Consumer Federation of America

# ONE YEAR AFTER: A PROGRESS REPORT ON THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

A year after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, implementation of its sweeping financial reforms is still very much a work in progress. Significant strides have been made in key areas, but significant challenges remain. Political attacks from some in Congress who never supported regulatory reform, efforts by Wall Street to delay or water down the implementing regulations, and efforts to starve the regulators of funding all have the potential to undermine the reform effort and leave the financial system exposed to dangerous risks. Despite these considerable challenges, regulators continue to forge ahead with efforts to strengthen protections for consumers and investors and reduce risks in the financial markets.

The following report assesses progress in implementing key consumer and investor protection provisions of the bill and identifies threats that could undermine effective implementation. It is not intended to provide a comprehensive assessment of all the bill's provisions. Instead it focuses on consumer and investor protection issues where the Consumer Federation of America (CFA) played an active role during the legislative debate and continues to be involved in implementation. These include, first and foremost, the creation of a new agency devoted to protecting financial consumers, as well as provisions in the investor protection title of the bill to strengthen protections for retail investors, initiatives to bring much needed transparency and regulatory oversight to the over-the-counter derivatives markets, and credit rating agency reforms.

## Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau was created because massive regulatory failures by federal banking and consumer regulators led to a proliferation of unfair and unsustainable lending practices, particularly in the mortgage and credit card sectors. These abusive practices deeply damaged the finances of millions of Americans, triggered a major decline in housing markets and helped cause the most significant economic crisis in our country since the Great Depression.

Regulatory failures occurred because federal consumer financial protection efforts were fractured and feeble. Seven different agencies had some responsibility for consumer finance, but none made consumer protection a priority. Bank regulators did not bother stopping dangerous mortgage lending and credit card practices because they were not independent of the lenders they regulated. In their role as prudential regulators who were supposed to ensure that depository institutions were "safe and sound," they also subordinated consumer protection to a dangerously shortsighted focus on the near-term profitability of these institutions. At times, these regulators actually competed against each other to weaken standards or to block states from initiating consumer protections. Federal regulators also paid little attention, until it was too late, to lending by non-banks, such as subprime mortgage companies, which pioneered many abusive financial practices.

<u>Regulatory Implementation</u>

What the law does:

The law establishes a Consumer Financial Protection Bureau (CFPB) that becomes operational on July 21, 2011, the anniversary of the enactment of the Dodd-Frank Act. The Act gives the CFPB a single mission to protect consumers in the financial services marketplace and revokes consumer protection authority previously held by seven federal agencies. The Bureau has broad authority over both banks and non-bank financial firms. It is charged with enforcing approximately 20 federal consumer financial laws, such as the Truth in Lending Act, and preventing unfair, deceptive and abusive practices. It will also conduct research to identify financial risks to consumers, supervise large banks and many non-banks for compliance with federal laws, collect and respond to consumer complaints and coordinate and conduct financial education programs.

To ensure clear accountability for consumer protection decisions, the agency will have a single director who is nominated by the President and confirmed by the United States Senate. If the CFPB does not do enough to protect consumers – or if the agency oversteps its authority – neither the director nor the agency can deflect blame onto other agencies. Congress also took several steps to ensure that the CFPB's independence would not be compromised by overwhelming political pressure from the financial services industry. As with every other banking agency, the CFPB is not subject to the appropriations process. (It receives non-taxpayer funding through the Federal Reserve.) Although the CFPB is technically part of the Federal Reserve System, the Federal Reserve Board is prohibited from interfering with CFPB decisions or actions.

At the same time, the Dodd-Frank Act placed a number of unprecedented controls on the CFPB's authority to ensure that the agency pursues its consumer protection mission in a balanced and responsible manner. For example, nowhere else in federal law can one set of regulators – in this case the members of the Financial Stability Oversight Council (FSOC) – veto the actions of another agency. The Dodd-Frank Act caps the amount of funding provided to the CFPB, a statutory limit imposed on no other financial regulator. The CFPB is also the only financial regulator that must comply with rulemaking procedures under the Small Business Regulatory Enforcement Fairness Act, which will likely add at least six months to the already lengthy rulemaking process and make it more difficult for the agency to effectively address serious financial abuses that spread quickly.

What has happened:

Nearly two months after he signed the Dodd-Frank Act, President Obama appointed Harvard law professor Elizabeth Warren to take charge of efforts to create the CFPB from scratch, so that it would be ready on July 21, 2011 to assume consumer protection powers that were being transferred to it from other federal financial regulators. (This is known as the agency's "transfer date.") Warren conceived the idea of an independent federal consumer financial protection agency and had been a high-profile proponent of the proposal during congressional debate on it.

