protiviti®
Risk & Business Consulting.
Internal Audit.

FS Insights

Financial Services Industry Newsletter • *Special Edition:* Volume 4, Issue 4

Dodd-Frank at 3: Accepting Uncertainty

July 21, 2013, marks the third anniversary of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). In advance of the anniversary, the media is once again posing the same question it asked for the first two anniversaries: "What is taking so long?" As in the past, the media answers its own question, at least in part, by noting that the law's timetable was not realistic to begin with given the extensive burden it placed on the regulators to promulgate hundreds of complex rules. The media also acknowledges a further complication: A number of the regulations require consensus by more than one regulatory body. This time, however, the stories seem to be tinged with a bit more outrage: "But now that deadlines appear to have little meaning, it's very hard for the financial industry to know when *anything* is happening, which creates a damaging sense of uncertainty."[1]

U.S. Treasury Secretary Jacob Lew recently commented that the "core elements" of DFA will be enacted by year-end,[2] and the financial services regulators have signaled the same in recent Congressional testimony, although many remain skeptical of these assertions. Not only does this uncertainty frustrate planning efforts, but some believe that "regulatory uncertainty – and especially the persistent wave of political attacks on global universal banks" is having a direct impact on stock prices of financial institutions and that this, in turn, affects banks' abilities to help the economy grow.[3]

Impact aside, what we seem to have today is a situation where those in the industry are more willing to speak up about troubling issues. At the same time, they are not aggressively pushing for answers that may not be to their liking, being resigned instead to accept the continuing uncertainty and deal with a host of other regulatory and business challenges.

The Uncertainties

Although the various law firms and industry associations that track DFA progress may not be in complete agreement on the status of rulemaking, the consensus is that approximately half of the required DFA rules have yet to be finalized. Following is a small sampling of these rules:

- The Volcker Rule would prohibit banking organizations from conducting proprietary trading and investing, except for a *de minimis* amount, in private equity and hedge funds. One of the sticking points for the industry is the Volcker Rule's requirement to distinguish between legitimate market making, which would be permissible under the rule, and proprietary trading. Lloyd Blankfein, Goldman Sachs' chief executive officer (CEO) and chairman, recently likened this to trying to regulate a "state of mind" – an impossible task.[4]
- Regulation of the cross-border swaps market has been stalled due to lack of an international framework.
- The so-called "Swaps Push-Out" provision would require banking organizations to spin off some derivatives trading operations to separate units that are not eligible for Federal Deposit Insurance Corporation (FDIC) insurance or Federal Reserve discount window borrowing. Both the Federal Reserve and the Office of the Comptroller of the Currency (OCC) recently gave their supervised institutions a two-year reprieve on complying with this rule because of industry concerns that it was still unclear, given overlapping rules relating to swaps, and a lack of understanding of what activities must be pushed out.[5]
- A Uniform Fiduciary Standard could require broker-dealers to act in their clients' best interests and not simply recommend "suitable" products or, depending on how the cards fall, might allow registered investment advisers to operate under the suitability standards currently imposed on broker-dealers.

[1] "Dodd-Frank is 3. So why isn't it ready yet?," *The Washington Post,* DePillis, Lydia, July 2, 2013: www.washingtonpost.com/blogs/wonkblog/wp/2013/07/02/dodd-frank-is-3-so-why-isnt-it-ready-yet/.

[2] "U.S. Treasury's Lew: core of Dodd-Frank to be enacted by yr-end," *Reuters,* Forgione, Sam, July 17, 2013: www.reuters.com/article/2013/07/17/usa-lew-cnbcconference-idUSL1N0FN0EX20130717.

[3] "Regulatory Uncertainty Hurts Bank Stocks, Stifles Economy," *American Banker,* Calomiris, Charles W. and Nissim, Doron, April 23, 2013: www.americanbanker.com/bankthink/regulatory-uncertainty-hurt-banks-stocks-stifles-economy-1058568-1.html.

[4] "Goldman Sachs CEO: 'Responsibility' to Challenge Dodd-Frank," *The Fiscal Times,* Boak, Josh, June 13, 2013: www.thefiscaltimes.com/Articles/2013/06/13/Goldman-Sachs-CEO-Responsibility-to-Challenge-Dodd-Frank.aspx#page1.

[5] "OCC Delays Implementation of Swaps Push-Out Rule," *American Banker,* Witkowski, Rachel, June 12, 2013: www.americanbanker.com/issues/178_113/occ-delays-implementation-of-swaps-push-out-rule-1059790-1.html.

