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Financial Services Alert

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Comprehensive Financial Reform Legislation Becomes Law

Richard P. Eckman, Chair, Financial Services Practice Group | eckmanr@pepperlaw.com
J. Bradley Boericke | boerickej@pepperlaw.com, David W. Freese | freesed@pepperlaw.com
Stephen G. Harvey | harveys@pepperlaw.com, Frank A. Mayer, III | mayerf@pepperlaw.com
Timothy R. McTaggart | mctaggartt@pepperlaw.com, Daniel G. Murray | murrayd@pepperlaw.com
Travis P. Nelson | nelsont@pepperlaw.com, Gregory J. Nowak | nowakg@pepperlaw.com
Matthew A. Vigunas | vigunasm@pepperlaw.com, William R. Wagner | wagnerw@pepperlaw.com
Audrey D. Wisotsky | wisotskya@pepperlaw.com

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act represents the most comprehensive financial services reform legislation since the Great Depression. Highlights of the Act are presented below.

The New Bureau of Consumer Financial Protection

The Act establishes the Bureau of Consumer Financial Protection (CFPB) as an independent entity within the Federal Reserve Board (FRB). The CFPB's director will be appointed by the President and confirmed by the Senate, and it will have the authority to make and enforce regulations to ensure that all consumers have access to markets for consumer financial products and services, and that these markets are fair, transparent, and competitive. Consumer financial products and services are defined broadly and include the following if offered or provided for use by consumers for personal, family or household purposes:

- extending credit and servicing loans, including acquiring, purchasing, selling, brokering, or other extensions of credit
- extending or brokering certain leases of personal or real property that are the functional equivalent of purchase finance arrangements
- providing real estate settlement services or performing appraisals of real estate or personal property
- taking deposits or transmitting or exchanging funds for use by or on behalf of a consumer
- selling, providing, or issuing stored-value or payment instruments (except for merchants that sell stored-value products but do not actually enter into the contract with the consumer for the product)
- providing check cashing, check collection, or check guaranty services
- providing credit counseling, debt management or debt settlement services
- collecting, analyzing, maintaining, or providing consumer credit reports, or
- collecting debt related to any consumer financial product or service.

More Resources on the Dodd-Frank Act

Pepper Hamilton conducted a webinar on this topic, "What the Financial Services Reform Legislation Means for You," on July 15. The webinar recording and PowerPoint slides from our session are available on Pepper's Web site: www.pepperlaw.com/webinars_update.aspx?ArticleKey=1832.

For additional information, please visit Pepper's Financial Services Reform Resource Center available online at www.pepperlaw.com/news.aspx?AnnouncementKey=655

The CFPB will have authority to promulgate regulations applicable to all banks and non-banks with respect to consumer financial law. However, it will only have examination and enforcement powers over banks and credit unions with more than $10 billion in assets, all mortgage lenders, servicers and brokers (and related businesses), and certain nonbank financial companies such as payday lenders, debt collectors and consumer reporting agencies. Banks and credit unions with assets of $10 billion or less will continue to be examined by their current regulators, although the CFPB may require such regulators to provide it with examination reports. The Act generally excludes certain persons from the CFPB's reach, including merchants, retailers and other sellers of non-financial goods and services, real estate brokers, sellers of manufactured and modular homes, tax preparers, accountants, and attorneys.

The CFPB is established as of July 21, 2010, and certain of its administrative and rulemaking authorities are effective as of that date. Other consumer financial protection authorities transferred to the CFPB from existing regulators will be effective as of the date that the Treasury Secretary transfers such authorities, which must occur between 180 days and 12 months from July 21, 2010 (the Designated Transfer Date).

Pepper Points: The CFPB has the potential to become one of the most powerful agencies in the United States. Its powers are breathtaking, and its has the potential to radically transform how financial services will be structured and delivered in the United States. In the near term, the most important thing to look for is who the Obama administration selects as the CFPB's first director, who will require Senate approval – or a recess appointment if the choice is too controversial. That first director will set the tone for the agency and could take on an aggressive agenda should he or she so choose. The second thing to watch is the staff that the CFPB will hire. The FRB's consumer staff possesses much history and experience, and if many of those staffers decide to stay at the new CFPB, that can provide some consistency and institutional memory for the CFPB. The background of others who are hired will be key to understanding how the CFPB will operate and what they decide to initially take on. Finally, which industries and practices the new CFPB focuses on will also reflect how it will take advantage of the significant powers it has been granted by Congress. Pepper will be presenting a separate program and analysis of the new CFPB shortly.

Preemption of State Law

The Act will have significant effects on the preemption of state consumer financial law. The Act affirms that in determining whether state law is preempted as applied to a national bank, the appropriate standard is that announced by the United States Supreme Court in its unanimous decision in *Barnett v. Nelson*, 517 U.S. 25 (1996), where the Court held that state law is only preempted as applied to a national bank if the state law "prevents or significantly interferes with" the exercise of the national bank's powers. This standard articulated in *Barnett* represents a stricter standard than contained in the Office of the Comptroller of the Currency (OCC)'s own preemption regulation, which purports to preempt any state law that "obstructs, impairs, or conditions" the exercise of a national bank's powers. 12 C.F.R. § 7.4009. State consumer financial law will also be preempted if it discriminates against out-of-state banks, or if it is otherwise preempted by some other provision of federal law.

The Act will continue the ability of the OCC to issue preemption determinations, on a case-by-case basis. In the exercise of this authority, the Comptroller must personally determine that the state consumer financial law at issue is preempted, *i.e.*, he may not delegate the determination duty to another agency official. Additionally, the OCC must consult the CFPB and must take the views of the CFPB into account in making the preemption determination.

The Act also affects the preemption accorded federal savings associations. Historically, federal savings associations have enjoyed the very broad standard of "field preemption," under which the Home Owners Loan Act (HOLA) and regulations promulgated by the Office of Thrift Supervision (OTS) were interpreted to have the broadest possible preemption as to potentially conflicting state law. The Act explicitly states that nothing in HOLA is to be interpreted as creating field preemption. Rather, the Act provides that federal savings associations are to enjoy the lesser preemption standard available to national banks – conflict preemption as reflected in the *Barnett* decision.

The Act codifies the exercise of visitorial powers as interpreted by the United States Supreme Court in *Cuomo v. Clearing House Ass'n*, 129 S.Ct. 2710 (2009). In *Cuomo*, the Court confirmed that the ability to exercise supervisory authority over a federally chartered institution, such as the routine examination of the books and records of the institution, resides in the primary banking regulator and not in state attorneys general. The Court also held, however, that this visitorial exclusivity does not displace the traditional law enforcement authority of state attorneys general to enforce compliance with non-preempted laws. The ability to conduct such law enforcement activities, however, is limited to civil litigation and may not be accomplished through state administrative enforcement actions.

Beyond the powers of federally chartered institutions themselves, the Act also eliminates the preemption enjoyed by operating subsidiaries of these institutions. Under the Supreme Court's decision in *Watters v. Wachovia*, 550 U.S. 1 (2007), the Court held that operating subsidiaries of national banks are entitled to the same preemption from state law as their national bank parents. The Act provides that operating subsidiaries are subject to the same laws as any other entity subject to state law.

