The stated purpose of the Dodd-Frank Wall Street Reform and Consumer Protection Act is “to restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them.” The 2,319-page act has a plethora of provisions addressing everything from mortgage reform to the liquidation of large financial institutions. The three main areas covered by the act are consumer protection, banking regulation, and Wall Street reform.

The following is a discussion of the salient sections of the Dodd-Frank Act that CPAs and financial professionals will be most interested in.

The Consumer Financial Protection Bureau

The act creates an independent financial watchdog housed within the Federal Reserve—the Consumer Financial Protection Bureau (CFPB). The CFPB has the authority to ensure that consumers get the clear and accurate information they need to make sound credit decisions. It is directed to protect consumers from hidden fees, abusive terms, and deceptive practices.

According to the act, the director of the CFPB will be appointed by the President and confirmed by the Senate. The bureau will autonomously write rules for consumer protection governing all financial institutions—bank and nonbank—that offer consumer financial products and services. The CFPB will have the authority to examine and enforce regulations for banks and credit unions with assets over $10 billion, as well as all mortgage-related businesses, payday lenders, and student lenders. Large nonbank financial institutions, such as debt collectors and credit reporting agencies, will also be regulated and examined by the CFPB. Banks with assets under $10 billion will be examined for consumer complaints by the appropriate bank regulator.

The CFPB consolidates and strengthens consumer protection responsibilities currently handled by the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, the National Credit Union Administration, the Department of Housing and Urban Development (HUD), and the Federal Trade Commission. Congress wanted to make one office responsible for consumer financial protection. The prior structure, consisting of several agencies with overlapping responsibilities, made it difficult to assign accountability. As a result, emerging problems were often not addressed in a timely manner.

The CFPB will oversee federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for individuals and communities. The bureau will monitor consumer financial products and services so that consumers will not have to wait for congressional action in order to be protected from bad business practices. The CFPB will be required to work with...
Investor Protection

The act gives the SEC the authority to impose a fiduciary duty on brokers who give investment advice. A fiduciary duty requires investment advice to be in the best interest of the client. The act also creates an Investment Advisory Committee that will be composed of investors who will advise the SEC on regulatory priorities and practices.

An Office of the Investor Advocate will also be established. This office will identify areas where investors have significant problems with the SEC. The office will employ an investor ombudsman to provide investor services and handle investor complaints.

An outside consultant will be hired to conduct a comprehensive study of the SEC. In addition, the commission will conduct an annual assessment of its internal supervisory controls. The Government Accountability Office will conduct a review of SEC management.

PACOB and SOX Reforms

Registration of auditors of brokers and dealers: The act amends the Sarbanes-Oxley Act of 2002 (SOX) to require auditors of all broker-dealers to register with the Public Company Accounting Oversight Board (PACOB). The PACOB is authorized by the Dodd-Frank Act to adopt rules for the inspection of audit reports of broker-dealers. The PACOB has also been given the authority to set auditing and independence standards for audits of broker-dealers. Rules adopted by the PACOB for broker-dealer audits must be approved by the SEC.

The PACOB may conduct and require a program of inspection of registered public accounting firms that provide one or more audit reports for a broker-dealer. The act allows the PACOB to differentiate among different classes of brokers and dealers. In particular, the PACOB is instructed to consider different inspection schedules for registered public accounting firms that issue audit reports only for one or more brokers or dealers that do not receive, handle, or hold customer orders or cash, or are not members of the Securities Investor Protection Corporation.

The act reconciles registration with inspection so that any auditors not covered by the inspection rule would also no longer be required to register with the PACOB.

Smaller companies permanently exempt from internal control requirements. The act provides a permanent exemption from SOX section 404(b) for companies with a market capitalization of less than $75 million. To date, a temporary order of the SEC has relieved these businesses of the internal control reporting requirements of SOX.

The act not only makes this exemption permanent but requires the SEC to conduct a study within nine months of enactment on how to reduce the section 404(b) requirements for companies with market capitalizations between $75 million and $250 million. The act requires the study to consider whether the exemption or reduction of SOX section 404(b) compliance would encourage companies to list on exchanges.

