DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: PROVISIONS RELATING TO PUBLIC RETIREMENT SYSTEMS

BACKGROUND[1]

The "Great Recession" of the late 2000s overwhelmingly impacted the U.S. financial service industry as a whole, including the financial institutions, market regulators and investors. The financial sector witnessed related reactions from the market participants: the banks stopped lending and the financial activities on Wall Street came to a standstill, regulators had a frenzied reaction and started criticizing Wall Street for its excesses, the investors stopped trading, unemployment rose and in general an environment of negative sentiment permeated the economy. The Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 (the "Dodd-Frank Act" or the "Act"), was a part of the reaction to the "Great Recession" and was signed into law by President Obama on July 21, 2010. The Act aims to "*promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayers by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."*[2] The Act is a consequence of the financial crisis that began in late 2000s; and is an unprecedented overhaul of the financial service industry of the U.S. The Act was passed after much deliberation and heated debates with the ascribed objective of restoring public confidence in the U.S. financial system and to avert another financial crisis.

The Dodd-Frank Act profoundly regulates the U.S. financial service industry and grants unprecedented power to several federal regulatory authorities, including the U.S. Securities and Exchange Commission (SEC), the U.S. Commodity Futures Trading Commission (CFTC), the Federal Reserve, the U.S. Department of the Treasury, the Securities Investor Protection Corporation (SIPC), and the Federal Deposit Insurance Corporation (FDIC). The Dodd-Frank Act also lends these agencies extensive discretionary rulemaking authorities in different areas of the U.S financial sector. Furthermore, the Act creates new offices, including the Financial Stability Oversight Council, Office of Financial Research, the Investor Advisory Committee, Investor Advocate, Office of Credit Ratings at the SEC, and the Bureau of Consumer Financial Protection to monitor the U.S. financial sector and provide greater protection to the investors and consumers. The Act also affects the market drivers, including the banks, investment funds, insurance companies, investment advisers, broker-dealers, public companies and credit-rating agencies that operate within the realm of the U.S. financial system. There are flurries of rulemaking provisions and studies under the Act which are still unfolding and the Act's impact will be determined over the next several years.

[1] This report does not constitute legal advice and is purely for informational purposes.

[2] *See* Public Law 111-203 111th Congress, H.R. 4173

This report will shed some light on the key provisions of the Act and provide a brief discussion on the various regulations established by the Act. The report will also attempt to outline how the Act would transpire in the public retirement system arena.

CHARACTERISTICS OF THE ACT

The Act is a huge piece of legislation with 16 titles, hundreds of rulemaking provisions, numerous studies to be conducted and reports to be issued by regulators over the next few years. The regulations would be adopted in stages and the SEC has already promulgated some of the rules required under the Act. The actual impact of the Act will be measured by the various rules and findings of the studies to be adopted and conducted by various federal regulatory authorities under the Act.

The Act creates the following key provisions:

- Creation of systemic risks regulator – Financial Stability Oversight Council
- Establishment of a liquidation process for systemic financial companies in order to avoid "too big to fail" bailouts
- Regulation of advisers to private equity and hedge funds
- Creation of the federal insurance regulatory regime
- Regulation of banks and their holding companies – Volcker Rule
- Regulation of the over-the-counter swaps market
- Regulation of securities, investor protection and corporate governance
- Creation of an independent consumer financial protection regulator
- Federal Reserve System provisions
- Implementing mortgage reforms

HIGHLIGHTS OF THE KEY PROVISIONS OF THE ACT

Addresses Systemic Risks – Title I of the Act is codified as the "Financial Stability Act of 2010" and establishes two new federal entities, the Financial Stability Oversight Council (the "Council") and the Office of Financial Research (the "OFR"). The Council is charged with identifying and responding to emerging risks to the stability of the U.S. financial system and promote market discipline. The OFR established within the Department of the Treasury is charged to support the Council in fulfilling its duties, increase market transparency by collecting and sharing financial data and conducting economic research and risk analysis of the market. Title I also enhances the authority of the Federal Reserve Board to supervise and regulate nonbank financial companies and certain bank holding companies.