Pepper Points: It remains to be seen whether the Act's preemption and visitorial powers provisions will have any significant consequences for federally chartered financial institutions. The *Barnett* standard for preemption of state consumer financial laws is different from the OCC standard only in degree, and the practical effect may be negligible, particularly given that reviewing courts are often more heavily influenced by pronouncements of the Supreme Court and not the OCC. As always, some disruption by state law will inevitably have to be tolerated by federally-chartered institutions.

Likewise, the codification of the *Cuomo* standard may have limited effect. However, it could embolden state attorneys general to become more aggressive in pushing the envelope of what constitutes non-preempted enforceable law.

In eliminating the operating subsidiary preemption under *Watters*, we are likely to see operating subsidiaries with significant consumer interaction converted to divisions of their parent financial institutions so as to retain as much of the benefits of preemption as possible.

Snowe-Pryor Amendment

Section 1100G of the Act sets forth the Snowe-Pryor amendment, which looks to ensure fairness and transparency for small businesses by designating the CFPB as a "covered agency" under the Regulatory Flexibility Act. As a covered agency, CFPB rulemakings that would have a significant economic impact on small businesses would be subject to small business review panel provisions. Additionally, the CFPB would have to give special consideration to the impact that such rules would have on the cost of credit for small businesses and consider specific alternatives to minimize increases in the cost of such credit. Such rulemaking hurdles, which are similar to those required of the Environmental Protection Agency and the Occupational Safety and Health Administration, can potentially increase the time it takes to pass new rules affecting small businesses from months to years.

Pepper Points: Deemed the "speed bump" provision, Section 1100G looks to slow down the CFPB rulemaking process for rules that would have significant economic impact on small businesses so that any intended or unintended effects of CFPB rulemakings on small businesses can be fully evaluated. Given the very broad definition of "small business" under the Small Business Act, the provision will provide necessary transparency and deliberation of CFPB rulemakings so as to protect a great number of businesses that are deemed to be small businesses.

Arbitration Clauses

The Act provides that the CFPB shall conduct a study and provide a report to Congress concerning the use of arbitration agreements in connection with consumer financial products or services. It also provides that the CFPB may by regulation "prohibit or impose conditions or limitations on the use of" arbitration agreements "if the [CFPB] finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers." The findings in the regulations must be consistent with the study.

Pepper Points: Congress has given the CFPB the authority to abrogate the 85-year-old Federal Arbitration Act but only with respect to arbitration agreements entered into by consumer financial services companies. Although the Act does not identify any particular concerns with arbitration agreements, consumer advocates and plaintiffs' class action lawyers have expressed concern that arbitration agreements can be used to defeat class action lawsuits and thereby prevent consumers from vindicating their rights. But numerous courts have already addressed the issue of when arbitration agreements may be unenforceable on the grounds that they would prevent consumers from vindicating their rights. It will be interesting to see how the CFPB conducts its study, what findings it makes, and how much deference it gives to the substantial body of legal precedent that already exists on the enforceability of arbitration agreements.

Reorganizing the Bank Regulators

The Act will dissolve the OTS and transfer its functions to other federal bank regulatory agencies. The OTS's supervisory responsibilities with respect to federal savings associations will transfer to the OCC, supervisory responsibilities with respect to savings and loan holding companies will transfer to the FRB, and supervisory responsibilities with respect to state savings associations will transfer to the Federal Deposit Insurance Corporation (FDIC). Supervision by the OCC of federal savings associations will be handled by the Comptroller through the new position of Deputy Comptroller for supervision of federal savings associations.

While the OTS may be dissolving and its oversight functions transferring to other agencies, all prior agency precedent, such as OTS or Federal Home Loan Bank Board legal opinions, will remain in force unless and until modified or withdrawn by a successor agency. The OCC will also acquire rulemaking authority for both federal and state savings associations.

Additionally, in consolidating all holding company regulation under the Federal Reserve, Congress has explicitly directed the Federal Reserve to apply its long-disputed source of strength doctrine to savings and loan holding companies. This doctrine requires holding companies to serve as a source of financial and managerial strength to their depository institution subsidiaries.

Pepper Points: The regulatory reorganization will affect institutions to varying degrees. For example, state savings associations will have to get accustomed to being accountable to four different banking regulators: state agencies and the FDIC for examinations, the OCC for rulemaking, and the Federal Reserve for holding company supervision and other rulemakings. This may lead to increased compliance review and risk management burdens. Additionally, in expanding the scope of the Federal Reserve's source of strength doctrine, not only has Congress included an entire category of regulated entities under the potentially burdensome source of strength doctrine, but Congress has also in effect given statutory approval to the doctrine itself, thereby eliminating the argument advanced by bank holding companies in the past that the Federal Reserve exceeded its statutory authority in adopting the source of strength doctrine.

De Novo Branching

Section 613 of the Act opens all states to interstate *de novo* branching regardless of whether a state affirmatively opts in and allows for *de novo* branching by out-of-state banks. Section 613 of the Act removes the required "opt-in" election by each state to permit interstate branching through *de novo* branches that was provided for in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Since the majority of states did not opt in after the passage of the Riegle-Neal Act, entry into such states was generally limited to an acquisition of an existing bank or an existing bank branch in such state. Under the Act, out-of-state banks will only be subject to such branching restrictions of a host state as that state imposes on its own in-state institutions. For example, some states require that any out-of-state bank seeking to branch *de novo* into that state must itself be located in a state that permits *de novo* branching by out-of-state banks. The Act would eliminate such reciprocity requirements.

Pepper Points: The interstate *de novo* branching provision has not garnered as much attention as other provisions of the Act, but it is an important provision for many large banking institutions looking to enter new markets. Without having to engage in acquisitions of existing banks or existing branches in a target state, out-of-state banks can now more easily pursue new markets. Additionally, interstate *de novo* branching will provide new challenges and competition for community banks and other state-chartered banks that were protected against competition from the larger banks under the previous opt-in regime.

Authority and Governance of the FRB

Limits on Emergency Lending Authority

The Act limits the FRB's Section 13(3) emergency lending assistance to a "program or facility with broad-based eligibility," making it unavailable to a specific individual, partner or corporation. As soon as practicable after the date of the Act's enactment, the FRB must establish policies and procedures, in consultation with the Treasury Secretary, designed to ensure that: (i) any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, (ii) the security for emergency loans is sufficient to protect taxpayers from losses, (iii) any such program is terminated in a timely and orderly fashion, and (iv) borrowers from the programs or facilities are not insolvent.

Authority to Require Reports and Conduct Examinations

Further, the Act provides the FRB with the power to require nonbank financial companies, including foreign nonbank financial companies, deemed by the newly created systemic risk regulator (as discussed below) to pose a systemic risk to the U.S. financial system ("Systemically Important Nonbank Financial Companies"), and their subsidiaries, to submit reports under oath regarding their financial conditions, risk management systems, and operations that pose a threat to the U.S. financial system. The FRB also has the power to examine Systemically Important

Nonbank Financial Companies to obtain the same information required in the reports.

Enforcement Authority

The Act grants the FRB the power to exercise the same enforcement authority it has as to bank holding companies over Systemically Important Nonbank Financial Companies, and their subsidiaries. The FRB also has the power to recommend that the primary financial regulator of depository institutions or functionally regulated subsidiaries institute enforcement proceedings.

Oversight

The Act requires a one-time audit by Congress's investigative arm, the Government Accountability Office (GAO), of the FRB's Section 13(3) emergency lending activities covering the period from December 2007 to the present. The Act specifically directs the GAO to examine potential conflicts of interest between the FRB and the banks that received assistance. The audit must begin no later than August 20, 2010 and must be completed no later than July 21, 2011.