Information sharing with foreign auditor oversight authorities: The act allows the PACOB to share information with foreign auditor oversight authorities. The intent of this provision is to encourage foreign countries to allow the PACOB to inspect their auditing firms. The PACOB has stated that many countries have been resistant to inspection because the PACOB was barred under SOX from sharing inspection information with foreign auditor oversight bodies. With this restriction eliminated by the Dodd-Frank Act, the PACOB believes foreign countries may be less resistant to the inspection of their country’s auditing firms.

Credit Scores, Deposit Insurance, and Interchange Fees

The act requires that consumers be given free access to their credit score if it negatively impacts them in a financial transaction or hiring decision. Consumers will be given credit score disclosure as part of an adverse action and risk-based pricing notice.

The act institutes a permanent increase in federal deposit insurance for banks, thrifts, and credit unions. The $250,000 deposit insurance amount is retroactive to January 1, 2008.

The act directs the Federal Reserve to issue rules governing interchange fees. Interchange fees are fees charged to merchants by financial institutions for processing credit and debit card transactions. The rules will ensure that interchange fees are reasonable and proportional to the costs of processing transactions.

Executive Compensation

Congress’s intent in drafting this section of the Dodd-Frank Act was to give share-
holders a voice in executive compensation. The act allows shareholders a nonbinding vote on executive compensation plans and “golden parachute” plans. The nonbinding vote is meant as a vehicle for shareholders to express their displeasure with compensation plans.

The act grants the SEC the authority to give shareholders proxy access to nominate directors. In addition, in noncontested elections, directors must receive a majority of the votes to be elected. This provision is intended to shift management focus from short-term goals to long-term goals.

The act alters standards for listing on an exchange to include the provision that compensation committees contain only independent directors. The new standards also require that the compensation committee be given the authority to hire compensation consultants to strengthen their independence. The act also requires companies to set policies that take back executive compensation if it is based on inaccurate financial statements that do not conform to accounting standards.

The SEC is directed to clarify the disclosure of executive compensation. Companies will be required to provide charts comparing their executive compensation plans with their stock performance over a five-year period. Provisions in the act require federal financial regulators to issue and enforce joint compensation rules applicable to institutions governed by federal regulators.

Reforming the Federal Reserve

The act makes significant changes to the Federal Reserve. Some of the changes expand its powers; others limit its powers and, to some extent, its independence.

The Government Accountability Office (GAO) will conduct a one-time audit of the emergency lending by the Federal Reserve that took place during the current financial crisis. The details of the audit will be published on the Federal Reserve’s website by December 31, 2010. Going forward, the Secretary of the Treasury must approve any of the Federal Reserve’s lending programs. The loans must be broad-based and cannot be made to insolvent firms. The collateral must be sufficient to protect taxpayers from losses.

In the future, the GAO will have the power to audit on an ongoing basis two areas of the Federal Reserve that it had never been allowed to audit before: discount window lending and open market transactions. In addition, the Federal Reserve will be required to periodically disclose information about its discount window lending and open market transactions, including the counterparties, amounts, and terms.

The discount window allows eligible institutions to borrow money to meet short-term cash shortages. This area was not previously subject to audit, as the Federal Reserve feared that disclosing the recipients of these loans might discourage troubled banks from accessing the window. Open market operations are the principal tool of monetary policy exercised by the Federal Reserve.

Regulation of nonbank financial companies and subsidiaries. Under the provisions of the act, the Federal Reserve is given the authority to supervise nonbank financial companies that pose a systematic risk to the financial stability of the United States. The Financial Stability Oversight Council will determine which nonbank financial companies will be subject to Federal Reserve regulation.

The Federal Reserve will examine nonbank subsidiaries that are engaged in activities comparable to subsidiary banks. The examinations will be done in the same manner and on the same schedule as bank exams.

Governance and supervision. The President will appoint a vice chairman for supervision of the Federal Reserve from the Board of Governors. The vice chairman will develop policy recommendations regarding supervision and regulation of the Board of Governors and will report to Congress semiannually on board supervision and regulation efforts.

