Dodd-Frank: What About Leasing?

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Part 1 of 2

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Dodd-Frank Basics

Public Law 111-203 was passed by the U.S. Senate on a 60-39 vote in the summer of 2010 and became effective when signed into law by President Barack Obama on July 21, 2010, just over one year ago. It is codified at 12 U.S.C. 5301, *et seq.* Having been sponsored primarily by Senator Christopher Dodd (D-CT) and Congressman Barney Frank (D-MA), its official short title is the Dodd-Frank Wall Street Reform and Consumer Protection Act, although it is often also referred to simply as Dodd-Frank, or as the DFA.

As described in this two-part article, the Dodd-Frank legislation is expected to have broad and deep implications for all sectors of the U.S. financial industry and marketplace, from securities to real estate to credit cards to banking. In particular, many of its sweeping provisions are likely, although they are not expressly intended to do so, to have long-term consequences for the equipment leasing and finance industry and for leasing counsel. The continuing uncertainty surrounding many of its provisions, and the ambiguity regarding its application, signal the need for counsel to be as informed as possible of its myriad new regulations, requirements, and implications.

The Dodd-Frank Act arose from the wide-spread perception that U.S. financial regulatory systems had failed in fundamental ways, resulting in rampant financial speculation, inadequate oversight and management of financial risk, and abuse of financial structures initially erected by the federal government specifically to control the consequences of such speculation and risk; and this perception in turn propelled the sprawling regulatory and statutory framework embodied in the Dodd-Frank legislation. Given its broad reach and scope, the Act has been described by at least one law firm commentator as "the greatest legislative change to financial supervision since the 1930s" (Davis, Polk & Wardwell, *July 2010*).

According to its own preamble, Dodd-Frank is intended to address four major issues in the U.S. financial marketplace:

- Transparency
- Risk Management
- Accountability
- Structural Oversight

Of course, with such sweeping objectives, the Act is necessarily long, complicated, and somewhat convoluted, affecting everything from banking to securities to securitization to consumer privacy to credit cards to enforcement to insurance.

Dodd-Frank is divided into sixteen titles, 37 sub-titles, and approximately 520 sections. Its total official length in the U.S. Code is 849 pages, a volume of words that may be put into perspective by comparison with certain other federal laws:

	Pages
Dodd-Frank	849
Gramm-Leach-Bliley	145
Sarbanes-Oxley	61
Glass-Steagall	37
Federal Reserve Act	31
U.S. Constitution	16

Dodd-Frank creates a number of powerful new bureaus and agencies of the federal government, consolidates and shifts the powers of several existing financial agencies and regulators, and establishes a new national framework for the regulation of banks and "nonbank financial companies" (a new term of art defined under the Act). In addition, it requires more than 243 rulemakings, more than 67 one-time reports and studies, and more than 22 new periodic reports to the Federal Reserve Board and other agencies. Many rulemakings under the DFA are well underway, but many more of them will not even begin until later this year and will run well into 2012 and beyond; indeed, as of July 2011, more than 200 provisions of the law remain to be enacted, with 23 others being overdue for enactment and 121 more still in the proposal process. Thus, there is likely to be significant regulatory uncertainty in many areas of the financial marketplace as new rules are made, hearings are held, rules are challenged, and courts endeavor to determine the final scope and effect of the Act's requirements.

<u>The Council</u>

In general, Dodd-Frank consolidates significantly greater regulatory authority in both the Federal Reserve Board of Governors and the U.S. Treasury Department (specifically,

the Treasury Secretary) than has historically been the case. For purposes of overseeing and managing the health of the U.S. financial system and U.S. financial markets, a new Financial Stability Oversight Council (FSOC, or simply "the Council") is created, whose stated mission is to "identify and respond to emerging systemic risks before they threaten the stability of the U.S. economy" (Section 111, *et seq.*, of the Act).

Statutory members of the Council include the U.S. Treasury Secretary (chair) plus the heads of the Federal Reserve Board, FDIC, OCC, SEC, CFTC, NCUA, CFPB (a new bureau, described below), FHFA (a new agency regulating Fannie Mae, Freddie Mac, and the Federal Home Loan Banks), one independent member (from the insurance industry), and five nonvoting members. (Note: OTS, the Office of Thrift Supervision, is eliminated under Dodd-Frank and is consequently not included as a member of the Council. Its historical responsibilities are generally absorbed into the Federal Reserve Board, FDIC, and OCC.)

As the principal overseer of the health and stability of the U.S. financial system, the Council is directed to carry out the following specific duties.