Pepper Points: The GAO is given the authority to conduct a one-time audit of the FRB to review the FRB's use of its emergency lending activities during the recent financial crisis. Moreover, the FRB is prevented from using the emergency lending authority on a prospective basis to benefit a specific individual, partner, or corporation. Congress certainly raised concerns about the appearance of favoritism and subjectivity in the use of emergency lending and other resolution decisions. This new requirement will limit the FRB's discretion by requiring consultation with the Treasury Secretary and require certain conditions to be put in place. This hardly defangs the FRB, especially when the new law gives it power to examine Systemically Important Nonbank Financial Companies and take other supervisory and enforcement actions that extend beyond its traditional purview of bank holding companies.

New Resolution Authority of the FDIC

The Act gives the FDIC authority to act as receiver for and to liquidate any bank holding company, financial holding company, or Systemically Important Nonbank Financial Company. The Act provides that together the FDIC and the FRB may recommend that the Treasury Secretary should appoint the FDIC as receiver for a distressed financial company. Recommendations with respect to distressed broker-dealers are to be made by the Securities and Exchange Commission (SEC) and FDIC, and recommendations with respect to insurance companies are to be made by the director of the newly created Federal Insurance Office (as discussed below) and the FRB. The recommendation should: (i) evaluate (a) whether the financial company is in default or in danger of default; (b) the likelihood of a private sector alternative to prevent the default of the financial company; (c) any cases under the Bankruptcy Code that may be applicable to the financial company; and (d) the effects on creditors, counterparties and shareholders of the financial company and other market participants; (ii) describe the effect that a default of the financial company would have on the financial stability in the United States and the effect that a default of the financial company would have on economic conditions or financial stability for low-income, minority, or underserved communities; and (iii) recommend actions that should be taken. If the Treasury Secretary agrees that the FDIC should be appointed as receiver, it must notify the affected financial company. If the board of directors of the financial company does not consent to the appointment of the FDIC as receiver, the Treasury Secretary must petition the U.S. District Court for the District of Columbia for an order authorizing the Treasury Secretary to appoint the FDIC as receiver. Either party may appeal the District Court's decision to the U.S. Court of Appeals for the District of Columbia and may also appeal the Court of Appeals' decision to the U.S. Supreme Court.

Once the FDIC is appointed, the Act provides detailed guidance to the FDIC about how it should act in its role as receiver. In general, the FDIC is to ensure that the creditors and shareholders bear the losses of the financial company, that the management responsible for the poor financial condition of the financial company is not retained, and that other appropriate agencies take all steps necessary and appropriate to assure that all parties having responsibility for the condition of the financial company, including management, directors, and third parties, bear losses consistent with their responsibility.

Funding for expenses related to the liquidation process initially will be provided by the FDIC through a fund established by the Treasury Secretary. The FDIC is required to create a specific plan and schedule that shows how it will repay the borrowings from the fund with interest. The FDIC is expected to receive income to repay the fund from the following sources: first, the liquidated assets of the financial company; second, special assessments imposed on any claimant that received additional discretionary payments or amounts from the FDIC pursuant to certain provisions in the Act; and third, if these other sources are not sufficient, from special assessments placed on eligible financial companies.[1] The Act explicitly states that taxpayers shall bear no losses from the FDIC's actions as receiver, and that no taxpayer funds shall be used to prevent the liquidation of any financial company.

Pepper Points: We will provide a detailed update to this section, particularly with respect to (i) the powers that the FDIC as receiver of a failed depository institution has, compared to the FDIC as receiver to a financial company, and (ii) consequences to collateral and repurchase arrangements.

Financial Stability Oversight Council

Effective July 22, 2010, the Act creates the Financial Stability Oversight Council (Oversight Council), chaired by the Treasury Secretary and composed of heads of the FRB, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the OCC, the FDIC, the Federal Housing Finance Agency, the CFPB, and an insurance industry expert appointed by the President. Non-voting members will include the director of the newly created Office of Financial Research (discussed below), the director of the newly created Federal Insurance Office (discussed below), a state insurance commissioner, a state banking commissioner and a state securities commissioner.

The Oversight Council is tasked with identifying, monitoring, and mitigating systemic risks to the financial system. To achieve this goal, the Oversight Council has the power, upon the vote of two-thirds of its members, to subject certain nonbank financial companies to FRB supervision. A "nonbank financial company" is a company that derives 85 percent or more of its and its subsidiaries' consolidated annual gross revenues or consolidated total assets from activities that are financial in nature. The Oversight Council may subject a nonbank financial company to FRB supervision if it determines that the company's financial distress or the sheer nature, size or interconnectedness of its activities could threaten the financial stability of the United States. When making this determination, the Oversight Council must consider, among other things, the nonbank financial company's leverage, off-balance-sheet exposure, transactions and relationships with other significant nonbank financial companies or bank holding companies and importance as a source of credit. A nonbank financial company has to register with the FRB within 180 days of a final determination by the Oversight Council that it is to be supervised by the FRB. The Oversight Council would be supported by a newly created Office of Financial Research within the Treasury Department that would assist in collecting data and analyzing systemic risks. Nonbank financial companies subjected to FRB supervision are referred to as "Systemically Important Nonbank Financial Companies."

Once a Systemically Important Nonbank Financial Company is under FRB supervision, the FRB may require it and its subsidiaries to submit reports regarding its financial condition, risk monitoring systems, and risk of systemic threat to the U.S. financial system. However, the FRB must, to the fullest extent possible, use reports submitted to other federal and state regulators and rely on examination reports of any subsidiary bank made by the subsidiary's primary financial regulator. The FRB also has the same enforcement authority over a Systemically Important Nonbank Financial Company and its non-bank subsidiaries that it has over a bank holding company. With respect to a bank subsidiary of a Systemically Important Nonbank Financial Company, if the FRB determines the subsidiary poses a threat to the financial stability of the United States or does not comply with its regulations or orders, it may recommend to the subsidiary's primary regulator that enforcement action be taken, and take such enforcement action itself if the primary regulator does not.

Systemically Important Nonbank Financial Companies and "large, interconnected bank holding companies" (typically bank holding companies with more than $50 billion in consolidated assets unless the FRB determines a greater amount of assets is appropriate) both are subject to heightened prudential standards to be promulgated by the FRB. The forthcoming prudential standards *must* include: (i) risk-based capital requirements, (ii) leverage limits, (iii) liquidity requirements, (iv) concentration limits and (v) overall risk management requirements, and *may* include (a) a contingent capital requirement, (b) enhanced public disclosures and (c) short-term debt limits. The FRB must promulgate the rule implementing the prudential standards by January 21, 2012.

Systemically Important Nonbank Financial Companies and large, interconnected bank holding companies also will have to prepare plans for their swift and orderly resolution (so-called "funeral plans") in the event of a financial crisis. Each such company also will have to provide periodic reports to the FRB and FDIC disclosing its credit exposure to other Systemically Important Nonbank Financial Companies and large interconnected bank holding companies and such companies' credit exposure to it. The FRB and FDIC must jointly issue rules implementing the funeral plan and credit exposure report requirements by January

21, 2012. The FDIC published a proposed rule on May 17, 2010 that would require an insured depository institution with greater than $10 billion in total assets whose parent company holds more than $100 billion in total assets to submit to the FDIC analysis, information, and a contingent resolution plan that addresses and demonstrates its ability to be separated from its parent structure, and to be wound down or resolved in an orderly fashion. The Oversight Council also may recommend that the primary regulators of other nonbank financial companies and bank holding companies adopt heightened standards for a systemically risky financial activity or practice. Further, if the FRB feels that a Systemically Important Nonbank Financial Company or large interconnected bank holding company poses a grave threat to the U.S. financial system, it may require such company to stop offering certain financial products or divest certain assets.