The election process for Federal Reserve Bank district presidents has been modified under the new law. Going forward, class A directors, elected by member banks to represent member banks, will no longer vote for Federal Reserve Bank district presidents. District presidents will be elected by class B directors, who are elected by member banks to represent the public, and class C directors, who are elected by the Board of Governors to represent the public. The GAO will also conduct a study of the current system for appointing Federal Reserve Bank directors to examine whether it effectively represents the public.

The Volcker Rule

The Dodd-Frank Act implements a strong version of the Volcker Rule (a proposal by former Federal Reserve chair and chair of the President’s Economic Recovery Advisory Board, Paul Volcker). Based on its provisions, banks are prohibited from proprietary trading and investing their money in hedge funds. The act provides a small exemption for hedge fund and private equity fund investments of up to 3% of bank Tier 1 capital. Tier 1 capital consists mainly of stockholders’ equity.

The act requires regulators to establish regulations for banks, their affiliates, and holding companies that prohibit proprietary trading in, investment in, and sponsorship of hedge funds and private equity funds. Banks will also be required to limit their relationships with hedge funds and private equity funds; however, they will still be allowed to engage in certain derivative trades on behalf of clients. Specifically, banks will be able to conduct client trades in interest rate swaps, foreign currency swaps, derivatives referencing gold and silver, and high-grade credit-default swaps. Banks will also be able to trade derivatives for themselves if hedging existing positions.

Nonbank financial institutions supervised by the Federal Reserve will also have restrictions on proprietary trading and investment in hedge funds and private equity investment. The Financial Stability Oversight Council (FSOC) will conduct a study to assist the regulators in establishing these rules.

The Financial Stability Oversight Council

The FSOC is charged with identifying and addressing systematic risk throughout the financial system. The FSOC will be chaired by the Treasury Secretary and will include the Federal Reserve Board, the SEC, the U.S. Commodity Futures Trading Commission (CFTC), the FDIC, the Office of the Comptroller of the Currency, the National Credit Union Association, the Federal Housing and Finance Agency, and the new CFPB. The FSOC will also include five nonvoting members from the Office of Financial Regulation; the new Federal Insurance...
Office; and state banking, insurance, and securities regulators.

The FSOC will make recommendations to the Federal Reserve for increasingly tough capital, leverage, liquidity, and risk management regulations. As companies increase in size and complexity, regulation will be increased. Companies that pose a significant risk to the financial system will face the toughest regulations. Congress included these provisions in the bill to discourage an excessive growth and complexity of financial institutions. Large bank holding companies that received Troubled Asset Relief Program (TARP) funds will not be able to evade these Federal Reserve provisions simply by dropping their banks. Congress cleverly named this the “Hotel California” provision.

The Federal Reserve will be permitted to regulate nonbank financial companies if two-thirds of the FSOC votes for the regulation. Congress intends for this provision to be instituted only when the council believes the company’s failure or its investment activities could cause significant risk to the financial system. The Federal Reserve may also be permitted to order large complex companies to divest some of their holdings if the FSOC approves of the measure with a two-thirds vote. According to the congressional mandate, this provision should only be instituted if the Federal Reserve believes that a company in its present form poses a grave threat to the financial stability of the United States. Congress stated that this provision should only be employed as a last resort.

The act establishes a framework to provide uniform risk management standards for systematically important market utilities and for the systematically important payment, clearing, and settlement activities of financial institutions.

The act creates an Office of Financial Research that will support the FSOC’s work by collecting financial data and conducting economic analyses. The office will be composed of economists, accountants, and lawyers and will be housed in the Treasury Department. The information provided by the Office of Financial Research will be used by the council to identify and monitor emerging risks. This information will be made public each year through congressional testimony and periodic reports.