The President announced on July 17, 2011 that he would nominate CFPB enforcement director Richard Cordray to be the agency's first director. While CFA does not endorse specific nominees, Cordray certainly has the requisite knowledge of the financial services marketplace and demonstrated consumer protection track record to qualify him as the CFPB's first director. As Ohio Attorney General, he was a national leader in seeking to assist consumers who had been harmed by abusive mortgage and predatory lending practices. As the agency's current director of enforcement, he is well-positioned to get the agency off to an effective start.

The delay in nominating a director until nearly a year after financial reform legislation was enacted means that the agency will open its doors without a director and without the full use of its powers. Moreover, a number of Republican Senators said in May that they would try to block the confirmation of any nominee unless far-reaching changes to the agency's structure and funding were made. (See below for more information.)

The Department of Treasury has requested more than $135 million to date for efforts to create the CFPB. The CFPB projects that it will spend about $143 million in the current fiscal year and $329 million in fiscal year 2012. Projected CFPB spending to date is far less than the $498 and $547.8 million that it is authorized to spend in fiscal years 2011 and 2012 under the law.

Despite this frugality, Warren and senior CFPB staff members have made significant progress in staffing up the agency. They have hired about 400 staff members from extremely diverse backgrounds, developed and implemented an organizational structure, and hired senior leaders to fill four of the six top leadership positions in the agency. (The agency has said that it intends to hire around 1,200 staff by the end of 2012.) Key staff hires include: bank industry executive Raj Date to lead research and rule-writing efforts; ; former Massachusetts banking commissioner Steve Antonakes to direct bank supervision; Peggy Twohig, from the Federal Trade Commission, to develop procedures for supervising non-banks; Leonard Chanin, formerly an attorney with the Federal Reserve and a banking industry law firm, to lead rule-writing efforts; and Gail Hillebrand, of the research and advocacy organization Consumers Union, to direct consumer outreach and financial education efforts.

In little more than six months, the CFPB staff has developed a number of systems and procedures to prepare the agency to assume its responsibilities on the transfer date. These include: an innovative website designed to communicate in plain language with consumers; a consumer assistance office, which will begin with expansive efforts to help consumers with credit card problems; and, protocols for the supervision of large banks to ascertain compliance with federal consumer laws. The agency is also starting to develop procedures for the crucial task of supervising non-banks, including mortgage, payday, and student lenders. The agency held four "roundtable" discussions with a diverse array of interested parties in July to determine whether and how it should supervise other types of large non-banks, such as credit bureaus, debt counseling and settlement companies, prepaid card issuers and installment loan companies.

The CFPB's initial efforts to fulfill its mandates are notable in a couple of key respects. First the agency is making significant efforts to reach out beyond "inside the beltway" interests to get broad and early public input on its plans. Warren, for example, has traveled widely to convene meetings with consumers, military Service Members, public interest activists, and local media and financial industry executives. She has met with community bankers in all 50 states. The agency's website is also unusually accessible compared to many federal agencies. It is written in clear language and often includes opportunities for the public to comment or offer suggestions. For example, when the agency created new mortgage disclosure prototype forms, it didn't just convene a meeting of interested parties in its offices in Washington DC. It posted the form on its website and received thousands of suggestions.

Second, the CFPB has made far-reaching efforts to be transparent about its activities and goals, acting early to get input before it has come to any conclusions about what it will do. For example, Congress required the agency to finalize rules on both simplified mortgage forms and what will be the "large" non-banks it might supervise, but not until July of 2012. The CFPB has deliberately acted well before those deadlines in order to be clear about its goals and to get as much input as possible. Warren has also posted her entire meeting schedule online, so that anyone who is interested will know who she is talking to.

These public outreach and transparency efforts have earned the CFPB widespread praise, including from some unexpected quarters. One credit union CEO, Marcus Shaefer of the Truliant Federal Credit Union said, "We've had a conversation going with CFPB for some time and are actually very pleased with this type of outreach. There's been a lot of round table idea exchange and discussion between team members."

