Financial Legislation
Takes a New Track

By Rich Shea
Illustration by Guy Parsons

The Dodd-Frank Act, considered the most far-reaching piece of financial legislation in 80 years, has dramatically changed the legal landscape for corporations and consumers alike. And while it may be too early to tell what direction it will take, one thing's for sure: Lawyers will need to help clients deal with uncertainty.

On a Tuesday morning in late March, Peter Holland '92 is projecting a chart on the classroom screen in the Consumer Protection Clinic class he is teaching as a visiting professor at UM Carey Law. An unpretentious native New Yorker, Holland has devoted the last 18 years to helping "the little guy"—mostly disadvantaged clients trying to pry themselves from the tenacious grips of debt collectors and predatory lending agencies. So it makes sense that he should explain on both the macro and micro levels the ways in which the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 will affect consumers and, thus, their prospective lawyers.

The chart he is using resembles a spider web with more than 100 red and black lines crisscrossing each other as they extend from left to right. The chart was created by a former student who had worked at one of the eight federal agencies listed on it. "She became so disillusioned, she quit and went to law school," Holland explains.

Part of the problem is there are too many government agencies supposedly enforcing 16 separate pieces of legislation aimed at protecting consumers. The Truth in Lending Act, for instance, is pierced by five red arrows, meaning that all of the pertinent agencies are charged with enforcing it: the OCC, the FDIC, the OTS, the NCUA, and the FTC. "How many people have ever even heard of the NCUA?" Holland asks. He scans the classroom, sees no hands raised. "Good," he says, "honest answer: nobody. And here you are, in a consumer protection class, and you never heard of it." So how, he asks, is your average consumer going to know that the National Credit Union Administration is, in theory at least, a potential legal resource?

Below the red and black spaghetti is another chart that the former student created. It lists the same 16 pieces of legislation in two tidy rows and links all to just one central agency. As part of the new Dodd-Frank Act, named for primary authors U.S. Representative Barney Frank and former U.S. Senator Christopher Dodd, the Consumer Financial Protection Bureau, or CFPB, should be up and running Summer 2011.

Dodd-Frank is described by UM Carey Law Professor Michael Greenberger as "the most far-reaching piece of financial legislation" in 80 years. As Holland points out, the CFPB will write the rules for and enforce consumer protection laws, but it won't, like those agencies listed in the first chart, be beholden to financial institutions that, as a matter of practice, help fund their operations.

"We are finally going to have an autonomous federal agency whose sole mission is consumer protection," Holland said prior to his class. "And that," he added, "has never happened before."

Dodd-Frank, if fully implemented, would mean the end of "toxic" loans, one of the many types of subprime loans that became such a large part of financial institutions' portfolios in the 2000s that, when the housing market tanked, almost caused a "second Great Depression," according to Greenberger.

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"The [Dodd-Frank] Act," Greenberger says, "would require lenders to verify the ability of the borrower to repay. That's huge."

Dodd-Frank is unique from traditional legislation in one very important respect, say those most familiar with it. While many pieces of legislation come in response to in-depth studies of the problem, Dodd-Frank implements legislation and then directs studies to be done to determine if the scope of regulation is appropriate or whether more or less action needs to be taken. This unprecedented procedure of "implement first, review later," places both lawyers and businesses affected by the Dodd-Frank Act in a sort of legal limbo. On Capitol Hill, the pro-business lobby is trying to scale back regulation, and there's speculation that, because the oversight agencies have to be federally funded, a now Republican-controlled Congress might "starve it" financially.

"The assault from the House majority on financial reform has been pretty relentless. And so, there is a lot of work to be done," says Lisa Donner, executive director of the advocacy coalition Americans for Financial Reform.

On the other hand, Thomas Quaadman, vice president of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness, is among those who believe that the CFPB will simply add to an already complex network of agencies that, prior to the crisis, failed to enforce regulations that might have kept irresponsible financial institutions in check. Dodd-Frank, Quaadman says, will "adversely impact the ability of companies to go out and raise the capital that they need to expand their businesses and create jobs."

Whether or not the act is gutted, starved, or brought to full fruition, the legal landscape has been altered. For several years to come, figuring out which parts of the act will or won't stick will be a fluid process. This is expected to pose a major challenge to lawyers advising financial institutions or businesses that deal with financial institutions—or even consumers. Whoever's paying, one thing's for sure: Lawyers will need to help clients deal with all the uncertainty.

ONE TRAIN, LOTS OF CARGO

Dodd-Frank, at 2,300-plus pages, is so comprehensive that what gets highlighted depends on to whom you're talking. In general, it purports to do a few big things: 1) consolidate and strengthen government oversight, ensuring that financial institutions don't pose systemic risk; 2) provide transparency in once-unregulated markets; 3) put a stop, via a liquidation process, to institutions whose collapse threatens the

economy; and 4) protect the consumer. It's also supposed to protect taxpayers from ever having to bail out financial institutions again.