Funeral Plans
The act requires large, complex financial institutions to periodically submit plans for an orderly shutdown in case of a financial failure. If companies fail to submit these plans, they will be subject to larger capital requirements and restrictions on growth and activity, as well as possible divestment of certain holdings. The purpose of these plans is to help regulators understand the structure of the companies that they regulate and to provide a blueprint for dissolution. Congress established strict penalties for failure to comply as an incentive for companies to construct credible plans.

Orderly liquidation process. If the Treasury, the FDIC, and the Federal Reserve all agree that the failure or bankruptcy of a financially significant firm would have an adverse effect on financial stability, upon judicial review, the FDIC can begin an orderly liquidation of the company.

The act provides for the shareholders and unsecured creditors to bear the losses upon liquidation. Taxpayers are not to bear any of the costs of the liquidation. The FDIC can borrow funds for the liquidation only up to the amount it expects to be repaid through asset sales. The government is to be repaid first. If the assets are not sufficient to repay the government debt, they may be repaid through the clawback of any payments to creditors that exceed the liquidation value. Management and directors who are found culpable for the financial failure will be removed from their positions.

Regulating Credit Rating Agencies
The act grants the SEC additional power and authority to monitor credit rating agencies.

SEC oversight. The act mandates structural changes within the SEC, authorizing the establishment of an Office of Credit Ratings (OCR). The OCR will be staffed with industry and compliance experts and will conduct annual reviews of each Nationally Recognized Statistical Rating Organization (NRSRO). NRSROs are federally registered credit rating agencies. There are more than 130 credit rating agencies worldwide, but only five have been designated as NRSROs by the SEC. Two of the five—Moody’s and Standard and Poor’s—control more than 80% of the ratings market.

The reviews will include, but are not limited to, an assessment of—
- the NRSRO’s ratings methodologies;
- the use of third parties for due diligence efforts;
- compliance to documented systems of internal control; and
- the overall business conduct of the NRSRO, based on a defined set of policies and procedures.

Based on OCR findings, the SEC will have the authority to set fines for noncompliance. NRSROs with a track record of poor performance may have their registration rescinded. The OCR reviews will be made public.

The act also establishes a seven-member self-regulatory advisory board. This board will advise the SEC and create rules and regulations to ensure that the SEC executes its oversight functions and responsibilities effectively. The board will report to Congress if it believes the SEC is not properly executing its oversight function.

Conflicts of interest. The credit rating agency (CRA) landscape is littered with conflicts of interest. Many financial experts believe that the “issuer-pay” model, whereby issuers rather than users pay a CRA for its ratings, is inherently flawed. The process is compromised because it enables the issuers to shop the market for favorable ratings. Senator Carl Levin (D-MI) commented on the flawed rating system at the recent Financial Crisis Inquiry Commission hearings: “It’s akin to having the plaintiff or the defendant paying the judge’s salary.” The new act charges the SEC with conducting a two-year study to establish a mechanism that will eliminate issuers from shopping the CRA market for favorable ratings.

Additional conflicts currently exist in the employment area. NRSRO employees are often hired by issuers recently rated by the NRSRO. Measures in the act attempt to eliminate these revolving-door practices. NRSROs will be required to conduct a one-year look-back review when certain employees go to work for an obligor or an underwriter of a security that has been rated by the NRSRO. In addition, the bill requires that NRSROs report to the SEC when certain employees become employed by an issuer, underwriter, or sponsor of an issue that the NRSRO has rated in the previous 12 months. The SEC is required to release this report to the public.
Increased liability. Since their inception, CRAs have successfully argued that credit ratings are opinions (i.e., expressions of free speech), and therefore protected by the First Amendment. For nearly 30 years, NRSROs have been shielded from “expert liability” under SEC Rule 436(g). The Dodd-Frank Act nullifies Rule 436(g), which opens the door to credible threats of liability. The act allows investors to bring private rights of action against NRSROs for knowing or reckless failure to conduct reasonable investigations of fact.

Education. The act requires the SEC to issue educational guidelines for CRA analysts who perform ratings. These analysts will be required to pass a qualifying exam that tests their knowledge of the ratings process. In addition, continuing education will be required to ensure that analysts meet the established standards of training, experience, and competence to produce reliable ratings.

