations. The SEC issued proposed rules under this authority in May 2011. In addition, Section 939 of the Dodd-Frank Act removed references to credit ratings in certain statutes, while Section 939A requires each federal agency to review any rules that require the use of an assessment of creditworthiness of a security or money market instrument and any references to or requirements in such rules regarding credit ratings. Each agency must modify those rules to remove references to or requirements of reliance on credit ratings and to substitute appropriate standards of creditworthiness. Numerous federal agencies have proposed or finalized rules that would modify their regulations and forms to comply with these requirements. Among others, the federal banking regulators sought initial public comment on proposed removals of references to rating agencies from the risk-based capital rules; the SEC proposed rules that would remove rating agency references from many of its investment company rules and forms, its registration statement forms, and its rules and forms applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions; the FDIC issued a final rule removing credit ratings from the calculation of deposit insurance risk-based assessments for large insured depository institutions; and the NCUA issued a proposed rule for public comment.

### 6.2.7 OFR

The Dodd-Frank Act also created the OFR in Treasury to, among other things, improve the quality of financial data and provide analytical support to the Council and its member agencies. The Director of the OFR must be appointed by the President and confirmed by the U.S. Senate. Treasury staff and personnel from other Council member agencies have worked to set up a framework for the OFR's functions. The OFR has made significant progress in meeting its statutory mandates. It is working closely with Council member agencies to improve the research and data capabilities of the regulatory community. The OFR has also issued a policy statement regarding the establishment of a universal "legal entity identifier" that would allow the Council to aggregate measures of risk across the system; made progress in establishing a research network that includes academics from several universities; and initiated the planning process for creating a data

center to set standards for financial reporting and to improve the quality of data that the Council and market participants rely on to manage risk.

### *6.2.8 Consolidation of Federal Banking Regulators*

The Dodd-Frank Act provides for the termination of the Office of Thrift Supervision (OTS), which had been the primary regulator of savings and loan holding companies and state and federally chartered savings associations, and for the transfer of its responsibilities to the Federal Reserve, the FDIC, and the OCC. This transfer occurred on July 21, 2011. As of that date, in accordance with plans prepared by these agencies, the Federal Reserve assumed responsibility for regulating savings and loan holding companies; the FDIC for regulating state savings associations; and the OCC for regulating federal savings associations. The Director of the CFPB will assume the seat of the Director of the OTS on the board of the FDIC.

## 6.3 Consumer and Investor Protection

### *6.3.1 Consumer Protection*

On July 21, 2011, most rulemaking and certain other authorities relating to consumer financial products and services transferred to the CFPB from seven federal agencies. The CFPB launched bank supervision, consumer response, and other functions on that date, and has issued a variety of required rules and reports under the Dodd-Frank Act. The CFPB is now the primary federal regulator focused on, and held accountable to Congress and the public for, consumer financial protection. The CFPB will work to ensure that consumers have the information they need to understand the costs and risks of financial products and services, so that they can compare products and choose the ones that are best for them. The CFPB also will clarify and streamline regulations and guidance to reduce unnecessary burdens on providers of consumer financial products and services.

Among its other duties, the CFPB will:

- conduct rulemakings with respect to federal consumer financial laws, including prohibitions on discrimination and unfair, deceptive, or abusive acts or practices, and supervise and enforce these laws for many financial service providers;
- take consumer complaints;
- promote financial education; and
- monitor financial markets for new risks to consumers.

The Dodd-Frank Act gives the Treasury Secretary responsibility for setting up the CFPB until the CFPB Director is in place. On September 17, 2010, President Obama appointed Professor Elizabeth Warren to serve as assistant to the President, and Secretary Geithner appointed her as special advisor to the Treasury Secretary on the CFPB. Professor Warren has led the effort to build the framework for the CFPB and, in consultation with other senior Treasury officials, helped to appoint a leadership team to assist with implementation. On July 18, 2011, President Obama nominated former Ohio Attorney General Richard Cordray as Director of the CFPB.

