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What's the Holdup With Dodd-Frank Rulemaking?

By Karen Kroll

Even though the Volcker Rule is scheduled to go into effect this month, many banks aren't sure exactly how they'll comply with it. That's because a final version of the Rule still didn't exist as of mid-June.

While the Securities and Exchange Commission, the Federal Reserve, and other federal agencies proposed a version of the Volcker Rule in October of last year, they have yet to issue final rules. The Rule, a cornerstone provision of the Dodd-Frank Act, generally prohibits banks from engaging in short-term proprietary trading for their own accounts, and from owning or sponsoring hedge funds or private equity funds. The proposal included several exceptions, and the final rules are expected to clear up existing confusion over how broadly the Rule will apply.

Recognizing the dilemma created by this delay, the agencies announced in late April that financial firms would have two years from the July 2012 effective date to "fully conform their activities and investments to the requirements of section 619 of the Dodd-Frank Act …"

To be sure, the Volcker Rule is just one of many rules required by Dodd-Frank that have yet to be issued, even though the law was passed nearly two years ago. As of May 1, of the 221 Dodd-Frank rulemaking requirement deadlines that had passed, two-thirds of them (148) had been missed, a report from the law firm of Davis Polk & Wardwell shows. Just 73, or 33 percent, had been met with finalized rules.


Greenberger

The SEC has been fairly quiet on the Dodd-Frank rulemaking front so far this year. That's not to say that the Commission hasn't been busy: It released a study, jointly with the Commodity Futures Trading Commission, on international swap regulation; requested comment on a financial literacy study; made public an analysis of market data related to credit default swap transactions; announced the formation of an investor advisory committee; and conducted another study on the extraterritorial scope of private rights of actions under Section 10(b) of the Securities Act. Perhaps its most significant action has been to announce, along with the CFTC, approval of the final rules defining several terms related to the over-the-counter swap market, including "swap dealer" and "major swap participant."

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Still, by its own estimate, the SEC has several dozen activities related to Dodd-Frank left on its to-do list for this year. One of the most important will be defining just what a "swap" is, says Michael Greenberger, professor at the University of Maryland School of Law, and previous director of trading and markets with the CFTC. The need to work with other agencies to finalize rules is one of the reasons securities regulation experts cite for the delays in Dodd-Frank rulemaking. That this definition will need approval from both the SEC and the CFTC probably is adding to the time frame, says Greenberger. "You've got to get majority approval in two different staffs," he says. "That kind of process is inherently difficult."

The SEC isn't the only entity behind on Dodd-Frank rulemaking. As of early May, banking regulators had missed 50-some deadlines, the CFTC had missed 17, and other agencies had missed almost 80, according to Davis Polk.

Several factors likely account for the delays. The job initially set before the SEC was daunting, both in its scope and in the time frames written into the legislation. The law's ambiguities and complexities increase the difficulty of defining and issuing appropriate rules. The Commission is also likely spending more time doing cost-benefit analyses before issuing rules, in light of several court challenges focused on this. And, the recently passed JOBS Act, which has an aggressive time-frame of its own, complicates the rulemaking environment.

Even when Dodd-Frank was enacted, the likelihood that the SEC would meet all the deadlines established in the bill was low, given the law's complexities and the already substantial responsibilities handled by the SEC, says Robert Kurucza, partner and chair of the financial services group with the law firm of Goodwin Procter, and a former assistant director with the SEC's division of investment management.


Kurucza

"These are not straightforward, easy-to-understand palliatives," Kurucza says. Each change or activity being considered—money market fund reform, for example—has potentially significant consequences that can be hard to predict. "There's a growing recognition by regulators and other interested parties that they can't just adopt regulations, come hell or high water," he says. "It would be reckless."

Several of the proposals already issued have generated massive amounts of comments. The proposed Volcker Rule alone prompted more than 18,000 comment letters. "The Commission does have to read the letters, and that takes time," says Paul Murdock, director of consulting and professional services at Wolters Kluwer Financial Services.