Transparency for Financial Instruments

The Dodd-Frank Act regulates derivatives, hedge funds, and mortgage-backed securities. Disclosure requirements for derivatives, hedge funds, and mortgage-backed securities are required.

Derivatives. To prevent further abusive practices and excessive risk taking, the SEC and the CFTC will now regulate over-the-counter derivatives. All derivatives which can be cleared will be cleared. Regulators will determine which derivatives can be cleared. The Federal Trade Commission and the CFTC must preapprove derivative contracts before they can be cleared. In addition, foreign exchange contracts—the second-largest component of the swaps market—will be regulated.

Regulators will be given broad authority to punish any company that knowingly helps clients defraud third parties or the public. Congress stated that the reason this provision was included in the act is to prevent future occurrences of the type of behavior wherein Wall Street companies helped Greece to use swaps to hide the true state of the country’s finances. Penalties will be doubled in cases where the clearinghouse requirements are evaded.

Regulators are required to establish a code of conduct for all registered swap dealers. When acting as counterparties to a pension fund, state and local governments, or endowment funds, the swap dealers must have a reasonable basis to believe the entity has an independent representative advising them.

Hedge funds. Congress hopes to put an end to the “shadow financial system” by requiring hedge funds and private equity firms to register with the SEC as investment advisors. Hedge funds and private equity firms will also be required to provide information about their trades and portfolios so that regulators can assess systematic risk. The SEC will report to Congress annually on how it uses this data to protect investors and the integrity of the market.

The asset threshold for federal supervision of investment advisors will be raised from $30 million to $100 million, which will expand the number of advisors under state supervision. Congress believes that the states are strong regulators of investment advisors. Increasing the role of the states in this area will allow the SEC to focus more closely on newly registered hedge funds.

Mortgage-backed securities. The act has risk retention provisions for most mortgage-backed securities. These provisions require companies that sell mortgage-backed securities to retain at least 5% of a mortgage security. High-quality mortgages, which are made to high-quality borrowers and have low loan-to-value ratios, will be exempt from the risk retention provisions. Issuers will also be required to disclose more information about the underlying assets. Congress’s intent with these provisions is to make mortgage originators more prudent.

Municipal securities. In addition, the act calls for better oversight of the municipal securities industry. Municipal securities advisors will be required to register with the Municipal Securities Rulemaking Board (MSRB) and follow the board’s rules. These rules will be enforced by the SEC. The act imposes a fiduciary duty on municipal securities advisors to ensure that they adhere to the highest standard of care when advising municipal issuers. The act requires the MSRB to have a majority of independent members in order to better protect the public.

Funding

The estimated cost of the Dodd-Frank Act is $19 billion, a projection that includes the cost of implementing the act and the potential cost of any large bank liquidation. The $19 billion will be paid from unspent TARP funds, as well as from an extra premium that the FDIC will charge to large banks.

Historic Reform?

The Dodd-Frank Act is arguably the most comprehensive financial reform bill since the Glass-Steagall Act of 1933. Today, Glass-Steagall is widely regarded as effective legislation that restored confidence in the U.S. financial markets and kept them relatively safe for several decades. Years from now, will commentators view the Dodd-Frank Act as positively?

The act has been criticized by some for being too lenient, and it has been criticized by others for being too strict. The main critique of the act has been its failure to reform Fannie Mae and Freddie Mac. Other than a mandated two-year study on the feasibility of continuing federal funding, the mortgage giants that played what many consider to be a significant role in the recent financial crisis are not mentioned in the act. In addition, some question the soundness of writing the law before the congressional panel studying the financial crisis has issued its final report.

While the act is indeed lengthy, much of the reform and regulatory work is left up to new and existing regulators. The act does, however, provide a clear mandate for drafting the rules and regulations to implement the legislated financial reforms.

Upon release of the act, sponsor Senator Christopher J. Dodd (D-CT) commented: “It is a great moment. I’m proud to have been here … No one will know until it is actually in place how it works. But we believe we have done something that has been needed for a long time. It took a crisis until we could actually get this job done.”

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