Pepper Points: The Oversight Council is chaired by the Treasury Secretary who additionally has effective veto power over any significant supervisory actions undertaken by the Oversight Council. This is a significant new level of authority for the Treasury, which historically has been involved in financial regulatory matters primarily on a policy basis, rather than on a supervisory basis. Additionally, Treasury has a new Office of Financial Research that will staff the Oversight Council and provide further data and analysis to the Treasury about market information and trends. Congress also clearly was reacting to the concern during the financial crisis of the past 18 months that too much power was concentrated in the hands of the FRB and the Treasury Secretary and consequently has moved to an arrangement with 10 different agencies and constituencies represented to evaluate significant issues of financial stability for large firms and for certain activities. The level of supervision for nonbank financial institutions at the federal level is also unprecedented, and certainly the law was passed in light of the experience with monitoring and addressing the risks posed by Bear Stearns, AIG, Lehman Brothers and other entities outside of the traditional FRB regulatory world. The new law intends to have the FRB very closely involved with such organizations, which are not banks or bank holding companies, if the Oversight Council determines that is appropriate. There also are various tools contained in the regulatory sections in Title I to combat upticks in risky behavior by bank holding companies and nonbank financial institutions, and they are designed to become more stringent as firms grow in size, scale, and complexity. It would appear that the Congress is desperately trying to guard against the so-called lemming effect, where one institution proceeds in a certain direction with respect to risk appetite and then many other competitors feel compelled to follow, like lemmings, to stay competitive. These measures, if successful, may have more impact than any other provision in Title I in terms of safeguarding the financial services sector.

The Volcker Rule

The Act includes the controversial Volcker Rule, named after former FRB Chairman Paul Volcker, which significantly curbs the ability of any banking entity or Systemically Important Nonbank Financial Company to engage in proprietary trading and sponsor or invest in private equity or hedge funds. A banking entity is any insured bank or thrift, any company that controls them, any company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate of any such entities. An exception is provided for trust companies that meet the condition for exclusion from the definition of a "bank" under the Bank Holding Company Act.

Limits on Proprietary Trading

The Act prohibits any banking entity from engaging in "proprietary trading." The Act defines proprietary trading as engaging as a principal for the trading account[2] of the banking entity in any transaction to buy or sell, or otherwise acquire or dispose of, any security, derivative, commodity futures contract, any option on any such instruments, or any other security or financial instrument that the federal banking agencies, SEC or CFTC may determine by rule.

The Act excludes certain transactions from the restrictions on proprietary trading, including:

- transactions in (i) U.S. government or agency obligations, (ii) obligations, participations or other instruments of or issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution, or (iii) municipal obligations
- transactions in connection with underwriting or market-making in so far as any such activities "are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties"
- hedging activities in connection with and related to holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such holdings

- purchases, sales, acquisitions or dispositions of any security or other financial instrument "on behalf of customers"
- transactions for the general account of a regulated insurance company in accordance with applicable regulations, and
- proprietary trading by foreign entities or entities doing no business in the United States, conducted pursuant to Section 4(c)(9) or (13) of the Bank Holding Company Act, provided that the trading occurs solely outside the United States and the entity conducting the trading is not a direct or indirect subsidiary of a U.S. banking entity.

Regulations adopted under the Volcker Rule may establish additional permissible activities that are determined to "promote and protect the safety and soundness of the banking entity and the financial stability of the United States." None of the above or any other exception from the restrictions on proprietary trading would apply if the transaction would (i) result in a material conflict of interest between the banking entity and its clients, customers or counterparties; (ii) result in direct or indirect material exposure to "high-risk assets" or "high-risk trading strategies" (as such terms shall be defined by rule); (iii) pose a threat to the safety and soundness of the banking entity; or (iv) pose a threat to the financial stability of the United States.

Organizing and Offering a Private Equity or Hedge Fund

For banking entities looking to organize and offer a private equity or hedge fund as a product for their clients, there is an exception that allows such activity if the banking entity provides bona fide trust, fiduciary or investment advisory services, and the fund is organized and offered in connection with the provision of those services and only to persons that are customers of such services of the banking entity.

The organizing banking entity may provide seed capital to the fund, but the amount of all such investments cannot exceed 3 percent of Tier 1 capital at any time (or such lower limit as may be set by regulation as an "immaterial" amount), and within one year after establishing the fund the investment of the institution must be below 3 percent of the total ownership interests of the fund.

In addition, there are a number of restrictions on the relationship between the banking entity and the fund, including:

- the banking entity cannot extend credit to or enter into any other "covered transactions" under Section 23A with the fund
- the banking entity may not guarantee or insure the obligations or performance of the fund
- the fund must not share the same name or a variation of the same name with the banking entity for corporate, marketing, promotional or other purposes
- no director or employee of the banking entity may have an ownership interest in the fund except for directors and employees directly engaged in providing investment advisory or other services to the fund
- the banking entity must disclose to investors that any losses in the fund are born solely by the investors in the fund and not by the banking entity.

Investing in a Private Equity or Hedge Fund

Subject to any restrictions or limitations that may be imposed by regulation, an exception is provided for investments in one or more Small Business Investment Companies (SBICs) to the extent otherwise permitted, and accordingly SBICs can be expected to take on renewed significance for banking entities. Under the SBIC Act and related provisions, banks and bank holding companies are generally permitted to invest in SBICs up to 5 percent of their capital and surplus.

The Volcker Rule exception also covers investments designed primarily to promote public welfare as described in paragraph (11) of the National Bank Act, or investments under certain historic tax credit programs.

Investments solely outside the United States are permitted for a foreign banking entity that is not a subsidiary of a U.S. banking entity, but only if no ownership interest in the hedge fund or private equity fund is offered or sold to a resident of the United States.

Finally, there is also authority for the regulators to approve other activities as part of their coordinated rule making based on a determination that allowing such activity would "promote and protect the safety and soundness of the banking entity and the financial stability of the United States."

Systemically Important Nonbank Financial Companies

Systemically Important Nonbank Financial Companies are not subject to the outright prohibitions of the Volcker Rule, but will be subject to additional capital requirements and quantitative limits as established by regulation.

Effective Dates

By January 21, 2012, the Oversight Council is required to complete a study and make recommendations on implementing the Volcker Rule provisions, and within nine months after completion of this study the appropriate regulatory agencies (the banking regulators, the SEC and the CFTC) are required to adopt coordinated regulations. The Volcker Rule goes into effect on the earlier of 12 months after adoption of such regulations or July 21, 2012, two years after the date of the Act's enactment.