Ambiguity in the legislation itself also makes the job of rulemaking more difficult. "Part of the reason it's so hard to adopt rules under Dodd-Frank is that the

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statute itself is badly flawed. Little consideration went into what the statute should require, why it's required, and its scope," says Steven Lofchie, a partner in the financial services practice of Cadwalader, Wickersham & Taft. To some extent, Lofchie says, the regulators actually are working around the statute, declaring, for instance, that insurance is not a swap, even though there's no basis in the legislation for making that determination.

Murdock

The Chamber Effect

Several recent court cases that have focused on regulators' need to conduct thorough cost-benefit analyses before implementing new regulations seem to be prompting the SEC to carefully deliberate before issuing rules. "The degree and frequency of the challenges is increasing," says Kurucza. Moreover, there appears to be a greater willingness by the courts to consider them. As a result, the agencies need to spend the time and effort required to craft effective, appropriate rules from the outset, he says.

SEC ECONOMIC ANALYSIS

Below is SEC testimony to Congress on making improvements to the Commission's economic analysis:

The Dodd-Frank Act required an unprecedented number of statutorily mandated rules for implementation by the SEC. The Commission and its staff—including our RSFI economists—have spent considerable time grappling with difficult judgment calls in the scores of rules the Act requires the Commission to promulgate. Moreover, we have learned valuable lessons from our experiences in implementing the Act to date. As a result, our rulemaking processes have continued to improve and evolve, including the analyses we conduct both to meet our legal requirements and to inform our policy judgments.

… the SEC's chief economist and general counsel have jointly developed new guidance for conducting economic analysis, taking into account the recommendations made in the reports from the GAO and OIG as well as comments from others, including Members of Congress and the courts. RSFI and OGC have distributed the new guidance both to the other Divisions and Offices and to the Commissioners, and are seeking any additional input from the Commissioners to incorporate suggestions for improvements.

Among the specific steps that we have been taking, and that are included in the current staff guidance, are:

» earlier and more comprehensive involvement of RSFI staff in the rulemaking process, so that RSFI economists can provide economic analysis of different policy options before a proposed course is chosen and throughout the course of the development of the rule;

» assuring that rule releases clearly identify the justification for the proposed rule, such as a market failure or a statutory mandate;

» where a statute directs rulemaking, staff should consider the overall economic impacts of the rule, including those attributable to Congressional mandates and those resulting from the Commission's exercise of discretion;

» where feasible, quantifying the costs and benefits and, where not reasonable to do so, transparently explaining why not, and then qualitatively explaining the remaining costs and benefits;

» more integrated analysis of economic issues (including efficiency, competition, and capital formation) in the Commission's rule releases;

» more explicit encouragement to commenters to provide quantitative, verifiable estimates of costs and benefits, and fuller analysis and discussion in Commission rule releases of the cost-benefit information received from commenters; and

» greater discussion of reasonable alternatives not chosen.

A fundamental improvement we have made that will enable us to implement more effectively the new guidance is the strengthened role of economists in rulemakings. Economists must play a central role in rulemaking—whether in identifying concerns or issues that may justify regulatory action or analyzing the likely economic consequences of competing approaches—and the staff's current guidance emphasizes that significant role. The guidance notes that to make the best use of RSFI's expertise, RSFI economists should be involved at the earliest stages of the rulemaking process (e.g., before the specific preferred regulatory course is determined) and throughout the course of writing proposed and final rules. Close collaboration with RSFI will help to integrate economic analysis as key policy choices are being made, thereby:

» assisting in the evaluation of different or competing policy options by identifying the major economic effects of those options;

» influencing the choice, design, and development of policy options;

» assisting in the evaluation of whether and to what extent any proposed policy would promote efficiency, competition, and capital formation;

» improving the quality of regulation;

» better supporting policy choices made by the Commission; and

» increasing confidence in the regulatory process.

Source: SEC.

Last summer, a panel from the U.S. Court of Appeals for the District of Columbia ruled to vacate the Security and Exchange Commission's Rule 14a-11, commonly known as proxy access. In its ruling, the court said the SEC "was arbitrary and capricious in promulgating Rule 14a-11." The court challenge, initiated by the U.S. Chamber of Commerce and the Business Roundtable, was based on the assertion that the SEC didn't conduct a proper analysis of the cost of the Rule. The chamber has since suggested that it could contest other Dodd-Frank rules on that basis.