The CFPB has also received very high marks for its initial implementation efforts from Inspectors General (IGs) for the Department of Treasury and the Federal Reserve System. In a joint evaluation released on July 15, 2011, the two offices concluded that the agency had identified the activities it had to undertake to meet its obligations in the Dodd-Frank Act, that it was developing and implementing appropriate plans to meet its mandates, and that it was communicating its plans effectively to its employees and to other financial regulators with which it must collaborate. The two offices offered no criticism of initial CFPB efforts.[1]

[1] "Review of CFPB Implementation Planning Activities," Offices of Inspector General, Board of Governors of the Federal Reserve System and Bureau of Consumer Financial Protection, Department of the Treasury, FRB OIG 2011-03, OIG-11-088, July 15, 2011.

The CFPB's initial policy priorities:

Warren and senior CFPB staff have said that their top early policy priorities will be to require companies to provide better information to consumers, so that they can understand the true costs and financial risks of the credit products they are buying. The CFPB has received praise from a variety of interested parties, including some lenders, on prototype mortgage disclosure documents it has proposed that offer borrowers a "good faith" estimate of what they will pay on a home loan. Warren has also said that the agency will be proposing a model credit card contract for card issuers to comply with that will offer clear, truthful information about card interest rates, fees and other charges.

Consumer groups have applauded the CFPB's initial efforts to improve crucial consumer disclosures and urged the agency to also address abusive financial practices for which substantive protections will be necessary. CFA, for example, has identified a number of questionable practices as ripe for CFPB action:

- **Unfair bank overdraft loans**. Banks continue to charge steep and multiple fees for overdraft loans, to require immediate repayments, and to take payment first out of account holders' next pay deposit, before other debits are paid. Some banks also continue to manipulate the order in which they pay debits, so that they can increase the number of overdrafts that occur and the amount of fees consumers must pay. The CFPB can prohibit payment order manipulation and ensure that banks provide information that allows consumers to make the best choices when considering overdraft options.

- **Plentiful fees and few protections for pre-paid cards**. Prepaid debit cards are becoming substitutes for bank accounts, but come with a dizzying array of fees and with fewer consumer protections than consumers get with other forms of plastic. The CFPB can ensure that fees are simple and transparent and that prepaid cards are covered by the same consumer protections that apply to bank account debit cards.

- **Wrongful foreclosure and abusive mortgage services practices**. Some banks have acknowledged that they have foreclosed on active-duty military families and overcharged many others in violation of federal law. Additionally, millions of homeowners have been harmed by the fraudulent and abusive practices of mortgage servicers whose staff are trained for collection activities, rather than loss mitigation, whose infrastructure cannot handle the volume and intensity of demand, and whose business records are a mess. The "robo-signing" allegations are the most visible, but certainly not the only, evidence that servicers routinely fail to comply with the requirements of the laws and with contractual requirements. The CFPB can write and enforce rules to stop wrongful foreclosure and ensure that mortgage servicing companies follow legal procedures when foreclosing on a home.

- **Internet payday lending**. Internet payday lenders are marketing loans online at rates and terms that mire cash-strapped consumers in repeat borrowing at extremely high rates. Electronic payday loans exploit a loophole in federal law designed to prevent lenders from conditioning a loan on electronic repayment. Internet lenders often attempt to bypass state consumer protections and loan limits by locating offshore, or by claiming that they only have to comply with the weak laws of states in which they are headquartered, or by affiliating with Native American tribes. The CFPB can provide much-needed federal oversight of these lenders and can work with states to ensure that these lenders do not skirt state laws.

Threats:

Threat #1: No Director for an Extended Period of Time

As mentioned above, the President took almost a year to nominate a director for the CFPB. Meanwhile, 44 Senate Republicans took the unprecedented step in May of saying that they will not confirm anyone for the position, no matter who that person is, unless far-reaching changes are made to the Bureau's structure, funding and independence. These Senators want to subject the Bureau's funding to appropriations, give banking regulators significantly more power to "veto" CFPB actions, and change the leadership structure of the agency from a single director to a commission. (See below for CFA's concerns with these proposed changes.)

The measures that these Senators are demanding were all considered and rejected by Congress last year because they would give powerful financial interests extraordinary influence over the Bureau's operations and weaken the ability of the agency to act vigorously on behalf of consumers. If these Senators succeed in blocking the President's nomination of Richard Cordray without a vote, because they continue to insist on broad structural changes to the CFPB, the agency could be without a director for quite some time. The President could conceivably try to circumvent efforts to block a nomination without a vote through the use of a "recess appointment," in which the director is installed until the end of 2012 without Senate confirmation. However, opponents of the CFPB in the House of Representatives and the Senate have attempted to prevent this option by refusing to allow the Senate to formally adjourn for scheduled recesses.