- Enhanced Prudential Standards would impose a host of new requirements (e.g., capital, liquidity, stress testing, single counterparty limits, risk committees, recovery and resolution framework) on large banking organizations and nonbank systemically important financial institutions (SIFIs).
- The Executive Pay Ratio Rule, a relatively straightforward, industry-agnostic requirement, would require that the ratio of CEO pay to the median of the pay of all other employees[6] be disclosed in a public company's proxy statement. This requirement has been met with tremendous backlash by the business community. The backlash seems to be having an impact, given the recent introduction of a bill in the U.S. House of Representatives to repeal the requirement on the grounds that it is too costly and burdensome.

The debate even continues about the rules that have been finalized – the best case in point being "too big to fail" (TBTF). While no one appears certain that we have solved TBTF (and no one likely wants to test it), supporters such as Sheila Bair, former chairman of the FDIC, and Thomas Hoenig, vice chairman of the FDIC, argue that the DFA at least has the "tools" to end "too big to fail." Critics, including Richard Fisher, president and chief executive of the Federal Reserve Bank of Dallas, and Jeffrey Lacker, president and CEO of the Federal Reserve Bank of Richmond, say the DFA doesn't solve the problem at all.[7]

Industry Activism

With the continued delays and passage of time since the financial crisis, the financial services industry, initially humbled by criticism of its role in causing the crisis, has become more active in lobbying against provisions it does not like and in challenging the rulemaking process itself – and it is scoring some victories. Some of these have involved a willingness on the part of the U.S. Congress to reconsider certain provisions of the law; others have resulted in voiding of final rules.

In July 2011, a federal appeals court blocked the U.S. Securities and Exchange Commission's (SEC) "proxy access" rule, which would have made it easier for shareholders to oust existing company directors and nominate new ones. The court, finding in favor of the lawsuit brought by the U.S. Chamber of Commerce and the Business Roundtable, determined that the SEC had failed to consider fully the economic impact of the regulation, a prerequisite to the rulemaking process.[8]

In September 2012, in response to a lawsuit filed by the Securities Industry and Financial Markets Association (SIFMA) and the International Swaps and Derivatives Association (ISDA), a federal appeals court blocked a U.S. Commodity Futures Trading Commission (CFTC) rule that would have set caps on positions in oil, natural gas, wheat and other commodities, charging that the CFTC had failed to make the case that the regulation was necessary and appropriate under the law.[9] In another case, though not a victory for the financial services industry, a federal judge recently threw out another SEC ruling that would have required oil companies to disclose payments they make to foreign governments. In this case, the judge ruled that the SEC failed to consider adequately that such disclosures are illegal under the laws of certain countries.[10] At the very least, these court decisions will cause the SEC and CFTC, if not all the involved regulatory agencies, to ensure that all the t's are crossed and i's dotted in their rulemaking, likely slowing down the process even more because it is evident that private enterprise isn't taking anything it disagrees with sitting down.

Another recent development that nonbank financial services companies are likely to follow with keen interest is the decision by Prudential Insurance to challenge its proposed designation as a nonbank SIFI on the basis that it doesn't meet the quantitative standards in the rule and does not pose a systemic risk to the financial system. This is the first test of the SIFI designation process. While some industry observers think it will be an uphill battle, many others are cheering Prudential for taking this step.

Uncertainty Drives Congress Back into the Game

While even the staunchest opponents of the DFA say repeal of the Act "ain't gonna happen,"[11] there seem to be more and more bills being introduced to try to improve the law and address provisions that may have unintended consequences, particularly for smaller community banks and end users in the derivatives market. For many, the willingness of Congress to redress onerous provisions of a hastily passed law is viewed as a positive development, though critics will undoubtedly try to correlate an increase in lobbying spending with a more engaged Congress. Of course, not all of the legislation being introduced is viewed positively by the industry – the McCain-Warren Glass-Steagall bill being one example.

[6] "Proposed Bill Would Squash Dodd-Frank's CEO Pay Ratio Disclosure," *Compliance Week,* Mont, Joe, June 24, 2013: www.complianceweek.com/proposed-bill-would-squash-dodd-franks-ceo-pay-ratio-disclosure/article/300168/.

[7] "Fed, FDIC Regulators Square Off Over End to 'Too Big to Fail'," *American Banker,* Finkle, Victoria, June 26, 2013: www.americanbanker.com/issues/178_123/Fed-FDIC-Regulators-Square-Off-Over-End-to-Too-Big-to-Fail-1060218-1.html.