Greenberger, a former official of the Commodities Futures Trading Commission who teaches a seminar on derivatives, helped shape what Dodd-Frank looks like by serving on Congressional advisory committees and testifying on Capitol Hill. So it's no surprise that his focus is Title VII, or "Wall Street Transparency and Accountability." These provisions regulate a market that grew at such precipitous rates that, by 2007, it accounted for more than $600 trillion in trade, exceeding the stocks and bonds markets worldwide, according to Greenberger. And because the market was unregulated, it operated without oversight or transparency.

Among the derivatives, which include options and futures, were over-the-counter "swaps," or quasi forms of insurance that investors financed to back mortgages they were "betting" would be repaid. As the housing and subprime markets grew, however, and loans were made available to those who had never qualified before, credit default swaps, or insurance paid by investors betting on the default of those loans, started to pop up—and grow exponentially.

Ethical questions aside, the insurance companies backing these bets didn't have to show they had the capital to cover potential losses. And, like many, they believed the housing market would stay robust. It didn't, and the subprime-loan market collapsed, ruining scores of financial institutions and investors.

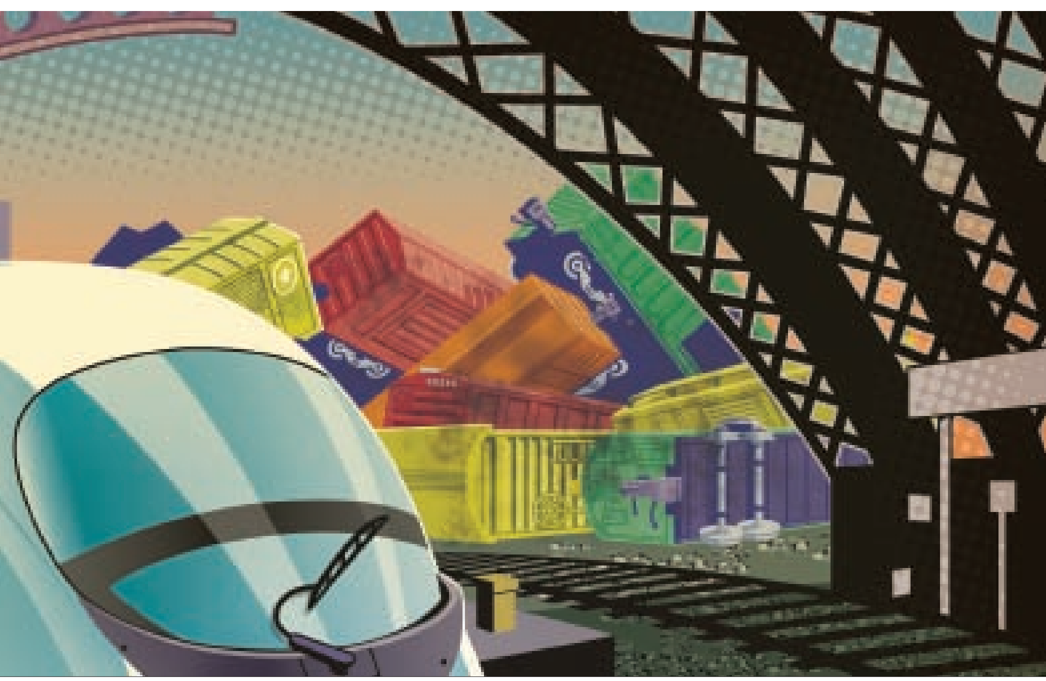
"The failure to have a regulatory format for that market was the principal—not the only, but the principal—reason for the meltdown," Greenberger explains. It started the dominoes tumbling, which is why Title VII takes up almost a third of Dodd-Frank, requiring that those who enter the over-the-counter swaps market "must enter it with sufficient capital to sustain your business operation," Greenberger says. So any type of swaps transaction—of which there are many, including interest-rate, currency, foreign-exchange, and energy—must be covered "so the taxpayer is not forced to bail out parties that make mistaken and reckless investments."

In addition, 90 percent of the transactions will have to be cleared by an exchange-like trading vehicle, meaning, Greenberger says, "that there must be a central guarantor on both sides of the contract." Had these rules been in place previously, an insurance company like AIG, which lost $85 billion it didn't have, probably wouldn't have gotten into the subprime mortgage game to begin with.

Among the materials Greenberger assigns to his UM Carey Law students (including the Academy Award-winning documentary *Inside Job* and the best-selling book *The Big Short*) is the PBS Frontline episode *The Warning*. It recounts the time he spent working, in the late 1990s, for the federal Commodity Futures Trading Commission (CFTC), where Chairperson Brooksley Born, foreseeing what eventually would occur, pushed for extensive regulation of the derivatives industry. But to no avail.