Once the Volcker Rule goes into effect, there is a two-year divestiture period for entities subject to the Rule to bring their activities and investments into compliance. The FRB may extend the divestiture period by rule or order in one-year increments, not to exceed an aggregate of three years. In addition, there are provisions for the FRB to extend the period during which a banking entity may take or retain an ownership interest in or otherwise provide capital to an illiquid fund, to the extent necessary to fulfill contractual obligations entered into prior to May 1, 2010, such extension not to exceed five years. The FRB is required to adopt regulations implementing the foregoing divestiture provisions separately from the coordinated rulemaking discussed above, by January 21, 2012.

Pepper Points: The ultimate effect of the Rule will depend on the coordinated regulations that come out of the required rulemaking process. Key matters left to the regulators to determine include:

- any further exceptions to the prohibitions of the Volcker Rule
- additional capital requirements and/or quantitative limitations to be imposed on any activities permitted as an exception under the Volcker Rule
- possible limitations on the statutory exceptions to the Volcker Rule, including to address material conflicts of interest, material exposure to high risk assts or trading strategies; and threats to the safety and soundness of the banking entity or to the financial stability of the Unites States.

Given the political climate and the statutory directives that will guide the regulations under the Volcker Rule, there may not be much hope for dramatic liberalization through the rule-making process. And pending the outcome of the rulemaking process, fund raising and new fund formation may be significantly affected as banking entities may be reluctant to commit new funds to any private equity or hedge funds.

The New Federal Insurance Office

Effective July 22, 2012, the Act creates a new Federal Insurance Office within the Treasury Department to monitor, but not regulate, the insurance industry, excluding health, long-term care, and crop insurance. The Federal Insurance Office is tasked with monitoring issues that could lead to a systemic crisis in the insurance industry, with the attendant consequences to the macro-financial system, and recommending to the Oversight Council any insurers it deems to be systemically important. The Federal Insurance Office will also oversee international insurance affairs, including developing U.S. policies, representing the United States in the International Association of Insurance Supervisors, and assisting the Treasury Secretary in negotiating international agreements applicable to insurance or reinsurance ("Covered Agreements"). Additionally, if the Federal Insurance Office determines that a state insurance law (i) results in less favorable treatment of a foreign insurer domiciled in a foreign jurisdiction that is subject to a Covered Agreement than a U.S. insurer domiciled, licensed, or otherwise admitted in that state, and (ii) is inconsistent with a Covered Agreement, it may preempt the state law.

However, the ability of the Federal Insurance Office to preempt state law shall not extend to: any state insurance measure that governs an insurer's rates, premiums, underwriting, or sales practices; any state coverage requirements for insurance; the application of state antitrust laws to insurance; or any issues related to the capital adequacy of an insurer, except to the extent that such state insurance measure results in less favorable treatment of a foreign insurer than a domestic insurer.

Pepper Points: Because of the interconnectedness of the insurance industry with the U.S. financial system, the federal government seeks to become knowledgeable about the insurance system, historically a system with state and local roots. Over time, if the Federal Insurance Office proves its value in addressing potential risk or instability in the insurance industry, or if significant deficits are observed in the state insurance regulatory system, then we may see calls for a federal-state chartering regime similar to the current dual banking system.

Risk Retention Requirement for Securitizations

Issuers and sponsors (securitizers) of a securitized product, such as a mortgage- or other asset-backed security, generally are required to retain 5 percent of the credit risk of the issuance and they are prohibited from directly or indirectly hedging any of the risk they are required to retain. Note, however, that the level of required risk retention is reduced or even eliminated for certain types of transactions depending upon the nature of the underlying assets and the ability to meet specified underwriting criteria. If all of the assets collateralizing the asset-backed security are, for example, "qualified residential mortgages," then no risk retention requirement applies. Forthcoming regulations must define the term "qualified residential mortgage," taking into account underwriting and product features that historical loan performance data indicate result in a lower risk of default. Also exempt are any residential, multifamily, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the United States or an agency of the United States, but not by Fannie Mae, Freddie Mac or the federal home loan banks.

Similarly, the level of required risk retention may be less than 5 percent if the originator of the underlying collateral meets certain underwriting standards to be established by forthcoming regulations. Compliance with those standards would, again, indicate that the credit risk associated with the underlying assets would be low enough to justify the issuer and sponsor retaining less risk in turn. Finally, the Act contemplates additional exemptions and/or reduced risk retention levels with respect to securitizations of commercial mortgage loans or securitizations of assets issued or guaranteed by the United States, individual states and certain government agencies. Additionally, the applicable risk retention levels for collateralized debt obligations, securities collateralized by collateralized debt obligations, and other similar instruments will be established separately by rule.

The FRB, OCC, FDIC and SEC have primary rulemaking authority, while the Secretary of Housing and Urban Development Compliance and the Director of the Federal Housing Finance Agency also have rulemaking authority with respect to residential mortgage-backed securities. Regulations implementing the credit risk retention requirements must be published in the Federal Register within 270 days from July 21, 2010. Regulations relating to credit risk retention requirements for residential mortgage assets would become effective one year from the date they are published. Regulations relating to credit risk retention requirements for all other asset classes would become effective two years from the date they are published. The FRB, OCC and FDIC can enforce the risk retention levels with respect to bank securitizers, while the SEC has similar enforcement authority over nonbank securitizers.

In addition, under the regulations to be established, the FRB, OCC, FDIC and SEC will have the discretion to allocate the risk retention percentage (5 percent or less) between the securitizer of the asset-based security and the originator of the asset who sells the asset to the securitizer. They also will have the authority to apply different underwriting standards and risk retention levels to different asset classes, including residential and commercial mortgages and automobile loans.

Pepper Points: The new risk retention rules contemplated by the Act will undoubtedly affect the scope and shape the future of the securitization markets. The regulations to be promulgated by the FRB, OCC, FDIC and SEC in accordance with the Act will not unfold overnight and, therefore, some uncertainty remains with respect to specific aspects of the new rules. Nonetheless, market participants should expect to adopt uniformly stringent underwriting standards and perform detailed analyses of asset quality and credit risk for future securitizations. Additionally, securitizers should expect to meet higher disclosure standards and undertake ongoing reporting requirements as contemplated by the Act. The structuring of future securitizations will impose a new balance among fundamental economic objectives, equity investment and risk mitigation.

Changes to Investment Adviser Registration Rules

Increase in Assets Under Management Threshold for All Advisers; Required Registration of Certain Hedge and Private Equity Fund Advisers

The Act affects the investment adviser registration status of all investment advisers, but especially of advisers of "private funds." The Act defines private funds as issuers exempt from registration as an investment company pursuant to Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.

Advisers with less than $25 million in assets under management cannot register with the SEC unless they advise a registered investment company. For these advisers, there is no change from before the Act was passed. Advisers with assets under management between $25 million and $100 million (although the SEC may raise the floor or ceiling) cannot register with the SEC unless they (i) would be forced to register as an investment adviser in 15 or more states, (ii) advise a registered investment company or (iii) advise a business development company. Advisers in this category, unlike before the Act was passed, will have to be registered under state law. Advisers with assets under management exceeding $100 million (or a higher amount that the SEC may determine) must register with the SEC unless an exemption from registration applies to them, such as an adviser whose only clients are insurance companies or whose only clients are private funds and who manage less than $150 million in assets (as described below).

Advisers no longer may rely on the "fewer than 15 clients" exemption from registration, which has been eliminated from the Investment Advisers Act of 1940 (the Advisers Act) altogether, and which many advisers to and general partners of hedge, private equity and venture capital funds have relied on for exemption from investment adviser registration.