- Determine which nonbank financial company and financial market utility (FMU) activities are systemically important (as defined in the statute) to the overall U.S. financial system.
- Make official determinations of "Systemic Importance" regarding individual companies, institutions, businesses, and activities in the U.S. financial markets.
- Monitor the U.S. financial system to identify systemic risks and potential gaps in the regulatory framework.
- Recommend supervisory priorities for the member agencies represented on the Council (essentially regulating all activities of the financial markets, including those of nonbank financial companies).
- Facilitate collection and sharing of financial stability data among member agencies and regulatory functions.

The last item on this list (collecting and sharing data) is to be carried out by yet another new entity called the Office of Financial Research (OFR), which reports to the Council and serves as its information-gathering arm (Section 151, *et seq.*). In carrying out this duty, the OFR may require periodic and other reports from any bank holding company or nonbank financial company (as defined in the statute and discussed further in this article) to determine whether its activities or its relevant financial market, or the company itself, "poses a threat to the financial stability of the United States."

The OFR may also require reports and information from foreign bank holding companies and foreign nonbank financial companies in consultation with an "appropriate foreign regulator" for similar purposes. Information gathered by the OFR is to held in confidence, although it is subject to existing rules under the federal Freedom of Information Act.

The Bureau

The other major, and perhaps most widely discussed, new agency created under Dodd-Frank (Title X) is the Consumer Financial Protection Bureau (the CFPB, or "the Bureau"), which, notwithstanding its consumer-oriented name, promises to have important implications for commercial financing and leasing (as described further in this article). The Bureau is established as an autonomous agency within the Federal Reserve, headed by a presidential appointee serving a 5-year term, with the statutory authority to write, conduct examinations in accordance with, and enforce consumer financial protection rules. (There was significant controversy surrounding former TARP overseer Elizabeth Warren as President Obama's initial appointee to be the first Director of the Bureau, and a new nominee, former Ohio attorney general Richard Cordray, is pending Senate confirmation as of July 2011. Although the Bureau has been partially funded and has begun operations, it nevertheless has not yet had an official Director.)

The Bureau is specifically intended to assume much of the authority currently held by the Federal Reserve, FTC, HUD, OCC, FDIC, NCUA, and OTS under federal consumer protection statutes. In particular, the Bureau is granted authority to regulate such products and services as (among others):

- Extensions of credit
- Deposit-taking
- Funds transmission
- Check-cashing
- Data processing
- Providing certain kinds of financial advice

With respect to its regulatory scope, the Bureau (Section 1021, *et seq.*) is granted exclusive federal consumer protection authority over larger nonbanks to the extent they offer, provide, or service consumer real estate loans; provide loan modifications or foreclosure relief services in connection with such loans; offer or provide private education loans; offer or provide payday loans; are "larger participants" in a market for

other consumer financial products or services as defined by the Bureau; or engage in conduct that "poses risks to consumers" with respect to provision of consumer financial products or services. In addition, the Bureau is granted authority to regulate any person who engages in offering or providing a "consumer financial product or service" or any affiliate service provider of such a person. As discussed in detail later in this article, these provisions provide very broad regulatory authority in areas that may overlap with traditional equipment leasing and financing activities.

Dodd-Frank defines "consumers" both as individuals and as agents, trustees, or representatives acting on behalf of individuals. The Bureau's authority excludes banks, thrifts, and credit unions with assets of less than $10 billion; and auto dealers, accountants, SEC and CFTC licensees, real estate licensees, charitable activities, and certain other entities are specifically excluded from its regulatory mandate. Nevertheless, although federal prudential regulators retain exclusive federal consumer protection enforcement authority over smaller insured depository institutions, the Bureau can still recommend enforcement actions and can include examiners on a sample of institutional examinations performed by the applicable prudential regulator. Thus, the Bureau is expected to play a significant role in the regulation of companies and institutions whose services include connections with consumer financing (including the mandatory collection of credit information, as described in detail later in this article).

<u>"Systemic Risk"</u>

Under the Dodd-Frank statute, the Federal Reserve Board is granted new powers and duties regarding "systemic risk" to the U.S. financial system (Section 203). These include safeguarding financial stability, providing "consolidated supervision" of systemically important financial institutions, helping ensure the safety and soundness of FMUs (financial market utilities), and setting, either on its own or as a result of a Council recommendation, heightened prudential standards both for bank holding companies with total assets of $50 billion or greater and for those nonbank financial companies the Council has deemed to be systemically important. These include requirements for:

- Risk-based capital, leverage, and liquidity
- Risk management
- Concentration limits (*i.e.*, limits on exposures to any single company)
- Stress tests
- Prompt corrective action