Professor Warren's effective leadership in standing up the agency – and the fact that the Bureau has largely been in the planning stages of its efforts – has meant that the lack of a permanent director has not affected the agency's ability to do its job. However, according to the IGs for the Department of the Treasury and the Federal Reserve System, the CFPB will be able to use only some of its powers after July 21, 2011 if it does not have a director. They say that if the CFPB is without a director, it can write rules and enforce requirements under consumer protection laws that existed <u>before</u> the Dodd-Frank Act was enacted. However, they say that the CFPB cannot use <u>new authority</u> granted to it under Dodd-Franks that, for example, requires it to supervise non-banks or allows it to prohibit some unfair, deceptive or abusive financial practices until a director is in place.[2]

[2] "Review of CFPB Implementation Planning Activities," Offices of Inspector General, Board of Governors of the Federal Reserve System and Bureau of Consumer Financial Protection, Department of the Treasury, FRB OIG 2011-03, OIG-11-088, July 15, 2011.

Threat #2: Funding the CFPB through Appropriations

The House of Representatives will soon vote on appropriations legislation for fiscal year 2012 (H.R. 2434) that would make far-reaching changes to CFPB funding. It would prohibit the Federal Reserve from transferring more than $200 million in fiscal year 2012 to the CFPB, a reduction of almost 50 percent in the Bureau's proposed $329 million budget that year. It would also prohibit the Federal Reserve from transferring any funds to the bureau beginning in fiscal year 2013, after which the CFPB would be entirely funded by appropriations.

Subjecting the CFPB to appropriations would increase taxpayer costs and allow powerful financial interests an opportunity to thwart CFPB funding if they are not happy with CFPB efforts. This would compromise the agency's ability to act independently. As mentioned above, neither the CFPB nor any other federal banking regulator currently receives appropriated funding. Unlike other banking agencies, which can set their own budgets, the CFPB's budget is capped at a maximum amount by law.

Reducing CFPB funding by almost half in fiscal year 2012 would also significantly impair the agency's ability to perform its consumer protection mission, just as the CFPB is opening its doors.[3] Moreover, restrictions on CFPB funding in this legislation are explicitly prohibited by the Dodd-Frank Act, which says that CFPB funds provided by the Federal Reserve "are not subject to review by the Committees on Appropriations."

Threat #3: Legislative Changes to Weaken the CFPB

The House of Representatives will also vote soon on legislation that would significantly impair the ability of the CFPB to act vigorously and independently to stop abusive financial practices. H.R. 1315 would increase the power of other financial regulators to block CFPB consumer protection measures, including banking agencies that failed to stop many abusive financial practices prior to the recession. It would allow a simple majority of regulators on the Financial Stability Oversight Council (FSOC) to veto CFPB rules under the exceedingly vague and easily-manipulated standard that they are "inconsistent" with the "safe and sound operations" of financial institutions.

One crucial lesson of the financial crisis is that strong consumer protections would have reduced, rather than increased, systemic financial risk. Consumers would have incurred less unsustainable debt. Banks would have had fewer losses and been more financially stable. If the unsound mortgage lending that ran rampant in the previous decade had been stymied, regulators would have reduced, if not eliminated, the likelihood of an economic collapse. However, this fact did not stop financial regulators like the Office of the Comptroller of the Currency (OCC) from continuing to claim that protecting consumers from unfair and deceptive credit card practices would harm bank "safety and soundness." H.R. 1315 would ensure that

[3] See below for examples of how congressional appropriators have for decades starved the SEC and CFTC of the funding needed to effectively fulfill their regulatory responsibilities.

bank regulators have an easy excuse when they want to block the CFPB from curbing abusive but lucrative financial practices.

The bill would also alter the leadership structure of the CFPB from that of a single director to a five-member commission. CFA is concerned that this approach would drive the CFPB decision-making process toward gridlock and inaction. Given all of the unprecedented limits on the CFPB's authority mentioned above, putting a commission in charge would likely impair the agency's ability to act in a timely manner to protect consumers.