One of the CFPB's highest priorities is consolidation of mortgage loan disclosure forms under the Truth in Lending Act and the Real Estate Settlement Procedures Act, both to make the information more useful to consumers and to reduce burdens on lenders. Existing federal regulators first began discussing consolidation of these forms a number of years ago. The Dodd-Frank Act consolidates rulemaking authority under the two statutes in the CFPB and mandates that the CFPB propose model forms by July 2012. The CFPB began testing prototype disclosure forms this spring through qualitative interviews with consumers, lenders, and brokers. The CFPB continues to gather input from industry, consumers, and other stakeholders via its website.

Also in the context of mortgages, significant progress has been made on a rule mandated by the Dodd-Frank Act requiring lenders to assess and verify consumers' ability to repay mortgage loans as part of the underwriting process. The Federal Reserve proposed a rule in April 2011 for public comment. The CFPB will be responsible for finalizing a rule after considering the public comments on the proposal.

### 6.3.2 Debit Interchange

Debit card interchange fees, which are established by a payment card network and ultimately paid by merchants to card issuers, became subject to regulation by the Federal Reserve under Section 1075 of the Dodd-Frank Act, referred to as the Durbin Amendment. The Durbin Amendment, among other things, requires the Federal Reserve to adopt a rule that sets standards for assessing whether the amount of an interchange fee for an electronic debit (but not credit) transaction is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. The fee standards do not apply to an issuer that, together with its affiliates, has less than $10 billion in assets, or to transactions initiated using debit cards issued pursuant to government-administered payment programs and certain reloadable prepaid cards.

After requesting comment on a proposed rule in December 2010, the Federal Reserve received comments from more than 11,500 commenters. On June 29, 2011, the Federal Reserve approved a final rule providing that the amount of an interchange fee that a covered issuer may receive may not exceed the sum of 21 cents plus 5 basis points of the transaction's value. The final rule also prohibits circumvention or evasion of the interchange fee standard, as well as an issuer receiving net compensation from a payment card network. The final rule exempts the statutorily exempt issuers and transactions from the interchange fee standard but does not mandate two-tier interchange fee structures.

The Federal Reserve also approved an interim final rule allowing an upward adjustment of no more than 1 cent to the permissible interchange fee. This adjustment makes allowance for an issuer's debit card fraud-prevention costs, provided the issuer satisfies the fraud-prevention standards set forth in the interim final rule. Comments on the interim rule are due by September 30, 2011; the Federal Reserve has stated that it will re-evaluate this adjustment, as appropriate, in light of the comments received.

In addition, the final rule implements the payment card network exclusivity and routing provisions of the Durbin Amendment by requiring each debit card be enabled on no fewer than two unaffiliated payment card networks and prohibiting an issuer or network from inhibiting the ability of any person that accepts debit cards as a form of payment from directing the routing of debit card transactions for processing. The statutory exemptions from the interchange fee standards do not extend to the network exclusivity and routing provisions in the final rule.

The interchange fee standards, fraud-prevention adjustment, and the routing restrictions are effective on October 1, 2011. The network exclusivity provisions are effective on April 1, 2012, with respect to issuers, and October 1, 2011, with respect to payment card networks. Issuers of certain health-related and other benefits cards and general-use prepaid cards have a delayed effective date of April 1, 2013, or later in certain circumstances.

### 6.3.3 Mortgage Transactions

Title XIV of the Dodd-Frank Act, the "Mortgage Reform and Anti-Predatory Lending Act," contains several measures designed to protect consumers in mortgage transactions. Many of these measures were enacted as amendments to the Truth in Lending Act (TILA). Prior to the designated transfer date, July 21, 2011, the Federal Reserve was responsible for regulations implementing TILA, but, in general, rulemaking authority under TILA transferred to the CFPB on that date.