Liquidation of Systemic Financial Companies – Title II of the Act provides for an orderly liquidation procedure for a covered financial company, which is a company for which a determination has been made that the failure of the company would have, among other things, serious adverse effects on the financial stability of the U.S. In other words, the company has been determined to be a systemically significant financial company. The Federal Deposit Insurance Corporation (the "FDIC") will unwind the failing company and become its receiver.

Regulation of Advisers to Private Equity and Hedge Funds – Title IV of the Act is codified as the "Private Fund Investment Advisers Registration Act of 2010." As the name suggests, this provision will remove the private funds investment advisers' registration exemption as provided under the Investment Advisers Act of 1940 (the "Advisers Act") and would impose more stringent recordkeeping and reporting requirements on such advisers. Currently, the Advisers Act exempts any private funds investment adviser, like an investment fund manager, from registration with the SEC if that adviser, among other things, has fewer than 15 clients, does not advise any registered investment company, and does not hold itself out generally to the public as an investment adviser. The registration exemption based on fewer than 15 clients was very misleading because each private fund was generally counted as one client and one fund could have hundreds of investors and hundreds of millions in assets being managed by an investment adviser without having to register with the SEC. The new provision will remove the aforementioned exemption and replace it with more limited exemptions, including an exemption based on assets under management threshold (less than $150 million) by private fund advisers. As a result of the elimination of the private fund adviser exemptions, private fund advisers will, absent the limited new exemptions, be required to register with the SEC and comply with the various recordkeeping and reporting requirements applicable to registered investment advisers.

Volcker Rule – Title VI of the Act is codified as the "Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010." This title of the Act contains provisions for the regulation and supervision of depository institutions and their holding companies. Title VI also implements the widely-debated "Volcker Rule," which prohibits banks and their affiliates from engaging in "proprietary trading," subject to certain exceptions. The term "proprietary trading" under the Act means a "banking entity" engaging as a principal for its trading account in any transaction to purchase or sell, or otherwise acquire or dispose of, securities, derivatives, commodities, bonds, or any other security or financial instrument as determined by the appropriate Federal agencies.

Under the Volcker Rule, subject to certain exceptions, a "banking entity" shall not:

- Engage in "proprietary trading;" or
- Acquire or retain an equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.

The Act defines a “banking entity” as any insured depository institution; any company that controls an insured depository institution; any company that is treated as a bank holding company under the International Banking Act of 1978; and any affiliates of any of the above entities. If the banks have any existing relationships with funds that do not conform to the aforementioned provision, they will have to be gradually divested.

Regulation of Derivatives and Swaps Transactions – Title VII of the Act is codified as the “Wall Street Transparency and Accountability Act of 2010.” This title of the Act provides for a comprehensive reform that includes substantial regulation of the over-the-counter derivatives, including both swaps and security-based swaps. The provision is intended to reduce abusive or systemically risky transactions in the swaps market, thereby promoting transparency and efficiency. Financial institutions that are swap dealers or major swap participants under the Act, will be subject to new registration, reporting and recordkeeping requirements and will have new standards of conduct with the aim of creating public access and accountability, and federal regulatory oversight on irresponsible and excessive risk-taking practices in the swap markets. In addition, the Act divides the oversight jurisdiction for swaps and derivatives between the U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC) and delegates to them the authority to promulgate rules and regulations to govern the market. Consequently, the effect of the Act on the swap markets would depend upon the enactment of such rules and regulations. The Act also requires, with limited exceptions, for swap transactions to be cleared through a registered clearing house and swap dealers and major swap participants as defined under the Act be registered with the CFTC and/or SEC.