**Investor Protections**

The recent financial crisis was a highly traumatic event for U.S. investors which revealed serious shortcomings in the regulation of certain securities markets and market players. In particular, regulatory failures with regard to the market for asset-backed securities (ABS) and the credit ratings on which their sales depended were major contributing causes of the crisis. The crisis and events that occurred in conjunction with the crisis – such as the exposure of the Madoff Ponzi scheme – also revealed more general short-comings in the quality of regulatory oversight provided by the Securities and Exchange Commission (SEC). In some cases, those regulatory failures can be attributed to a lack of will to regulate in the years leading up to the crisis. But in other cases, gaps in authority and inadequate resources appear to be the cause. Title IX of the Dodd-Frank Act includes a package of provisions to strengthen basic investor protections both by providing the Securities and Exchange Commission (SEC) with improved tools to enforce the laws effectively and by authorizing the agency to strengthen investor protections in specific areas. The following are a few of the highlights.[4]

<u>Fiduciary Duty:</u>

What the law requires:

Among the most important investor protection provisions in Title IX is the provision authorizing the SEC to adopt rules holding brokers to a fiduciary duty when they offer personalized investment advice to retail investors. This empowers the SEC to address one of the most serious problems facing investors today: that the financial professionals they rely on for advice on how to fund their retirement and other long-term goals, professionals who are indistinguishable to the average investor, are nonetheless subject to two very different standards of conduct when providing that advice. Brokers do not face the same obligation to act in their customers' best interests that all other advisers are held to when rendering investment advice. Before moving forward with rules to raise the standard that applies to brokers, however, the legislation required the SEC to conduct a study to determine whether the heightened standard was warranted, and it gave the agency six months to complete the study.

[4] For a more complete and detailed assessment of investor protection provisions of the act, see CFA Director of Investor Protection Barbara Roper's July 12, 2011 testimony before the Senate Committee on Banking, Housing and Urban Development, available here.

What has happened:

The agency issued the required study in January. It calls for adoption of parallel rules under the Securities Exchange Act and the Investment Advisers Act imposing a uniform fiduciary duty with regard to personalized investment advice to retail investors. Consistent with the legislation, it makes clear the intention of the agency to adopt a standard that would permit brokers to offer transaction-based advice and charge commissions for that advice and to both sell proprietary products and sell from a limited menu of products. The study was widely praised, not only by the traditional advocates of a fiduciary duty, such as CFA and state securities regulators, but also by the major broker-dealer trade associations. Unfortunately, efforts to raise the standard for brokers continue to meet resistance in some quarters. The two Republican SEC commissioners dissented from the study at the time of its release, arguing that the SEC had not done enough to provide an economic justification for raising the standard. Since then, a number of House Republicans have written to the agency echoing that concern, and leaders of the House Financial Services Committee have announced their intention to hold hearings on the issue. Despite that resistance, SEC Chairman Mary Schapiro has indicated her intent to move forward with rule-making sometime after the one-year anniversary of Dodd-Frank.

Threats:

Continued congressional resistance could weaken the Commission's resolve to move forward, or members of Congress could attempt to intervene more directly. Once a rule is adopted, certain segments of the industry could attempt a legal challenge, a strategy that has been used effectively against the agency in the past. So far, however, the agency appears to be on track in implementing this long-time investor priority.

<u>Office of Investor Advocate:</u>

What the law requires:

Recognizing that investors often find it difficult to make their voices heard on investor protection issues that directly affect their interests, Dodd-Frank called for creation of a new Office of Investor Advocate within the SEC with responsibility for ensuring that investors' views are reflected in the agenda and policy-making process of the SEC and industry self-regulatory organizations. The statute includes a number of provisions, similar to those governing inspector generals, designed to ensure that the Investor Advocate is both independent and effective. These include not only placement within the regulatory structure reporting directly to the Chairman, but also a mandate to report to congressional oversight committees without prior review by the Commission or its staff.

What has happened:

Before it can establish any new offices that report directly to the Chairman, the SEC must get approval from its House and Senate appropriators for its plan to reprogram funds for this purpose. The SEC has submitted the required reprogramming plan and is awaiting approval from the House and Senate appropriations committees.

Threats:

Absent action by the appropriators, creation and staffing of this office could continue to be delayed while issues of tremendous importance to investors are decided with minimal opportunity for their investor input.

SEC Funding:

What the law does:

Although Congress rejected a proposal to give the SEC the same self-funding authority that the bank regulators enjoy, it did authorize significant funding increases to help make up for past under-funding and to enable the agency to effectively fulfill its dramatically expanded responsibilities under Dodd-Frank. Specifically, Dodd-Frank authorized increases that would result in a doubling of the agency budget by 2015, and it created a special reserve fund that the agency could use for certain one-time expenditures, such as improvements to the agency's technology. In order to minimize the incentive to under-fund the agency, the statute includes a provision that requires the fees that off-set agency funding to be adjusted to match the appropriation, making the agency's budget deficit-neutral.