In October 2010, the Federal Reserve issued an interim final rule to implement the appraisal independence provisions in Section 1472 of the Dodd-Frank Act. The interim rule seeks to ensure that appraisers are free to use their independent professional judgment. To protect the quality of appraisals, the rule also requires independent appraisers to receive customary and reasonable compensation for their services. Compliance with the rule became mandatory on April 1, 2011. Several regulatory agencies are jointly responsible for issuing permanent rules on appraisal independence.

In February 2011, the Federal Reserve issued a final rule pursuant to Section 1461 of the Dodd-Frank Act to revise the escrow requirement for jumbo mortgage loans. As amended, the escrow requirement will

apply to first-lien jumbo loans only if the loan's annual percentage rate is 2.5 percentage points or more above the average prime offer rate. Also in February 2011, the Federal Reserve issued a proposed rule to implement additional escrow account requirements for higher-priced loans pursuant to Sections 1461 and 1462 of the Dodd-Frank Act. The proposed rule would expand the minimum period for mandatory escrow accounts, while providing an exemption for certain creditors that operate in "rural or underserved" counties. The proposed rule also would implement new disclosure requirements.

In April 2011, the Federal Reserve issued a proposed a rule to implement the provisions of Title XIV relating to the requirement for a creditor to determine a consumer's ability to repay a mortgage loan before extending the loan. The proposed rule would provide four options for complying with the ability-to-repay requirement. A creditor could meet the standard by: (1) considering and verifying specified underwriting factors, such as the consumer's income, assets, and obligations; (2) making a "qualified mortgage," which is subject to certain limitations on loan terms and features; (3) making a balloon-payment qualified mortgage, for certain creditors operating predominantly in rural or underserved areas; or (4) refinancing a "non-standard mortgage" with risky features into a more stable "standard mortgage" with a lower monthly payment.

### *6.3.4 Investor Protection*

The Dodd-Frank Act includes various provisions to strengthen investor protection, such as those promulgated under the regulatory actions discussed above and below. These provisions include regulation of the over-the-counter derivatives markets and governance and compensation reform.

A key investor protection provision requires the SEC to complete a study of any gaps, shortcomings, or overlaps in the standard of conduct and supervision of broker-dealers and investment advisers that provide personalized investment advice about securities to retail customers. The SEC staff completed this study in January 2011. The study recommends that the SEC establish a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers that is no less stringent than the standard currently applied under Sections 206(1) and (2) of the Advisers Act. In addition, the staff recommended that broker-dealers and investment advisers be subject to the same or substantively similar regulatory requirements when providing services to retail investors.

The SEC also completed a study of the need for enhanced examination and enforcement resources for investment advisers, and in particular, the extent to which having Congress authorize the SEC to designate a self-regulatory organization (SRO) to augment the SEC's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers. This study recommended presenting Congress with three options:

1. Authorize the SEC to impose user fees on investment advisers to fund their examinations.
2. Authorize an SRO to examine investment advisers.
3. Authorize the Financial Industry Regulatory Authority to examine dual-registrants for compliance with the Advisers Act.

The SEC finalized rules in June 2011 that will implement provisions in Section 410 of the Dodd-Frank Act. The rules will realign the regulatory responsibilities of investment advisers between the state securities regulators and the SEC. These provisions increased the number of investment advisers that will be primarily regulated by the states. Estimates indicate that as a result of these changes, approximately 3,200 investment advisers will transition from SEC registration to state registration. That transition is scheduled to conclude by mid-2012.

The securities laws also were modified in a number of ways to facilitate SEC enforcement actions. These changes include enhancing the application of antifraud provisions and providing authority to bring actions against aiders and abettors.