The Act does provide several carve-outs. First, new Advisers Act Section 203(l) states that advisers to one or more "venture capital funds," which the SEC must define by rule by July 21, 2012, are expressly exempted from registration. Second, new Advisers Act Section 203(m) states that the SEC by rule must exempt from registration any investment adviser that acts "solely" as an investment adviser to private funds and that has assets under management of less than $150 million. It is hoped that the SEC will outline what qualifies as "solely" advising private funds in the forthcoming regulations, but in the absence of such a definition, advisers to private funds should not manage separate account money if they intend to rely on this $150-million exemption from registration. Under new Advisers Act Section 203(n), the SEC may issue rules requiring the registration and examination of investment advisers to "mid-sized private funds," which the Act does not define. Such rules must "reflect the level of systemic risk posed by such funds."

A "foreign private adviser" need not register with the SEC. A foreign private adviser is an investment adviser that does not have a place of business in the United States, has less than $25 million in aggregate assets under management attributable to U.S. clients and to U.S. investors in its private funds, has fewer than 15 clients invested in its U.S. private funds, does not hold itself out to U.S. investors as an investment adviser and does not advise a U.S. registered investment company.

The practical effect of the new registration provisions is that (i) advisers to venture capital funds, as such term will be defined by SEC, will be exempt from registration; (ii) foreign private advisers are exempt from SEC registration; (iii) advisers to hedge and private equity funds with assets under management exceeding $100 million will have to register with the SEC unless they "solely" advise private funds, in which case they only must register if they manage assets exceeding $150 million (with the contours of the $150-million exemption to be determined by the SEC); (iv) all other investment advisers with assets under management exceeding $100 million will have to register with the SEC unless they qualify for an exemption from registration; (v) no investment adviser with assets under management between $25 million and $100 million (as such floor or ceiling may be adjusted by the SEC) may register with the SEC unless they then would be forced to register as an investment adviser in 15 or more states or advise a registered investment company (in which case they must register) or business development company (in which case they may register); and (vi) advisers with less than $25 million in assets under management cannot register with the SEC unless they advise a registered investment company (in which case they must register, regardless of the level of assets under management).

Pepper Points: Note that a non-U.S. adviser that does not meet the definition of a foreign private adviser and does not qualify for another exemption from registration could be required to register as an adviser. The Act defines a foreign private adviser so narrowly that some non-U.S. advisers may discontinue managing money for U.S. investors.

New Books and Records Requirements Relating to Systemic Risk

Hedge and private equity fund advisers registered with the SEC also are subject to recordkeeping and reporting requirements designed to allow the Oversight Council to monitor systemic risk. The Act gives the SEC power to define the recordkeeping and reporting requirements, but states that for each private fund, the fund must describe: (1) the amount of assets under management and use of leverage, (2) counterparty credit risk exposure, (3) trading and investment positions, (4) valuation policies and practices of the fund, (5) types of assets held, (6) side arrangements or side letters, (7) trading practices, and (8) such other information "necessary and appropriate" to protect investors and assess systemic risk. The SEC has examination authority over the records and reports and must make them available to the Oversight Council.

Adjusting the Definitions of 'Accredited Investor' and 'Qualified Client'

With respect to the definition of "accredited investor," the net worth threshold for a natural person to qualify as an accredited investor will be $1 million, excluding the value of the investor's primary residence, for four years following July 21, 2010, the date of the Act's enactment. The SEC may conduct an initial review and determine whether to adjust by rule the definition as applied to natural persons, although the SEC may not adjust the net worth threshold. Four years after the date of the Act's enactment, July 21, 2014, and every four years thereafter, the SEC must review the entire definition of accredited investor, as applied to natural persons. The SEC may then modify the definition "as appropriate for the protection of investors, in the public interest, and in light of the economy," although any adjusted net worth threshold must be greater than $1 million, excluding the value of the investor's primary residence. The SEC also must adjust for inflation the asset threshold that a client must meet qualify as "qualified client" (currently at $750,000 in assets under management or $1.5 million in net worth) no later than July 21, 2011 and every five years thereafter.

Regulation of Derivatives

The Act effects a sweeping overhaul of how derivatives are regulated, imposing significant clearing, trading and trade reporting requirements and mandating the "pushout" of certain swap-related activities. The provisions discussed below become effective 360 days from July 21, 2010, except for the Swaps Push-Out Rule, which becomes effective two years after the other provisions are effective. After the Swaps Push-Out Rule becomes effective, insured depository institutions have an additional 24 months to bring their derivatives activities into compliance, although the appropriate federal banking regulator, after consulting with the CFTC and SEC, may extend the transition period for an additional year.

CFTC/SEC Jurisdiction

The Act calls for significant cooperation between the SEC and CFTC. The CFTC has jurisdiction over almost all "swaps," which are broadly defined as options, forwards and similar instruments whose value is based on reference to interest or other rates, currencies, commodities, debt instruments, indices, quantitative measures, or other financial or economic interests or property. Contracts of sale of commodities for future delivery (or options thereon) and certain physically settled forwards, among other things, are excluded from the definition. The SEC has jurisdiction over "security-based swaps," which are swaps based on a narrow-based securities index, a single security or loan or an event relating to a single issuer or the issuers in a narrow-based security index. The SEC and CFTC have joint jurisdiction over "mixed swaps," or those swaps with both swap and security-based swap components.[3]

Mandatory Clearing of Swaps

The Act requires the clearing of swaps that (i) the CFTC or SEC, as appropriate, determine are of a type that require clearing and (ii) are accepted for clearing by an exchange. A swap is exempt from the clearing requirements if it was entered into before July 21, 2010 or before the effective date of its clearing requirement and if it is reported either to a "swap data repository"[4] or the CFTC or SEC, as appropriate, within 180 days of the Act's effective date, July 22, 2010. Nonfinancial company end-users that use swaps to hedge their own commercial risk are excluded from the clearing requirements.

Swaps Push-Out Rule

The Act creates new categories of swap market participants, "swap dealers" and "major swap participants," and significantly limits their ability to engage in swap-related activities. Swap dealers are those that regularly enter into swaps in the ordinary course of business for their own account or hold themselves out as swap market makers. Major swap participants are not swap dealers but hold significant positions in swaps and could pose a systemic risk to the U.S. financial system.[5] Swap dealers and major swap participants may not access "federal assistance," such as FRB credit facilities or the discount window. Insured deposit institutions are subject to the federal assistance prohibitions only if they act as swap dealers, and they may engage in the following swap-related activities in-house and still access federal assistance:

- hedge risk directly related to their own activities
- enter into interest rate, foreign exchange and gold, silver or certain other precious metal swaps, and
- enter into exchange-traded credit default swaps.

Lending Limits

Section 610 of the Act expands national bank lending limits to include derivatives and securities lending credit exposure. Section 610 of the Act amends the National Bank Act lending limits by amending the definition of "loans and extensions of credit" to include any credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction between a national bank and such person. Section 610 also defines a "derivative transaction" to include any transaction that is a contract, agreement, swap, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets. The amendments provided in Section 610 will take effect one year after the date of enactment of the Act, or July 21, 2011.

Section 611 of the Act effectively provides for consistent treatment of derivative transactions in lending limits for state-chartered banks as such banks will only be able to engage in derivative transactions if the state law governing lending limits for such state-chartered banks takes into consideration credit exposure to derivative transactions. Section 611 of the Act will take effect January 21, 2012.