What has happened:

Senate Democrats succeeded in winning a modest funding increase for the agency in 2011, overcoming efforts by House Republicans to enact significant budget cuts. The funding increase to $1.18 million was a major victory for investors, but it still falls short of the $1.3 billion authorized in Dodd-Frank. Meanwhile, House appropriators approved and the full House is expected to vote soon on a 2012 funding bill that would hold the agency's budget for next year to its current level, well short of the $1.4 billion requested by President Obama and the $1.5 billion authorized by Dodd-Frank. Meanwhile, a number of leading Senate Democrats continue to make the case for a funding increase.

Threats:

There is a very real threat that Congress will not come through with adequate funding. If the SEC does not get a funding increase on the order of that authorized in Dodd-Frank, it will not be able to hire the personnel needed to implement Dodd-Frank reforms, with potentially dire consequences for the safety and integrity of the financial system. Of particular concern is the agency's ability to carry out its new responsibilities for oversight of securities-based swaps, including the credit default swaps that played such a central role in the financial crisis. In addition, the Act's credit rating agency reforms rely heavily for their effectiveness on the ability of the SEC to provide tough and effective oversight. That will not be possible if Congress denies the agency the resources necessary to provide that oversight. Meanwhile, long-standing funding shortfalls would continue to go unaddressed, further eroding the agency's ability to fulfill its mission to protect investors and promote the integrity of our capital markets.

## Derivatives

Outside the mortgage area, much of the harm to average investors and consumers in the financial crisis was collateral damage resulting from a failure to effectively regulate markets in which those investors and consumers do not directly participate. Front and center in this regard was the lack of regulation in the over-the-counter derivatives markets, which helped to increase financial institutions' appetite for risk, magnify losses, and transform a relatively contained U.S. housing crisis into a global financial catastrophe. Title VII of the Dodd-Frank Act provides the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) with broad new authority and responsibility to regulate this roughly $600 trillion market.

<u>Regulatory Implementation</u>:

What the law does:

The law provides the CFTC and SEC shared authority for regulating over-the-counter derivatives or "swaps." The SEC is given authority for securities-based swaps, while all others fall under the purview of the CFTC. Among the most important reforms are those requiring most standardized swaps to trade through central clearinghouses and, where possible, on exchange-like "swap execution facilities." These provisions are designed to prevent the domino effect that allowed the failure of Lehman Brothers to cause panic and cascading losses throughout the financial system and led regulators to believe they had no choice but to intervene to prevent the failure of AIG. In addition, Dodd-Frank requires swap dealers and major swap participants to register and subjects them to regulatory oversight, including capital and margin requirements, reporting and record-keeping rules, and business conduct standards. Banks that are swap dealers would also be required to move certain derivatives activities from the bank to affiliates, including trading in any derivative except to hedge their own commercial risks. And, the CFTC is directed to develop position limit rules to curb excessive speculation that contributes to high food and fuel costs. The law sets a one-year timeline for adoption of these rules.

What has happened:

With the one-year anniversary of Dodd-Frank approaching, neither the CFTC nor the SEC has completed the rule-making process, in part because the one-year timeline set by the law was too ambitious under the best of circumstances, and in part because the agencies were not provided the increase in personnel necessary to enable them to work at a faster pace. In addition, the agencies have been under pressure by some members of Congress, particularly House Republicans, to slow the rulemaking process in order to give members of industry more time to analyze and comment on the entire suite of rule proposals. The CFTC responded by re-releasing a number of rule proposals for comment once the majority of the initial rule-writing had been completed to provide interested parties an opportunity to comment on the entire package of reforms. Despite these delays, both agencies have managed to get all of the rules required by Dodd-Frank proposed and out for public comment by the one-year anniversary, and both have said they expect to have them implemented by year's end. Overall, the rule proposals have generally been well-received by investor advocates, with a few significant exceptions. Among the problem areas:

- The Treasury Department has indicated that it will grant an exemption for foreign exchange swaps and forwards from the law's trading and clearing requirements, despite extensive evidence that this market nearly collapsed in the financial crisis and poses significant systemic risks.

- The SEC's proposed swap execution facility rule does too little to ensure that these facilities promote transparency.

- And the CFTC has so far failed to fulfill the mandate to develop strong position limit rules to end excessive speculation.

Despite those short-comings, the agencies are well on their way to developing a comprehensive set of rules to promote transparency, integrity, and stability in these markets.