Regulation of Securities Trading – Title IX of the Act is codified as the “Investor Protection and Securities Reform Act of 2010.” This provision, among other things, is focused on establishing stringent rules for transparency and accountability to protect investors and businesses by closing regulatory gaps, increasing disclosure, and implementing enhanced regulations and limitations on securities products and providers. The key substantive provisions within Title IX relating to securities trading are as follows:

- **Credit Rating Agencies** – This provision of the Act creates increased accountability on the part of credit rating agencies. The provision was enacted in response to the negative role played by credit rating agencies in the recent financial crisis. The provision acknowledges the importance and reliance placed on credit ratings by individual and institutional investors and its role in building investor confidence and in the efficient performance of the economy. The SEC will be promulgating regulations on this subject with the help of a newly created Office of Credit Ratings within the SEC. Under the Act the investors will also have the right to bring private suits against rating agencies.
- **Asset-Backed Securities –** Entities selling asset-backed securities like mortgage-backed products will be required to retain at least 5% of the credit risk for the

products. Consequently, if the investment turns out to be a bad one, the company that sold the product will lose along with the investors they sold it to. The SEC is again mandated to promulgate rules in this area.

- **Municipal Securities –** Under this provision, the SEC will have a new Office of Municipal Securities to oversee the rules of the SEC concerning the practices of municipal-securities brokers, dealers and advisers and to coordinate rulemaking and enforcement actions with the Municipal Securities Rulemaking Board (the "MSRB"). The Act also requires the registration of municipal advisers with the SEC and imposes a fiduciary duty on such advisers when advising municipal issuers. Furthermore, the Act makes changes to the MSRB, including requiring that a majority of the board of directors are independent members, in order to better safeguard the public interest in the regulation of municipal securities.

Investor Protection and Corporate Governance – As stated earlier, Title IX of the Act is codified as the "Investor Protection and Securities Reform Act of 2010," which is primarily focused on establishing tough rules to improve investor protection. Title IX of the Act contains provisions that will have a comprehensive impact on public companies, including the SEC's additional rulemaking authority that will impact the reporting and disclosure practices of public companies. This section of the Act also focuses on reforming the SEC by arming it with additional funds, new divisions, and rulemaking authority with the aim of strengthening and expanding its oversight capacity. There is an assortment of other provisions under this title, including the strengthening of broker-dealer regulation that is again intended to improve investor protection. The key substantive provisions within Title IX relating to investor protection are as follows:

- **Broker-Dealer Fiduciary Duty –** The SEC has the discretionary rulemaking authority to impose a fiduciary duty on broker-dealers who give investment advice to investors. Presently, this fiduciary duty standard is applicable to investment advisers, but not to broker-dealers who also provide investment advice about securities to investors. However, the SEC will first have to conduct a study on the different standards applicable to investment advisers and broker-dealers and impose rules thereafter.
- **Encouraging Whistleblowers –** The Act creates a program within the SEC to provide greater monetary incentives to encourage people to report securities violations. Under the new provision the SEC will come up with rules creating rewards up to 30% of funds recovered for information provided.
- **Investor Advisory Committee and Office of Investor Advocate –** The Act creates the Investor Advisory Committee, a committee of investors to advise the SEC on its regulatory priorities and practices. The Act also creates the Office of Investor Advocate in the SEC, to identify areas where investors have significant problems dealing with the SEC and provide them assistance.

- **SEC Funding –** The Act provides for additional funding for the SEC to carry out its new duties.
- **Executive Compensation and Corporate Governance –** Title IX promulgates a number of provisions relating to corporate governance at public companies, including shareholders' vote on executive pay, long-term shareholders proxy access to nominate directors, an independent compensation committee, and SEC review of public companies' proxy disclosures relating to executive compensation. Title IX also requires federal financial regulators to develop and enforce guidelines relating to executive compensation at financial institutions with federal regulators.

Creates an Independent Consumer Protection Regulator – Title X of the Act is codified as the "Consumer Financial Protection Act of 2010," and establishes the Bureau of Consumer Financial Protection (the "Bureau"). The Bureau will have the authority to promulgate substantive standards for regulating and strengthening consumer protection, look for bad deals, take actions to protect consumers, and also educate and create financial awareness among consumers. With the creation of this agency, there will be accountability and a clearly defined mandate for overseeing and protecting consumers. Whereas, earlier this mandate was shared among several federal regulatory agencies, including the FDIC, the Federal Trade Commission (FTC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Department of Housing and Urban Development (HUD).