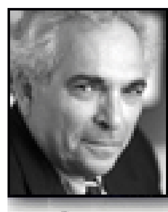
In fact, the Chamber of Commerce, along with the Investment Company Institute, challenged the CFTC's amendment to Rule 4.5, which requires advisers to investment companies regulated by the SEC to be dually regulated by the CFTC as "commodity pool operators." In a statement, David Hirschmann, president and CEO of the Chamber's Center for Capital Market Competitiveness, said, "The CFTC completely ignored its statutory duty to evaluate the costs this unnecessary regulation will undoubtedly impose on the economy."


Hirschmann

Two more recent suits, although they target the CFTC, also highlight the need for regulatory agencies to undertake thorough analyses before issuing rules. In December, the International Swaps and Derivatives Association, along with the Securities Industry and Financial Markets Association, challenged the CFTC's rules limiting the positions investors may hold in certain commodities. In announcing the suit, the associations claimed "the CFTC failed to conduct any meaningful cost-benefit analysis."

During April testimony before a U.S. House sub-committee, SEC Chairman Mary Schapiro discussed a review, conducted by the Government Accountability Office and the SEC's Office of Inspector General, of the Commission's cost-benefit analysis in rulemaking, particularly for Dodd-Frank. "While these reviews found that the Commission engages in a systematic approach to cost-benefit analysis in rulemaking, they also provided useful direction for improvement in our processes. Recent court decisions and communications from members of Congress also have raised issues about certain aspects of the Commission's economic analysis in rulemaking." Later in her speech, Schapiro says that she remains committed to enhancing both the substance and process of the SEC's analysis. In other words, once bitten, twice shy.

"That's a huge undertaking and it's going to slow things down," says Hal Scott, Harvard University law professor of international financial systems.


Scott

The recent passage of the Jumpstart Our Business Startups (JOBS) Act throws another spanner into the SEC's works. Among other provisions, the bill eases reporting requirements and allows the use of crowdfunding for some companies.

It's unclear just how much the deadlines imposed by the JOBS Act will impact Dodd-Frank rulemaking. Of course, any additions to the SEC's to-do list are likely to affect work already underway, although much of the JOBS Act work involves the SEC's Corporate Finance and Investment Management division, which has not had as much heavy lifting to do on Dodd-Frank, Lofchie says.


Lofchie

Still, "the SEC has been very proactive on the JOBS Act guidance and interpretations," says Robert Wild, a partner with the law firm of Katten Muchin Rosenman. Although the Act was just signed in early April, the SEC already has posted on its Website several FAQs and announcements. In part, that's due to the fact that most of the provisions were immediately effective. Also, some deadlines occur as quickly as 90 or 120 days after the law passed.

In addition, the JOBS Act is "very popular with the new issuer community and their investors," Wild says. The SEC probably doesn't want to be seen as dragging its feet issuing guidance and regulations for legislation intended to stimulate the economy. That's in contrast to the controversy generated by many of the provisions under Dodd-Frank, controversy that is only heightened in a presidential election year.


Wild

If nothing else, the JOBS Act highlights the sometimes schizophrenic approach to regulation that sometimes prevails in Washington. "The JOBS Act "is kind of a counterpunch," Kurucza says, pointing out that the SEC took a beating for not taking quicker action to halt Bernie Madoff's schemes, and it is currently is enmeshed in trying to issue the many regulations emanating from Dodd-Frank. At the same time, the JOBS Act heads in the direction of regulatory relief.

The delays to Dodd-Frank rulemaking have positive and negative implications for the companies affected by the legislation. On the one hand, firms have to move forward without knowing exactly when the deadlines will be set, and what the final regulations will say. "Firms have to prepare as if they're real deadlines," Lofchie says. "Our clients can't take the risk of assuming that the deadlines will be missed, so we are preparing their compliance procedures and reviewing their documentation."

At the same time, the delays "offer more opportunity for issuers to express their concerns to the SEC staff and even have their concerns be understood and considered by the staff before the SEC proposes the remaining rules," Wild points out. ■

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