Pepper Points: Credit exposure to derivative transactions is viewed in some circles as one of the main culprits in the financial crisis as banks were able to increase such credit exposure outside regular lending limits. Congress has followed this view and has looked to curb such actions by including credit exposure to derivative transactions in national bank lending limit requirements and effectively extending such requirements to state-chartered banks. Once such amendments become effective, both national banks and state-chartered banks will have to review and adjust credit exposure and capital provisions to ensure compliance under such new laws.

Leverage Capital and Risk-Based Capital Requirements

The Act includes a version of the so-called Collins Amendment that requires the appropriate federal banking agencies to establish minimum leverage capital and risk-based capital requirements applicable to banks, bank holding companies, thrift holding companies and Systemically Important Nonbank Financial Companies. Such companies will be subject to the minimum leverage capital and risk-based capital requirements to be established by the appropriate federal banking agencies, which cannot be less in amount than those requirements that were applicable to banks before the Act was passed.[6]

Instead of prohibiting trust preferred securities from qualifying as Tier 1 capital at the holding company level, which was contemplated by Congress at various points, there is significant grandfathering with respect to trust preferred securities. Specifically:

- bank holding companies with more than $15 billion in consolidated assets as of December 31, 2009 may phase-in the elimination of trust preferred securities as Tier 1 capital for the period January 1, 2013 through January 1, 2016, for any trust preferred securities issued before May 19, 2010
- bank holding companies with less than $15 billion in consolidated assets as of December 31, 2009 permanently may treat as Tier 1 capital all trust preferred securities issued before May 19, 2010
- bank holding companies with less than $500 million in consolidated assets as of December 31, 2009 ("Small Bank Holding Companies") may continue to treat trust preferred securities as Tier 1 capital
- thrift holding companies with more than $15 billion in consolidated assets as of December 31, 2009 may phase-in the elimination of trust preferred securities as Tier 1 capital for the period January 1, 2013 through January 1, 2016, for any trust preferred securities issued before May 19, 2010 (although they will not be subject to the new leverage capital and risk-based capital requirements until July 21, 2015, the fifth anniversary of the Act's enactment)
- thrift holding companies with less than $15 billion in consolidated assets as of December 31, 2009 may treat as Tier 1 capital all trust preferred securities issued before May 19, 2010
- mutual holding companies may treat as Tier 1 capital all trust preferred securities issued before May 19, 2010
- Systemically Important Nonbank Financial Companies may phase-in the elimination of trust preferred securities as Tier 1 capital for the period January 1, 2013 through January 1, 2016, for any trust preferred securities issued before May 19, 2010
- trust preferred securities issued after May 19, 2010, other than those issued by Small Bank Holding Companies, can no longer be counted as Tier 1 capital and are not granted a phase-in. They may be treated as Tier 2 capital.

Pepper Points: The banking regulators have been given significant authority to prescribe new capital and leverage ratios for regulated institutions. Given the impending Basel III capital standards, the regulators will need to consider the impact of higher capital or prescribing more restrictive leverage ratios on the cost of capital and the ability of financial institutions to make credit available given the disappointing economy at this point in the recovery. The phasing out of trust preferred securities will no doubt result in higher costs of institutions above $15 billion in assets. These changes will bear watching carefully to determine their ultimate impact on the industry.

Mortgage Reform and Anti-Predatory Lending Act

Title XIV of the Act, entitled the Mortgage Reform and Anti-Predatory Lending Act (the Mortgage Reform Act), among other things, amends the Truth-in-Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) to set standards for the origination and servicing of residential mortgage loans. In amending TILA, Congress determined that passage of the Mortgage Reform Act would enhance economic stabilization. Its stated purpose, among other things, is to make sure that residential mortgage loans offered to and received by consumers reflect their ability to repay the loans and are not unfair, deceptive or abusive.

Mortgage Originators

The Mortgage Reform Act sets standards for the qualification of mortgage originators, subject to regulations to be adopted by the CFPB. The term "mortgage originator," subject to certain exceptions, is defined broadly to include any person who takes a residential mortgage loan application, assists a consumer in obtaining or applying for a mortgage loan, offers or negotiates the terms of a residential mortgage loan, or represents to the public that it can or will provide any of those services. Persons who perform purely clerical and administrative tasks are not included. Each mortgage originator must be qualified, and, when required, licensed in accordance with applicable state or federal law. The CFPB will adopt regulations to implement the standards regarding mortgage originator qualifications.

The Mortgage Reform Act also restricts the compensation that can be paid to mortgage originators. Any compensation paid to mortgage originators may not vary based upon the loan terms, except for the principal balance, and a mortgage originator, subject to certain exceptions, may not be compensated by both the consumer and a third party. It is important to note that the limitations do not restrict compensation paid for secondary mortgage market transactions.

Regulation of Mortgage Lending Practices

The CFPB is given broad authority to prescribe regulations that prohibit practices of mortgage originations. Those practices include such things as:

- steering a consumer to a loan that the consumer lacks a reasonable ability to repay or that has predatory characteristics or effects (equity stripping, excessive fees, abusive terms)
- steering a consumer who qualifies for a "qualified mortgage" (described below), basically a "plain vanilla" mortgage, to a "non-qualified" mortgage (the concept of what constitutes a qualified mortgage is specified in the Mortgage Reform Act, subject to modifications of that criteria by the CFPB and certain other agencies)
- abusive or unfair lending practices that promote disparities based upon race, ethnicity, gender or age
- mischaracterizing or inducing another to mischaracterize the appraised value of the mortgaged property
- discouraging consumers from seeking a loan from another lender if the mortgage originator cannot suggest, offer or recommend a loan that is not more expensive than a loan for which the consumer qualifies.

Further, the CFPB may, by regulation, prohibit or condition any acts or practices that it determines are unfair, deceptive or predatory.

The CFPB is required to adopt prescribed regulations in final form 18 months after the transfer of oversight to the CFPB (as previously discussed in this Alert). The applicable provisions of the Mortgage Reform Act and the regulations issued thereunder will take effect 12 months after issuance of the applicable final regulations. If regulations have not been issued within the 18 month period, the applicable section of the Mortgage Reform Act will take effect 18 months after the transfer to the CFPB.

Restrictions on Mortgage Loan Terms

The Mortgage Reform Act imposes other restrictions on terms of mortgage loans. Prepayment penalties are prohibited if the mortgage loan is not a qualified mortgage. For purposes of this provision, adjustable rate loans and mortgage loans with an APR that exceed certain levels will not be considered qualified mortgages. Even with respect to qualified mortgages, limitations on the amount and duration of prepayment penalties are imposed. In addition, before providing a loan with a prepayment penalty, a creditor must offer the consumer a loan that does not contain a prepayment penalty.

The Mortgage Reform Act also prohibits the financing of single premium credit insurance and loans that contain negative amortization features unless certain conditions are satisfied. Further, it requires that, with respect to hybrid adjustable rate loans, a creditor or servicer of the mortgage loan provide a six-month notice of interest rate reset. The content of the notice, which must be a separate and distinct notice, is specified in the Mortgage Reform Act. The CFPB may also require an interest rate reset notice for adjustable rate loans.