IMPACT OF CERTAIN PROVISIONS OF THE ACT ON PUBLIC RETIREMENT SYSTEMS

Overview – The Dodd-Frank Act will re-design the financial service industry of the U.S. by promulgating stricter regulations with the primary focus of restoring public confidence in the financial system and protecting investor's interest from the excesses of Wall Street. However, as mentioned earlier, the entire scope of the Act is still to be defined, because the Act requires numerous new regulations to be issued by various federal regulatory agencies. For example, the SEC has been chartered with a multitude of new rulemaking responsibilities, including promulgating investor protection rules. This section will attempt to briefly outline the impact of the Act on public retirement systems in general.

Public retirement systems are among the largest and most active institutional investors in the U.S.[3] Collectively, they have the potential to be a powerful shareholder force in affecting public companies and also play a very significant role in the securities market. Before the onset of the financial crisis, these institutional investors required little to no investor protection or regulatory

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[3] In this discussion the term "public retirement system" will be used interchangeably with "institutional investors" and "public pension funds."

oversight. Furthermore, institutional investors like the public pension funds were assumed to be more knowledgeable and due to their resources were said to have better bargaining power, and hence, the ability to protect themselves. However, the recent downturn and the various securities fraud orchestrated on the very same public pension funds discredited the aforementioned belief and made it apparent that like all the other investors, public pension funds also required protection. Additionally, any loss incurred by the coffers of a public retirement systems adversely affects many individual retail investors who are the public pension fund beneficiaries and the taxpayers. Therefore, investor protection, which is at the very heart of the Act, will impact the public retirement systems in several different ways.

Public retirement systems are inherently long-term investors. They distribute billions of dollars annually in retirement benefits. In order to discharge that responsibility, they undertake long investment horizons and diversify to provide sound investment returns. Furthermore, since the last decade, public retirement systems have considerably diversified their asset classes and are invested throughout the capital market in search for yield. They have also been significantly participating in both domestic and global financial markets. Consequently, the Dodd-Frank Act is bound to impact their investment activities either directly or by regulating other financial institutions and entities that provide services to the public pension funds. Some notable changes include stricter regulations related to municipal advisers and securities market, new regulations for private fund advisers and regulation of swap markets. Below are some of the key provisions of the Act that may affect the investment activities of the public retirement systems or the financial institutions or entities providing services to public retirement systems:

A. **Regulation of Advisers to Private Equity and Hedge Funds –** Title IV of the Act codified as the "Private Fund Investment Advisers Act of 2010" amends the Investment Advisers Act of 1940 by eliminating certain registration exemptions provided to private fund advisers and requiring them to register with the SEC. Additionally, advisers already registered with the SEC will have to collect and report more information to the SEC. These provisions are focused on establishing greater accountability and transparency in the area of hedge fund investments and are also aimed at granting greater investor protection. Public pension funds investing in hedge funds and other private investments must contact the fund managers in order to ensure their compliance to the new regulation.

B. **Volcker Rule –** Title VI of the Act imposes new regulations on certain banks and their holding companies known as the Volcker Rule. The rule prohibits banks and their holding companies from engaging in "proprietary trading" or from acquiring or retaining equity, partnership, or other ownership interest in or sponsoring a hedge fund or a private equity fund. In addition, under the Act the term to "sponsor" a fund, among other things, means to serve as a trustee of a hedge fund or a private equity fund. Banks subject to the Volcker Rule can act as trustees, or advisers to public pension funds that have assets invested in private equity funds or hedge funds. Consequently, the Act could have required such banks to resign from their trustee positions. However, the present version of the Act does provide certain exceptions that permit the banks to continue to serve as trustees, but rules related to this provision of the Act should be closely monitored and studied by the public retirement systems' fiduciaries for compliance purposes.