### *6.3.5 Governance and Compensation*

The financial crisis showed that improperly structured compensation arrangements can lead executives and employees of financial institutions to

take imprudent risks that are not consistent with the long-term health of their organizations. To facilitate prudent risk management at financial institutions and to align the interests of executives and other employees with the long-term health of their organizations, Section 956 of the Dodd-Frank Act requires the Federal Reserve, FDIC, FHFA, NCUA, OCC, OTS, and SEC to jointly prescribe rules or guidelines that (1) require certain financial institutions to disclose to their appropriate federal regulator the structure of their incentive-based compensation arrangements so the regulator can determine whether such compensation is excessive or could lead to material financial loss to the firm; and (2) prohibit any type of incentive-based compensation that the regulators determine encourages inappropriate risks by providing excessive compensation or that could lead to material financial loss to the covered firm.

In April 2011, the agencies published a three-part proposed rule for public comment. First, a financial institution with $1 billion or more in total consolidated assets (a covered financial institution) would be required to file an annual report with its appropriate federal regulator describing the structure of the firm's incentive-based compensation arrangements. Second, the proposed rule would prohibit a covered financial institution from establishing or maintaining an incentive-based compensation arrangement that could lead to material financial loss or that encourages inappropriate risks by providing certain "covered persons" (which include all executives and employees) with excessive compensation. Finally, the proposed rule would require each covered financial institution to adopt specific policies and procedures approved by its board to ensure and monitor compliance with the rule.

The prohibitions portion of the proposed rule would require larger covered financial institutions—those with $50 billion or more in total consolidated assets—to defer at least 50 percent of the incentive compensation of executive officers and heads of major business lines for at least three years, award such compensation no faster than on a pro-rata basis, and seek to ensure that the amounts ultimately paid over the course of the deferral period reflect losses or other aspects of performance over time. For these larger covered financial institutions, the prohibitions portion of the proposed rule would also set forth additional requirements for employees of the firm who might have the ability to expose the institution to risk of substantial loss. For these employees, the board of directors or a board committee would be charged with identifying the persons (other than the executive officers subject to deferral requirements) who individually have the ability to expose the firm to possible losses that are substantial in relation to the firm's size, capital, or overall risk tolerance. Once such persons are identified, the board or committee would need to approve the incentive-based compensation arrangement for each person. For credit unions, large financial institutions would be defined as those with $10 billion or more in assets. The FHFA proposed that the income-deferral provisions apply to all entities it regulates, regardless of size.

In addition, on January 25, 2011, the SEC adopted final rules implementing provisions of the Dodd-Frank Act that require public U.S. companies to conduct separate shareholder votes on executive pay (say-on-pay) and on the frequency of the say-on-pay vote, as well as specific disclosures about any agreements to offer a form of executive compensation (so-called golden parachutes) in connection with merger and acquisition transactions.

## 6.4 Council Activities

### *6.4.1 Determination of Nonbank Financial Companies to Be Supervised by the Federal Reserve and Designation of Financial Market Utilities*

#### Nonbank Financial Companies

One of the Council's statutory purposes is to identify risks to financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected BHCs, or nonbank financial companies. Under Section 113 of the Dodd-Frank Act, the Council is authorized to determine that a nonbank financial company's material financial distress—or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities—could pose a threat to U.S. financial stability. Such companies will be subject to consolidated supervision by the Federal Reserve and enhanced prudential standards.

The Dodd-Frank Act provides a list of 10 considerations the Council must use in making determinations under Section 113. In fall 2010, the Council began a rulemaking process to further clarify these statutorily mandated considerations. Seeking public input on the criteria, the Council issued an advance notice of proposed rulemaking (ANPR) in October 2010 and a notice of proposed rulemaking (NPR) in January 2011. The Council received significant input from market participants, nonprofits, academics, and members of the public about the need to develop an analytical framework for making determinations that will provide a consistent approach and will incorporate both quantitative and qualitative judgments. The Council expects to seek additional public comment regarding its approach to determinations and the considerations mandated by the Dodd-Frank Act, and to publish a final rule describing the process and guidance regarding the criteria for its determinations.

