Dodd-Frank Wall Street Reform and Consumer Protection Act

Dodd-Frank Overview


Dodd-Frank aims to: (1) increase stability, (2) improve transparency and (3) empower regulators. These policy goals address causes of the 2008 financial crisis, such as under capitalization, insufficient transparency in the markets, and lax regulatory oversight.

Dodd-Frank creates new agency functions. It establishes the Financial Stability Oversight Council (FSOC) to monitor activities that pose a risk to financial stability, and creates the Consumer Financial Protection Bureau (CFPB) to protect average consumers.

Rulemaking responsibility is concentrated in four agencies: the Securities and Exchange Commission (SEC), the Federal Reserve Board (FRB), the Commodity Futures Trading Commission (CFTC), and the CFPB.

Dodd-Frank targets financial instruments, like derivatives, and financial institutions such as banks.

OTC Derivatives

Dodd-Frank seeks to regulate derivatives. A derivative is a financial instrument whose value depends on an underlying variable, such as interest rates, currencies or securities. There are three kinds of derivatives: futures, options and credit default swaps.
**Futures** create an agreement to buy or sell a stated amount of a security, currency or commodity at a specific future date and at a pre-agreed price. Futures trade on official exchanges (futures markets), and are often used to hedge against movements in the spot prices of the underlying asset. [http://lexicon.ft.com/Term?term=futures-contract](http://lexicon.ft.com/Term?term=futures-contract)

**Options** create a contract that entitles the holder to buy or sell an underlying asset (stock, bond, commodity, currency, etc.) at a given price (the exercise or strike price) and before a certain date (the expiry date). [http://lexicon.ft.com/Term?term=options](http://lexicon.ft.com/Term?term=options)

**Credit default swaps** offer protection against the non-payment of unsecured corporate or sovereign debt. A typical CDS contract features one counterparty agreeing to "sell" protection to another. The "protected" party pays a fee each year in exchange for a guarantee that if a bond goes into default, the seller of protection will provide compensation. [http://lexicon.ft.com/Term?term=credit-default-swaps--CDS](http://lexicon.ft.com/Term?term=credit-default-swaps--CDS)

Derivatives are useful for price discovery and hedging risk. A derivative’s price will reflect, for example, future attitudes on inflation and market volatility. A derivative is formed by two counterparties who contract in one of two ways: contracts for delivery and contracts for differences.

Historically, derivatives have been used to hedge commodity price risks, and were traded on exchanges. They were formed by contracts for delivery, where counterparties intended to receive actual goods – usually a commodity.

At different times in history, speculators have traded derivatives under contracts for differences. These highly customized contracts are not traded on exchanges and are created over-the-counter (OTC). Counter-parties to these derivatives do not intend to exchange commodities, but rather net out their differences in cash.

OTC derivatives were largely illegal, but often left unregulated. Recent history starts in 1922, when Congress made OTC derivatives illegal under the Grain Futures Act. In 1936, and again in 1974, Congress enacted further derivatives legislation. In 1974, the CFTC was formed to regulate commodity futures and option markets.

Despite the weight of law, in the 1980s, speculators began heavily trading OTC derivatives. The CFTC did not challenge OTC contracts because they were formed by sophisticated (private) counterparties. For the next 20 years, the government did not challenge OTC derivatives, and in 2000, Congress enacted the Commodity Futures Modernization Act to deregulate financial products.

There are four main problems with OTC derivatives:

1. Derivatives are often so complex that directors and officers do not always understand the true risks
2. Unregulated derivatives trade with little transparency and can lead to uncertainty in the markets
3. Derivatives are traded on little margin and allow parties to quickly become over-leveraged
4. Derivatives-trading has become excessively speculative with trades moving very quickly
To address these problems, Dodd-Frank increases the CFTC’s power to regulate swaps, and the SEC’s power to regulate security-based swaps. These agencies will have oversight of swap dealers and major swap participants. (Non-financial end-users who use derivates to hedge commercial risk are exempt; this is called the end-user exception, and accounts for about 5% of the derivatives market.)

In addition, Dodd-Frank provides for the establishment of OTC clearinghouses. These clearinghouses will act as market makers (and a backstop to unexpected loss). They will set margin requirements to limit counter party exposure. They will also act to standardize OTC contracts. Parties will now contract with each other and also with clearinghouses. (The CFTC & SEC will define if a swap must be cleared.)

Increased oversight and the development of clearinghouses are designed to improve market transparency and prevent unexpected losses.

**The Volcker Rule**

The Volcker Rule, named after former Federal Reserve Chairman Paul Volcker, seeks to restore prudential regulation of banks by limiting proprietary trading (trading with own money for own accounts).

After the stock market crash of 1929, Congress enacted a series of statutes to help restore confidence in the banking industry. One of those statutes was the Glass Steagal Act. This Act sought to limit the scale of commercial banks. It required banks to adhere to strict capital standards and avoid proprietary trading. (Investment banks were left to trade securities with regulations focusing on reporting and fraud prevention.)


Today, Dodd-Frank, through the FSOC, seeks to regulate the largest bank holding companies and other systemically important institutions. The Volcker Rule will prohibit proprietary trading and limit bank holdings of hedge funds and equity funds to 3% of its tangible common equity. It will also limit the scale of any bank to no more than 10% of the overall liabilities of financial services companies.

The Volcker Rule attempts to limit the scale of commercial bank and protect the federally protected deposits. So far, implementation has been stalled by banking advocates.

**Resources for Researching Dodd-Frank**

**Legislative History**


Grab documents associated with the legislative process, including draft bills.

**Congressional Research Services (CRS) Report re: rulemaking (Nov. 3, 2010)**


CRS is the public policy research arm of Congress; its reports provide balanced commentary.
Government Agencies
Agency websites are rich with information, including agendas, timelines, regulations and reports.


FSOC: http://www.treas.gov/FSOC/

Code of Federal Regulations & Federal Register (& Regulatory Tracker)
http://www.gpo.gov/fdsys/
The Federal Register contains most of the important summary, explanatory and documentary information on an agency’s rule; the Code of Federal Regulations contains the text of final rules. For help tracking regulations, check out http://knowledgemosaic.com/net/public/DoddFrankTracker.aspx

Law Firm Memos
Memos are often free and indexed to Google. They are a great resource for getting an overview of the scope and impact of Dodd-Frank regulations.

Bloomberg
Bloomberg (Law or Terminal) aggregates a variety of Dodd-Frank information, including Bloomberg proprietary reports, law firm memos, news and laws.

International Swaps and Derivatives Association (ISDA)
http://www2.isda.org/dodd-frank
The ISDA master agreement is the most commonly used master contract for OTC derivative transactions internationally. ISDA offers commentary on proposed swap regulations.

Bank for International Settlements (BIS)
http://www.bis.org/search/?q=dodd+frank&mp=any& _st=false&c=10&sb=0
BIS provides analysis of banking regulations, and offers commentary on bank capital requirements.

Harvard Business Law Review (HBLR)
http://www.hblr.org/category/dodd-frank-anniversary/
HBLR provides open access to articles assessing and commemorating the one-year anniversary of the signing of Dodd-Frank.

Books