[8] "Dodd-Frank executive pay rule still in limbo amid pushback from corporate America," *The Washington Post,* Markon, Jerry and ElBoghdady, Dina, July 6, 2013: http://articles.washingtonpost.com/2013-07-06/politics/40404900_1_rule-financial-overhaul-legislation-agency.

[9] "Court Blocks Dodd-Frank Curbs on Derivatives Speculation," *Bloomberg,* Brush, Silla and Schoenberg, Tom, September 28, 2012: www.bloomberg.com/news/2012-09-28/court-blocks-dodd-frank-curbs-on-derivatives-speculation.html.

[10] "Judge Throws Out SEC Oil-Payments Disclosure Rule," *Barron's,* Holzer, Jessica, July 2, 2013: http://online.barrons.com/article/SB10001424127887324436104578581523970826446.html.

[11] Rep. Scott Garrett (R-N.J.) as quoted in "Dodd-Frank repeal 'ain't gonna happen'," *RegWatch, The Hill's* Regulation Blog, Goad, Ben, June 14, 2013: http://thehill.com/blogs/regwatch/finance/305575-gop-lawmaker-dodd-frank-repeal-aint-gonna-happen-.

Other Regulatory and Business Challenges

While the outcome of a number of key DFA provisions remains unknown, the financial services industry is faced with a host of certain regulatory and business challenges, which include, among many others:

- Dealing with the continued regulatory emphasis and significant enforcement activity related to anti-money laundering and sanctions compliance
- Addressing the sustained focus on consumer compliance issues, championed by the Consumer Financial Protection Bureau (CFPB), but with the continued engagement of the legacy bank regulators
- Determining how to address and monitor compliance in the 24/7 world of social media
- Fortifying against the randomness, unpredictability and inevitability of cyberattacks
- Implementing the Foreign Account Tax Compliance Act (FATCA)
- Enhancing risk management and internal audit functions to meet the new regulatory standard of "Strong"[12]
- Changing operating models and fostering innovation to maintain and improve profitability

Tackling these issues, even without trying to plan for additional reforms, is daunting enough.

[12] *Getting to Strong – What Banking Organizations Need to Know,* Protiviti, 2013: http://www.protiviti.com/en-US/Pages/What-Banking-Organizations-Need-to-Know_Whitepaper.aspx.

Looking Ahead to DFA Year 4

Predicting what will happen within the Beltway is always a fool's errand and nonetheless so as we contemplate what might happen in Year 4 of the DFA. Our best guess is that rules that affect the domestic financial services industry only, or primarily, and can be issued by a single agency – such as Enhanced Prudential Standards for domestic banking organizations, the growing list of consumer regulations expected from the CFPB, and maybe even the Uniform Fiduciary Standard – will be finalized, but that many other requirements will continue to be mired in international debate and disagreements among multiple regulators.

What should financial institutions do in the face of the continuing uncertainty? Our best advice is simple: Practice responsible risk-taking. While there is little a single institution can do to resolve the many open DFA issues, each institution should at least strive to ensure that it is positioned as well as it can be to withstand the next financial crisis. And our fearless forecast is that inevitably, whether or not all of the DFA rules ever are finalized, the industry will be tested again in another crisis. It's just a question of whether the institution will be resilient enough to recover on its own or require government assistance. If the industry doesn't like the current regulatory environment, it's not seen anything like the environment it will face if another wave of government assistance is needed to unwind another crisis.

For More Information …

Protiviti (www.protiviti.com) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit.

Protiviti's dedicated Financial Services practice includes professionals with deep industry experience in banking, insurance, brokerage and investment companies. These financial services professionals can work with you to find approaches to help you improve and establish strategies for your business as changes in the industry and regulatory environment impact your organization. Their guidance on regulatory reform can be found at www.protiviti.com/regulatoryreform.

For additional information about the issues reviewed in *FS Insights* or about Protiviti's services, please contact:

Carol M. Beaumier
Managing Director
+1.212.603.8337
carol.beaumier@protiviti.com

Cory Gunderson
Managing Director
+1.212.708.6313
cory.gunderson@protiviti.com

Andrew Clinton
Managing Director
+44.20.7024.7570
andrew.clinton@protiviti.co.uk

Giacomo Galli
Managing Director
+39.02.6550.6303
giacomo.galli@protiviti.it

protiviti®
Risk & Business Consulting.
Internal Audit.