"The power of Wall Street, in terms of lobbying, is overwhelming," Greenberger says. "And in the absence of a crisis, they convinced Congress—and they were aided by people like Alan Greenspan, who was [Chairman of the Federal Reserve], and Larry Summers, who was Secretary of the Treasury—that this was a market that presented no risk." That, he says, was obviously a mistake. "It not only presented risk, it presented systemic risk that almost brought the economy down."

There are specific provisions in the new law aimed at preventing system-wide failure in the future. Title II, or "Orderly Liquidation Authority," for example, enables the government to monitor companies' operations and force them into bankruptcy should their activities threaten the economy. Those familiar with this provision note that it provides the government an important mechanism—not in place before—for dealing with systemic risk.



Quaadman, at the U.S. Chamber of Commerce, says that portions of the derivatives and liquidation provisions in Dodd-Frank make a lot of sense. He worries, however, that other provisions will "take risk out of the equation, and that's exactly the wrong thing to do. If you're talking about excessive risk-taking, that's one thing. But if you look at the financial crisis, you have companies that were looking at the same economic data and making different strategic decisions. Some people made smart decisions; some people made not-so-smart decisions. …But you can't grow a free-enterprise economy without risk."

Excessive, not reasonable, risk-taking was the norm for too long, according to Donner, at Americans for Financial Reform. Dodd-Frank, she believes, steers financial policy-making in a new direction. Prior to the crisis, she says, "there were laws passed or policies made, at the behest of special interests, to remove regulation or prevent oversight. And the consequence of that was a series of failures."

Like Donner, Holland and Greenberger are concerned that current lobbying efforts, backed by the same forces that shut down the CFTC's attempt to regulate derivatives trading in the late '90s, may all but gut Dodd-Frank. "My message to students," Greenberger says, "is that this thing could become completely unwound within the next year."

Having studied the derivatives market for 15 years, Greenberger can't help but get passionate about the subject. "We have seen conduct that almost put us into a second Great Depression," he says. "Unemployment is as high and sustained as it's ever been. People are insecure in their jobs, if they have them. Pension funds have been depleted." State and city budgets, he adds, are in terrible shape. "So that, to me, is the deluge—stunted economic growth on steroids."

PROTECTING CONSUMERS

Holland sounds a similar theme, saying, "Dodd-Frank is about increasing transparency. And we know what happens when things are not transparent: the mortgage meltdown. Also, the act is very pro-Capitalist and very pro-business.

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—Professor Michael Greenberger

When you let people get away with deceptive practices, then the honest, transparent business is put at a competitive disadvantage." Which is one reason he and his clinic students, who aid mostly economically disadvantaged victims of unfair or deceptive trade practices, are so excited today. On April 1, a Dodd-Frank regulation created by the Federal Reserve kicked in, banning what's known as the "yield-spread premium." The YSP is the extra percentage point or two a mortgage broker tacks on to a client's interest rate, and which he or she splits with the lending institution.

A common source of profit, the YSP is indicative of the larger problem that lawyers like Holland and his protégés had to face pre-Dodd-Frank—legal loopholes allowing financial institutions to gouge the public. Another upcoming Dodd-Frank ban, on prepayment penalties, is just as significant, Holland tells his students. Then he asks, "Can anybody explain this?"

One young man volunteers, noting that 30 years ago when banks both loaned and collected money for mortgages, they ensured the borrower was able to pay by engaging in due diligence. But once lending and collecting were separated, and the desire to lure greater numbers into the market grew, financial institutions began promising no-interest loans—at least for the first couple years—to those who had never before hoped to own a house. Once the initial period was over, the ARM, or adjustable-rate mortgage, would kick in at more than 10 percent. When the borrower would try to refinance with a better loan, he or she would then discover a prepayment penalty buried in the contract's fine print that made it all but impossible to get out from under the original loan.

"So, you're locked in, you're a prisoner, because you can't afford the penalty," Holland explains. "Banning that is huge; it's a huge reform that will directly impact the consumers that we represent in this clinic."

There seems little doubt that Dodd-Frank will impact the practices of lawyers throughout the profession—whether they are advising large businesses on provisions dealing with derivatives and disclosures or small businesses that use consumer financial products to finance their businesses and thus must understand Title X and the Consumer Financial Protection Bureau.

As for law students, those who want to go into government will now have more opportunities because federal agencies need assistance with the new charges of the legislation. Greenberger believes that the move toward increased regulation has prompted law schools—UM Carey Law, included—to better prepare students for working in both the agencies and the financial industry. "For those going into investment-banking or securities law, they have to understand how the market operates," he says. And with more than 2,300 pages of regulations in Dodd-Frank, "there's a lot there for lawyers to work on."

As for Holland, he advises students to look at any major law firm's website. Dodd-Frank, he says, is the hot topic. "And if you could become an expert in some aspect of the law—whether it's consumer protection or something else—you're going to be way ahead of the game. It's going to affect people whether it totally flops or goes a hundred percent. Regardless of what the end game looks like, you have the opportunity to seize this thing." ■