The Council's proposed analytical framework organizes the 10 statutory considerations into six broad categories that reflect a company's role in the financial system and potential to experience material financial distress. Three of these six categories—size, lack of substitutes for the financial services and products the company provides, and interconnectedness with other financial companies—seek to assess the potential for spillovers from one company's financial distress to the broader financial system and real economy. The other three categories—leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny—indicate the vulnerability of a company to distress, whether it is an idiosyncratic or systemic shock.

The Council's commitment to a robust determination process goes beyond transparency during rulemakings. Each determination will be firm-specific. Before an initial Council vote on a proposed determination, the company under consideration will have an opportunity to submit written materials to the Council regarding the proposed determination. Council members will vote on a proposed determination only after they have reviewed that information, and the proposed determination will proceed only if approved by two-thirds of the Council, including the affirmative vote of the Chairperson. Upon a proposed determination, a company may request a hearing, and the determination will be finalized only after a subsequent two-thirds vote of the Council, including the affirmative vote of the Chairperson. The Council must submit a report to Congress detailing its final decision, which will be subject to judicial review.

As of the date of this report, the Council has not made any determinations under Section 113 of the Dodd-Frank Act.

### Financial Market Utilities

Financial market utilities (FMUs) exist in many markets to support and facilitate the payment, clearing, or settlement of financial transactions, thereby forming a critical part of the nation's financial infrastructure. However, the function and interconnectedness of FMUs also concentrate risk because the systems they operate are highly interdependent, either directly through operational, contractual, or affiliation linkages, or indirectly through liquidity flows or common participants. Problems at one system could spill over to other systems or financial institutions in the form of liquidity and credit disruptions. Accordingly, the Dodd-Frank Act provides the Council with the ability to designate an FMU as systemically important if the Council determines that the failure of or a disruption to the functioning of an FMU's operations could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system.

An FMU designated by the Council will be subject to enhanced prudential standards and supervisory requirements, such as heightened risk management standards beyond existing regulatory oversight that may otherwise be applicable. Designation further subjects an FMU to additional examinations, enforcement actions, and reporting requirements. Under unusual or exigent circumstances, designated FMUs could potentially gain access to the Federal Reserve's discount window.

Following the publication of an ANPR in December 2010 and an NPR in March 2011, and two corresponding rounds of public comment, the Council approved a final rule outlining the criteria,

processes, and procedures for the designation of FMUs at its July 18, 2011 meeting. As of the date of this report, the Council has not made any designations under Title VIII of the Dodd-Frank Act. The Council expects to address the designation of payment, clearing, or settlement activities in a separate rulemaking.

#### *6.4.2 Risk Monitoring*

One of the Council's central purposes is the ongoing identification of risks to U.S. financial stability. To help identify risks, promote market discipline, and respond to emerging threats, the Council facilitates information sharing, coordination, and communication among member agencies.

In the past year, the Council examined significant market developments and structural issues within the financial system, including topics discussed elsewhere in this report. The Council will continue to monitor potential threats to financial stability, whether from external shocks or structural weaknesses.

To facilitate this risk-monitoring process, the Council established the Systemic Risk Committee (SRC), composed primarily of agency staff in supervisory, examination, surveillance, and policy roles. The SRC helps the Council identify, analyze, and monitor risks to financial stability, and provides the Council with periodic risk assessments. Accountable for interagency coordination, the SRC meets periodically to share information to assess risk-related issues that affect financial markets and institutions and financial stability. This forum enables member agency staff to identify and analyze potential risks that may extend beyond the jurisdiction of any one agency and to collaborate on regulatory responses.