C. **Regulation of Over-the-Counter Swaps –** Public retirement systems have a substantial presence in the swap markets for various investment purposes. Title VII of the Act has been codified as the "Wall Street Transparency and Accountability Act of 2010," which establishes new regulatory framework and comprehensive reform for the over-the-counter derivatives market, including both swaps and security-based swaps. The Act also expands the authority of the SEC and CFTS over the swap markets and over the next few months these federal regulatory authorities will be promulgating rules governing the swap markets. Additionally, with limited exceptions, swap transactions will have to be cleared through a registered clearing house and swap dealers and major swap participants as defined under the Act will be required to register with the CFTC and/or SEC. Public retirement systems using swaps should closely monitor the forthcoming rules and potential changes in the terms and conditions and costs associated with swaps transactions. Furthermore, one of the provisions under the Act relates to requirements imposed on swap dealers and major swap participants who act as advisers to "Special Entities." Under the Act "Special Entities" include public pension plans and where a swap dealer or major swap participant advises a "Special Entity," the Act makes it unlawful for such advisers to defraud the "Special Entity" and imposes an affirmative duty on them to make a reasonable effort that their recommended swap is in the best financial interest of the "Special Entity." These provisions will again afford greater protection to public retirement systems' fund investments.

D. **Securities Trading Regulations –** Title IX of the Act is codified as the "Investor Protection and Securities Reform Act of 2010." This provision, among other things, is focused on establishing stringent rules for transparency and accountability to protect investors and businesses by closing regulatory gaps, increasing disclosure, and implementing enhanced regulations and limitations on securities products and providers. As discussed earlier, the key substantive provisions under the Act include amendments relating to credit rating agencies, asset-backed securities and municipal securities. The public pension funds' fiduciaries should closely monitor the changes related to municipal securities market, including the new Office of Municipal Securities to be created at the SEC for administering the SEC rules related to municipal securities.

E. **Regulations Relating to Investor Protection and Corporate Governance Provisions –** Title IX of the Act also contain initiatives intended to improve investor protection, securities investment and disclosure, including some changes to the SEC rules relating to shareholder rights and disclosure of executive compensation. Some of the key provisions include:

- **Say on Pay –** Shareholders nonbinding advisory vote on the compensation payable to executive officers as described in the proxy statement.
- **Compensation Committee Independence –** Compensation committees must be fully independent and should be given certain oversight responsibilities.
- **Shareholder Proxy Access to Nominate Directors –** The SEC will have the authority to promulgate proxy access rules pursuant to which long-term shareholders would be allowed to use the company's proxy statement to nominate candidates to the board of directors.

The aforementioned provisions relate to shareholder corporate governance rights. Such reforms would empower public retirement systems as institutional investors to play an active role in corporate governance and hold the management accountable for actions that do not promote shareholder welfare, ensure appropriate transparency and accountability and rein in on risks at the corporate level. Accordingly, this would lead to improvement in a firm's long-term health and performance of the business and would ultimately translate to an appreciation in the equity holdings of the public retirement systems.

In addition, under the Act the SEC, among other things, is mandated to conduct a study to examine the effectiveness of existing legal and regulatory standards of care applicable to broker-dealers and investment advisers and the existing gaps in those standards. Under the present standards, the investment advisers have fiduciary duty towards their clients; however, broker-dealers are not subject to the same standard of care. Hence, this study would be crucial for implementing similar standards to both investment advisers and broker-dealers and again would impact the public retirement systems that employ such broker-dealers for giving advice on pension fund investments.

Conclusion

As discussed above, many provisions of the Act could potentially impact the investments of public pension funds. Some scholars are already speculating that due to the enhanced regulatory requirements for alternative investment management businesses, investment innovations would be inhibited. However, as stated earlier, the actual impact of the Act is yet to be seen, but the public retirement systems' fiduciaries should be alert and aware regarding the various rulemaking activities that have already begun under the Dodd-Frank Act.