Some members of Congress continue to press to weaken derivatives rules, particularly with regard to clearing, capital and margin requirements for so-called end users. The Act provides an exemption for those who use derivatives to hedge legitimate commercial risks. Efforts to undermine the law have focused on expanding that exemption to include financial entities and financial risks. Toward that end, the House Financial Services Committee Capital Markets Subcommittee approved legislation (H.R. 1610) in May that would open up a gaping loophole in the definition of major swaps participants, thus limiting the ability of regulators to subject these major market players to appropriate oversight and to margin and capital requirements. So far, the Senate has shown little if any interest in pursuing a similar legislative strategy to undermine Dodd-Frank implementation. Even there, however, some members have continued to make the case for expanding the end-user loophole.

Threats:

Pressure from members of Congress could erode regulators' determination to enact tough rules. By far the greater threat, however, is that the CFTC and SEC will be denied the funding they need to implement and enforce the new rules.

<u>CFTC Funding</u>:

What the law does:

Despite a last-minute effort in conference committee, Dodd-Frank does nothing to change the CFTC's dependence on the appropriations process for funding or to off-set its budget through user fees. As a result, the agency continues to be dependent on congressional appropriators to provide the funding it needs to carry out its vastly expanded regulatory responsibilities.

What has happened:

Congressional Republicans have used the appropriations process to conduct a backdoor attack on derivatives regulations. Like the SEC, with which it shares derivatives oversight responsibility, the CFTC survived House Republican efforts to cut its 2011 funding. Senate Democrats succeeded in winning an increase in the agency's 2011 budget from $168.8 million to $202 million, a major victory but still well short of the $286 million level sought by the administration after reform legislation passed. The administration is once again seeking a funding increase for the CFTC, this time to $308 million for fiscal year 2012, but House Republicans remain intent on cutting agency funding. In June, the House Appropriations Committee passed an Agriculture appropriations bill that would cut the agency's 2012 budget almost back to 2010 levels, to $171.9 million. This would leave the agency with a staffing level roughly equivalent to what it had when the agency was first created in the 1970s even as it takes on responsibility for a nearly $300 trillion swaps market.

Threats:

While the Obama Administration and key Senate Democrats have voiced their support for full funding of the CFTC, there is no guarantee that they will be able to fend off House attempts to cut the agency's budget this year. Without a significant funding increase, the CFTC simply will not have the personnel or technology needed to implement the regulations it has worked so diligently to adopt. The regulatory process – including registration of swaps dealers, major swaps participants, and clearinghouses as well as determinations of what swaps are required to clear – is likely to be grindingly slow. And, without adequate funding, market oversight is doomed to be weak and ineffective, leaving the markets subject to many of the same risks that led to the crisis.

**Credit Rating Agencies**

While consumers and investors are rarely direct users of credit ratings, they nonetheless suffered significant damage as the result of rating agencies' willingness to give AAA ratings to mortgage-backed securities and collateralized debt obligations based on subprime mortgages. Title IX of the Dodd-Frank Act includes a package of credit rating agency reforms designed to improve regulatory oversight, increase ratings transparency, increase rating agencies' legal accountability for following appropriate procedures, and reduce the financial system's vulnerability to ratings failures.

<u>Regulatory Oversight</u>:

What the law does:

The Dodd-Frank Act creates a new Office of Credit Ratings within the SEC and requires annual inspections of credit rating agencies. It also imposes new rules to improve the transparency of ratings, improve oversight of the ratings process, and reduce (albeit minimally) conflicts of interest.

What has happened:

As the one-year anniversary of the Act approaches, the SEC was still awaiting approval of its funding reprogramming plan, a necessary step before it can establish the Office of Credit Ratings. The SEC has nonetheless moved forward with implementation using personnel in existing divisions to write rules and conduct inspections. The agency recently released for comment the package of rules implementing the regulatory requirements of the act. These include measures to strengthen ratings agencies internal controls over ratings methodologies and procedures as well as other compliance and governance practices, to improve practices to address conflicts of interest, and to make the ratings more transparent and to highlight ratings' performance record.

Threats:

The rules fall short in several areas, in particular by allowing too much leeway for ratings agencies in determining how to comply with the Act's requirements. Moreover, effective oversight could be hampered if the agency does not receive the resources it needs to conduct thorough inspections and does not receive the resources and authority it needs to hire the specialized staff to oversee this complex area.