High-Cost Mortgages

The Home Ownership and Equity Protection Act (HOEPA) is amended to, among other things, lower the thresholds that subject a loan to HOEPA. The interest rate trigger for a first lien loan of $50,000 or more secured by a principal dwelling is 6.5 percent above the average prime rate. With respect to first lien loans less than $50,000, and subordinate liens on a principal dwelling, the interest rate trigger is 8.5 percent above the average prime rate. The points and fees trigger, as well as the definition of what fees are included, were also modified. The points and fees trigger is 5 percent for loans for $20,000 or more and for loans less than $20,000, 8 percent, $1,000, or an amount set by the CFPB.

Additional requirements and restrictions are imposed with respect to high-cost mortgages, including the prohibition of balloon payments, limitations on late fees, restrictions against acceleration of loans, and restriction of financing points and fees.

Mortgage Servicing

The Mortgage Reform Act regulates the servicing of mortgage loans. Subject to certain exceptions, it requires that escrow accounts be established for first lien loans on principal dwellings for taxes, hazard insurance, flood insurance, mortgage insurance, ground rents and other periodic payments with respect to the property or required by the loan's terms. The escrow account must remain in existence for at least five years. The administration of escrow accounts is also addressed, subject to regulations to be established by the CFPB.

Also with regard to mortgage servicing, RESPA is amended to include prohibitions against and conditions on a mortgage servicer's activity including:

- force placed insurance
- charging of fees to respond to consumers, as determined by the CFPB
- failure to take timely action in response to borrower requests
- failure to provide the name of the owner of a loan within 10 days of a consumer's request, and
- failure to comply with regulations to be established by the CFPB.

TILA was also amended by the Mortgage Reform Act to address mortgage servicing, including requiring the prompt crediting of borrower payments and servicer response time to borrower payoff requests.

Disclosures

Additional TILA consumer disclosures are required, including with respect to variable rate loans the amount of the monthly payments and the fully indexed monthly, each including the required escrow payments. Other disclosures include the aggregate amount of settlement charges, the aggregate amount of fees paid to the mortgage originator by the consumer and creditor, and the total amount of interest paid over the life of the loan as a percentage of the principal amount of the loan. Subject to certain exceptions, monthly statements, containing specified information, will also have to be provided to borrowers by the creditor, assignee or servicer. The CFPB is charged with developing a standard form, which may be transmitted to a borrower in writing or electronically.

Appraisal Requirements

The Mortgage Reform Act also establishes appraisal requirements for "higher-risk" mortgages. Higher-risk mortgages are defined as non-qualified mortgages that exceed certain interest rate thresholds. Broker price opinions, for example, cannot be used and, in certain cases, a second appraisal will be required.

In addition, there are a host of other provisions regarding appraisals, including appraiser independence standards, many of which will be defined by regulation.

Pepper Points: The drastic bureaucratic overhaul will take years to establish, perhaps to the distraction of focusing on enforcement of existing laws, regulations and guidelines that already address many of the mortgage lending practices of concern to the "good" actors on both sides of the issue. For example, as early as 2006, federal banking regulators issued guidance regulations encouraging "plain vanilla" mortgage loans and addressing underwriting standard, portfolio and risk management practices, and consumer protection issues regarding "non-traditional mortgage loans."

While some lawmakers indicate that the costs of compliance will not detrimentally affect "good" actors, it is clear that the cost of compliance will increase for an extraordinary number of entities and we are yet to see the economic affect of the Mortgage Reform Act on businesses and consumers alike.

The CFPB is given broad authority to adopt regulations with respect to substantially all of the issues addressed by Title XIV, so the full impact on the mortgage lending industry and consumers will not be seen for years.

Endnotes

1 Eligible financial companies are defined as any bank holding company with total consolidated assets equal to or greater than $50,000,000,000 and any nonbank financial company supervised by the Board of Governors.

2 A "trading account" is defined as any account used for acquiring or taking positions in any security or other financial instrument principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the federal banking agencies, SEC or CFTC determines by rule.

3 For ease of reference, the term "swap" also refers to a security-based swap.

4 A "swap data repository" is defined as "any person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for swaps."

5 For ease of reference, the term (i) "swap dealer" also refers to a security-based swap dealer and (ii) "major swap participant" also refers to a major security-based swap participant. The SEC and CFTC are required to further define the terms "major swap participant" and "major security-based swap participant."

6 Bank holding companies and Systemically Important Nonbank Financial Companies are not required to deduct from their regulatory capital investments in financial subsidiaries that national banks are required to deduct, unless the FRB, in the case of bank holding companies, or the primary financial regulatory agency, in the case of Systemically Important Nonbank Financial Companies, requires such a deduction.

Pepper Hamilton's Financial Services Practice Group will continue to monitor developments in the financial services reform process and the forthcoming rules and regulations that will implement the provisions of the Act. For additional information regarding the issues addressed in this *Alert*, please contact any of the following Pepper Hamilton attorneys.

Richard P. Eckman, Chair, Financial Services Practice Group
(302.777.6560 | eckmanr@pepperlaw.com)

Powers of the Bureau of Consumer Financial Protection
Richard P. Eckman (302.777.6560 | eckmanr@pepperlaw.com)
Stephen G. Harvey (215.981.4450 | harveys@pepperlaw.com)
Daniel G. Murray (609.951.4202 | murrayd@pepperlaw.com)

Preemption of State Law
Stephen G. Harvey (215.981.4450 | harveys@pepperlaw.com)
Travis P. Nelson (215.981.4187 | nelsont@pepperlaw.com)

Snowe-Pryor Amendment
Matthew A. Vigunas (609.951.4114 | vigunasm@pepperlaw.com)

Arbitration Clauses
Stephen G. Harvey (215.981.4450 | harveys@pepperlaw.com)

Reorganizing the Bank Regulators
Travis P. Nelson (215.981.4187 | nelsont@pepperlaw.com)

De Novo Branching
Travis P. Nelson (215.981.4187 | nelsont@pepperlaw.com)
Matthew A. Vigunas (609.951.4114 | vigunasm@pepperlaw.com)

Authority and Governance of the Federal Reserve Board
Timothy R. McTaggart (202.220.1210 | mctaggartt@pepperlaw.com)

FDIC Resolution Authority
Frank A. Mayer, III (215.981.4632 | mayerf@pepperlaw.com)

Financial Stability Oversight Counsel
Timothy R. McTaggart (202.220.1210 | mctaggartt@pepperlaw.com)

The Volcker Rule
J. Bradley Boericke (215.981.4790 | boerickej@pepperlaw.com)

The New Federal Insurance Office
Frank A. Mayer, III (215.981.4632 | mayerf@pepperlaw.com)
Travis P. Nelson (215.981.4187 | nelsont@pepperlaw.com)

Risk Retention Requirement for Securitizations
William R. Wagner (212.808.2756 | wagnerw@pepperlaw.com)

Changes to Investment Adviser Registration
Gregory J. Nowak (215.981.4893 | nowakg@pepperlaw.com)

Regulation of Derivatives
Gregory J. Nowak (215.981.4893 | nowakg@pepperlaw.com)

Lending Limits
Matthew A. Vigunas (609.951.4114 | vigunasm@pepperlaw.com)

Leverage Capital and Risk-Based Capital Requirements
Richard P. Eckman (302.777.6560 | eckmanr@pepperlaw.com)

Mortgage Reform and Anti-Predatory Lending Act
Daniel G. Murray (609.951.4202 | murrayd@pepperlaw.com)
Audrey D. Wisotsky (609.951.4133 | wisotskya@pepperlaw.com)