#### *6.4.3 Studies Required Under the Dodd-Frank Act*

##### Section 619 Study: The Volcker Rule

Section 619 of the Dodd-Frank Act, known as the Volcker Rule, strengthens the financial system and constrains risks by generally prohibiting banking entities from engaging in proprietary trading and limiting their investment in or sponsorship of hedge funds and private equity funds. The Dodd-Frank Act requires the Council to issue a study and make recommendations on the implementation of the Volcker Rule within six months after the enactment of the Dodd-Frank Act. In October 2010, the Council sought input from the public in advance of the study by issuing a request for information; it received more than 8,000 comments. The Council issued the final study at its meeting on January 18, 2011.[2] The Council's study recommends principles for implementing the Volcker Rule and suggests a comprehensive framework for identifying activities prohibited by the rule, including an internal compliance regime, quantitative analysis, and reporting and supervisory review.

##### Section 622 Study: Concentration Limits

Under the Dodd-Frank Act, the Council was also required to issue a study and make recommendations on the implementation of Section 622 within six months of the Dodd-Frank Act's enactment. Section 622 establishes a financial-sector concentration limit generally prohibiting a financial company from merging or consolidating with, or acquiring the assets of or control of, another company if the resulting company's consolidated liabilities would exceed 10 percent of the aggregate consolidated liabilities of all financial companies. This concentration limit is intended, along with a number of other provisions in the Dodd-Frank Act, to promote financial stability and prevent large financial institutions from becoming "too big to fail."

The Council issued the report at its meeting on January 18, 2011, meeting the statutory deadline. The Council's study concludes that the concentration limit will reduce moral hazard, increase financial stability, and improve efficiency and competition within the U.S. financial system. The study also includes largely technical recommendations to mitigate practical difficulties likely to arise in the administration and enforcement of the concentration limit, without undermining its effectiveness in limiting excessive concentration among financial companies.

On February 8, 2011, the Council published a notice and request for comment on the recommendations in the concentration limit study.

2 The report and other reports cited in this section are available online at http://www.fsoc.gov/

### Section 946 Study: Risk Retention

The Treasury Secretary, as Chairperson of the Council, issued a study on the macroeconomic effects of the Dodd-Frank Act's risk-retention requirements for asset-backed securities, as required by Section 946, within 180 days of the Act's enactment. This study, which is separate from the joint rulemaking on risk retention under Section 941, was delivered to Congress on January 18, 2011. The study recognizes the economic benefits of asset-backed securitization but notes that without reform, risks arising in the securitization process can detract from these benefits. The study provides several objectives that a risk-retention framework should seek to achieve to help promote safe and efficient lending.

### Section 123 Study: Economic Impact

The Dodd-Frank Act directs the Treasury Secretary, as Chairperson of the Council, to carry out a study within 180 days of the Act's enactment (and every five years thereafter) addressing the economic impact of possible financial services regulatory limitations intended to reduce systemic risk. The statute requires the study to estimate the benefits and costs of various potential regulatory limits on the efficiency of capital markets, on the financial sector, and on national economic growth, and to make recommendations on the optimal structure of those limits.

The Council Chairperson met the statutory deadline, publishing the study on January 18, 2011. The study contains a critical review of existing research on the impact of the types of financial regulation identified in Section 123 of the Dodd-Frank Act, as well as recommendations for future research to better quantify the benefits of the Act and financial regulation generally. The study recommends that a cost-benefit analysis of other potential limitations on the activities or structure of large financial institutions be addressed in the next periodic study, which is due in 2016.

### Section 215 Report: Secured Creditor Haircuts

The Dodd-Frank Act also required the Council to issue a report within one year of the Act's enactment, evaluating the importance of maximizing U.S. taxpayer protections and promoting market discipline with respect to the treatment of fully secured creditors in the utilization of the OLA. Among other topics, the study outlines how various secured creditors are treated in existing resolution regimes and examines whether a secured creditor haircut would be an effective means of improving market discipline and protecting U.S. taxpayers. The Council approved this report for submission to Congress on July 18, 2011.