<u>Reduced Reliance</u>:

What the law does:

The law removes references to credit ratings where they appear in federal financial statutes and requires the federal financial regulators to remove references to ratings from their rules. In both cases, it directs federal financial regulators to substitute alternative measures of creditworthiness, but without identifying what those alternative measures might be.

What has happened:

The banking regulators have begun the search for alternative measures of creditworthiness. They released a joint Advance Notice of Proposed Rulemaking last fall seeking suggestions, but so far they have not put forward a formal plan for revising bank capital standards that does not rely on credit ratings. Meanwhile, the SEC has pushed ahead with several proposals to remove references to ratings in the securitization process, for money market mutual funds, and with regard to net capital rules for broker-dealers. With the exception of the securitization proposal – with directly addresses the flawed regulatory assumption that ratings could substitute for disclosure – these proposals largely rely on subjective judgment rather than objective measures of creditworthiness to substitute for ratings. None of those rule proposals has yet been finalized.

Threats:

Unless regulators are able to come up with reliable alternative measures of creditworthiness, removing references to credit ratings could make the financial system riskier rather than safer. In addition, this effort to eliminate regulatory reliance on ratings puts the

U.S. out of step with international capital standards for financial institutions (Basel III), which rely heavily on credit ratings, creating a risk of regulatory arbitrage.

Legal Liability:

What the law does:

Dodd-Frank seeks to make credit ratings more reliable by making rating agencies more accountable for following sound ratings practices. It does so both by clarifying that recklessness is the standard of proof that applies in claims against rating agencies and by removing rating agencies' exemption from expert liability when ratings are used in prospectuses.

What has happened:

Since the legislation was passed, several court decisions have come down that continued to treat ratings as opinions protected by the First Amendment, limiting rating agencies' legal exposure. [5] Meanwhile, faced with a threatened boycott by the major ratings agencies that could have disrupted the still fragile market for asset-backed securities, the SEC adopted and then extended a "no action" position allowing asset-backed securities to be issued without inclusion of a rating in the prospectus. This had the intended effect of shielding the ratings agencies from expert liability with regard to those ratings. In May, the House Financial Services Capital Markets Subcommittee reported out legislation (H.R. 1539) to repeal the Dodd-Frank provision imposing expert liability on ratings agencies.

Threats:

If credit rating agencies continue to escape legal accountability, they will have less incentive to adopt and follow sound ratings procedures. That would put even greater pressure on an under-funded and under-staffed SEC to achieve the same result through effective regulatory oversight.

Conflicts of Interest:

What the law does:

Dodd-Frank includes a few minor provisions to reduce conflicts of interest within credit rating agencies. In particular, it requires ratings agencies to conduct a look-back review to determine whether a conflict may have influenced a rating when an employee involved in issuing ratings leaves to work for a company whose securities were rated by the firm. In addition, it places restrictions on the involvement of sales and marketing personnel in the rating process. When it comes to the major issue of the conflict-laden issuer-pays business model, however, the law relies primarily on studies to address the issue. It does require the

[5] In May, for example, a U.S. Court of Appeals for the Second Circuit ruled that ratings cannot be held liable for their ratings on the grounds that the ratings are opinions protected by the First Amendment. Meanwhile, according to one account, Moody's indicated during an investor conference call in April that about 20 lawsuits against the firm have been dismissed or withdrawn since the financial crisis. (See "Ratings Firms Notch Legal Victory," by Michael Corkery, *Wall Street Journal,* May 12, 2011.

SEC to act to address conflicts in the area of credit ratings for structured finance products, but not until after an extended period of study.

What has happened:

The SEC has issued the proposed rules on conflicts of interest required by the Act. They are currently out for comment. However, most of the studies on the issue are on a slower track and have not yet been a primary focus of agency action.

Threats:

In an environment that is increasingly hostile to reform, the agency may be reluctant to consider any meaningful restrictions on the issuer-pays business model that is at the root of credit rating agencies' conflicts of interest.

**Conclusion**

Financial reforms that could protect consumers, investors and our financial system for decades rose from the ashes of a near-death experience by the American economy. The Dodd-Frank Act establishes a sound framework for strengthening consumer and investor protections. One year after the law's enactment, however, the fate of those reforms hangs in the balance. While key investor and consumer protections are generally on schedule and on track, large financial interests and their allies in Congress have taken steps that endanger the long-term success of these reforms. Now it is up to supporters of financial reform in Congress and the President to ensure that regulators get the oversight, backing and resources they need to make the promises of Dodd-Frank a reality for the American people.