- Resolution plan ("living will") and credit exposure reporting

The Federal Reserve is also granted authority to include within any new prudential standards for systemically important bank holding companies or nonbank financial companies:

- A contingent capital requirement
- Enhanced public disclosures
- Short-term debt limits
- Other prudential standards deemed appropriate by the Board of Governors or as a result of a Council recommendation

Under the Act, failing financial companies that have been found to represent systemic risk to the U.S. financial system or "pose a significant risk to the financial stability of the United States" may be liquidated and placed into receivership under the FDIC in a manner "that mitigates such risk and minimizes moral hazard" (Section 204). In this section of the Dodd-Frank, as in many others, a great deal of discretion in determining the nature and extent of "systemic risk" to the U.S. financial system and the specific methods of enforcing their particular mandates is given to the Federal Reserve Board, the Council, the OFR, the FDIC, and the Bureau.

<u>The Volcker Rule</u>

The Dodd-Frank Act includes the mandatory implementation of the so-called Volcker Rule (Section 619), prohibiting insured depository institutions *and their affiliates* from engaging in proprietary trading and from investing in, sponsoring, or having certain business relationships with a hedge fund or private equity fund. Although the statute excludes certain transactions entered into on behalf of customers, in connection with underwriting or market-making activities, or risk-mitigating hedging activities, the prohibition on proprietary trading has the potential to significantly change the scope and scale of trading within federally insured banks, credit unions, and their affiliates.

Unfortunately, although the Volcker Rule is supposed to go into effect two years after the enactment of Dodd-Frank (*i.e.*, July 21, 2012) or one year after promulgation of final rules, the final rules have not yet even been proposed; yet the Council regulators have already set forth a regulatory framework for enforcing the rules. In a study published in January 2011, the Council stated that "permitted activities are prohibited if they involve or would result in a material conflict of interest," but the study did not suggest a definition of material conflict of interest and did not provide significant interpretive

guidance. To make matters even more uncertain, Dodd-Frank authorizes regulatory agencies to grant certain exemptions from restrictions on proprietary trading and private fund investments, but no specific guidance has to date been given with regard to such exemptions.

Other Significant Provisions

A full exposition of the myriad and far-reaching provisions of Dodd-Frank is beyond the scope of this article, but several specific items are worthy of mention for their potential impact on bank affiliates and other equipment leasing and finance companies.

CAPITAL REQUIREMENTS (COLLINS AMENDMENT)

The Act subjects bank and thrift holding companies and systemic nonbank financial companies to risk-based and leverage capital requirements at least as strict as the risk-based and leverage capital requirements already applicable to banks (Section 171). The new requirements are applied differently depending on each bank holding company's or nonbank financial company's total assets as of the end of 2009, with new rules being phased in for companies having total assets exceeding $15 billion, old rules being grandfathered for companies having total assets below $15 billion, and exemptions being given for certain companies having total assets below $500 million.

RETENTION OF SECURITIZATION RISK

Under Dodd-Frank, federal agencies must write joint rules requiring securitizers to retain at least 5% of the credit risk of securitized assets (Section 941), although statutory exemptions are specified for "qualified residential mortgages" and other assets meeting certain agency underwriting criteria. For purposes of this provision, a "securitizer" means an issuer of securities or a seller of securitized assets, and an "asset-backed security" includes a security collateralized by a loan, a lease, or a secured or unsecured receivable. It has been said that this provision of the Dodd-Frank Act "has the potential to be one of the most sweeping and impactful reforms on the secondary markets and could significantly influence the structure and pricing of securitizations," including those of commercial loans (*DLA Piper News Release*, April 4, 2011).

AND MANY, MANY MORE

Dodd-Frank includes many, many more provisions that may affect specific leasing and finance companies, particularly larger firms and bank affiliates. Among many others,

these include regulation of hedge fund advisors (Title IV), creation of a new Federal Insurance Office (Section 501), setting of new concentration limits on large financial firms (Section 622), regulation of financial swaps (Title VII), expanded whistleblower provisions (Section 922), regulation of credit rating agencies and analysts (Section 932), changes to executive compensation for supervised financial institutions (Section 951), and TARP repayment requirements (Section 1301).

So, What About Leasing?

Part 2 of this two-part series will discuss in detail the provisions of Dodd-Frank which are expected to have the most immediate and greatest impact on U.S. equipment leasing and finance companies, including the continuing overlap of consumer and commercial financing, new borrower data collection requirements of the Consumer Financial Protection Bureau, details of the securitization risk-retention requirements, expansion of the Sarbanes-Oxley whistleblower protection provisions, and the anticipated costs and risks to leasing and finance companies of compliance with the enormously far-reaching Dodd-Frank legislation.

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