## *6.4.4 Rulemaking Coordination by the Council*

As Chairperson of the Council, the Treasury Secretary is required to coordinate several major rulemakings by the member agencies under the Dodd-Frank Act.

To facilitate the joint rulemaking on credit risk retention for asset-backed securities, certain member agencies participated in an inter agency working group to develop the rule text and preamble for an NPR for public comment. The Dodd-Frank Act generally requires that securitizers retain at least 5 percent of the credit risk of an asset sold to investors through the securitization process. It also calls for specific exemptions from this requirement, such as for asset-backed securities that are collateralized solely by qualified residential mortgages. The purpose of the risk-retention requirement is to help address the misalignment of interests and deterioration of underwriting standards in the securitization markets leading up to the financial crisis. The Federal Reserve, FDIC, SEC, OCC, Department of Housing and Urban Development, and FHFA issued a joint NPR on March 30, 2011 that proposes rules to implement this requirement and represents a significant step toward strengthening securitization markets. The agencies extended the comment period for the proposed rule from June 10, 2011 to August 1, 2011.

The Chairperson of the Council is also required to coordinate the issuance of final regulations implementing the Volcker Rule, which are required to be issued within nine months of the publication of the Volcker Rule study described above. The Council Chairperson has played an active role in coordinating the agencies' work to develop consistent and comparable regulations and to promote the consistent application of those regulations.

### *6.4.5 Operations of the Council*

The Dodd-Frank Act requires the Council to convene no less than quarterly. In its first year, the Council's principals met approximately every eight weeks.[3] The meetings bring principals from member agencies together to discuss and analyze emerging market developments and financial regulatory issues. The Council is committed to conducting its business as openly and transparently as practicable, given the confidential supervisory and sensitive information at the center of its work. The Council opens its meetings to the public whenever possible. The Council held a public session at five of its meetings and has committed to holding at least two open sessions each year.

The Council's committee structure promotes accountability and coordination among the staffs of the member agencies. Due to the substantive agenda of the Council in its first year, every two weeks, the Deputies Committee, which is composed of senior officials from each of the Council's member agencies, has convened to discuss the Council's agenda and to direct the work of the SRC and the five other functional committees. As mentioned above, the SRC supports the Council's efforts to monitor the U.S. financial system and identify potential threats to the health of the system. The other functional committees are organized around the Council's ongoing statutory responsibilities: identifying nonbank financial firms and financial market utilities for designation; making recommendations to primary financial regulatory agencies regarding heightened prudential standards for financial firms; consulting with the FDIC on orderly liquidation authority and reviewing resolution plans for designated nonbank financial firms and the largest BHCs; and collecting data and improving data-reporting standards.

To help with the identification of emerging risks in the financial system, the Council may request data and analyses from the newly created OFR housed in Treasury. The OFR will support the Council and its member agencies by providing critical data and research as well as the analytical tools required to monitor and respond to future emerging vulnerabilities. The OFR will also work with member agencies to reduce reporting burdens and increase market transparency.

#### Council Administration

In its first year of operation, the Council has worked to establish its institutional framework; adopted rules of operation[4]; released proposed regulations implementing its Freedom of Information Act obligations; and passed its first budget. The Council also adopted a transparency policy[5] and has complied with the policy.

### *6.4.6 Section 119 of the Dodd-Frank Act*

Section 119 of the Dodd-Frank Act provides that the Council may issue nonbinding recommendations to member agencies on disputes about the agencies' respective jurisdiction over a particular BHC, nonbank financial company, or financial activity or product. (Certain consumer protection matters, for which another dispute mechanism is provided under Title X of the Act, are excluded). To date, no member agency has approached the Council to resolve a dispute under Section 119.

3 The Council met on October 1, 2010; November 23, 2010; January 18, 2011; March 17, 2011; May 24, 2011; July 13, 2011; and July 18, 2011.

4 The rules of operation are available online at http://www.fsoc.gov/

5 The transparency policy is available online at http://www.fsoc.gov/