



On Wednesday, June 30, The House of Representatives voted 237-192 in favor of a bill overhauling financial regulation in the United States. This bill, which has been in the works for the past 12 months and spearheaded by Sen. Christopher Dodd (D., Conn.) and Rep. Barney Frank (D., Mass.), was finally passed by the U.S. Senate by a vote of 60-39 on Thursday, July 15. President Obama is expected to sign the bill into law sometime next week.

Media outlets have spent an enormous amount of time focusing on one aspect of the bill; the “Volcker” rule, named after former Chairman of the Federal Reserve Paul Volcker. This rule aims to mitigate risk taking by federally insured banks by curbing the amount of proprietary trading they can do. The Obama administration initially wanted to ban proprietary trading altogether, but that proposal was softened to win votes in the Senate. Banks are now limited to investing no more than 3% of their Tier 1 capital in hedge funds or private-equity. Further more, banks are prohibited from bailing out a fund in which they are invested. Supporters for the “Volcker” rule claim that it will prevent banks from taking unnecessary risks, and therefore mitigate the chance of a bank failure. Opponents argue that it will reduce bank profits, which will ultimately hurt investors.

Perhaps the second largest aspect of the bill is the restriction it places on derivatives trading. Selling over-the-counter derivatives is among the most lucrative businesses for financial companies. U.S. commercial banks held derivatives with a notional value of \$212.8 trillion in the fourth quarter of 2009, with JPMorgan, Citigroup, Bank of America, Goldman Sachs and Morgan Stanley holding 97% of that total. Arkansas Democrat Senator Blanche Lincoln originally proposed banning all swaps-trading by commercial banks. However, neither Republicans nor Democrats supported this proposal, citing the fact that it could drive up costs for businesses and send business to foreign lenders. Instead, banks will be allowed to retain operations for interest-rate swaps, foreign exchange swaps, and gold and silver swaps among others. All other over-the-counter derivatives must be pushed through third-party clearinghouses and onto regulated exchanges or similar electronic systems, making it easier for the market and regulators to track the trades. The tightened restrictions on derivatives trading could force banks to push some of their swaps-trading into subsidiaries, in fact, several banks already have.

The bill contains many other provisions in addition to imposing new restrictions on private-equity and hedge-fund investing on financial institutions. For example, the bill introduces new consumer protection policies. It calls for the creation of a new Consumer Financial Protection Bureau, housed in the Federal Reserve but run independently. The Consumer Financial Protection Bureau will be responsible for writing consumer protection rules and policing banks and financial-services businesses for credit-card and mortgage-lending abuses. It will have

authority to enforce these rules for banks and credit unions with more than \$10 billion in assets, with bank regulators continuing to examine consumer practices at smaller financial institutions.

In addition to creating a new Consumer Protection agency, the bill establishes a new regulatory authority. The 10-member Financial Stability Oversight Council would be charged with addressing systemic risks to the nation's financial stability. The council would recommend to the Fed stricter capital, leverage guidelines, and other rules for large, complex financial firms that are judged to threaten the financial system. It also gives federal regulators new authority to seize and break up large troubled financial firms to avoid a taxpayer bailout, with the hope of ending the idea of "too big to fail". To finance the bill, the Federal Reserve will impose fees on large, systemically important firms in an amount it determines "necessary and appropriate" to carry out its supervisory duties.

There are many changes this 2,300 page bill will bring to the financial services industry. Among some of the less publicized changes are new rules on credit and debit cards. Under the new legislation, the Federal Reserve will have the power to limit the fees that card issuers can collect on debit-card transactions. However, this rule applies only to large banks, not to credit-card issuers such as Visa and MasterCard. Currently, banks typically charge between 1% and 2% for each debit-card swipe. This may turn out to be a double-edged sword. It is widely expected that banks will recoup these transaction fees by raising other fees and rates, or scaling back "rewards points" and free checking.

Perhaps the most closely watched aspect of the financial overhaul bill, from our point of view, has been investor protection. Currently, broker-dealers for companies such as Merrill Lynch, UBS, Citi, etc., operate under the title of "Financial Adviser". However, most people are not aware that these broker-dealers are purely in the business of selling products, and many receive commissions on what they sell. Currently they are only required to follow a "suitability standard", meaning they only have to provide investment advice to their clients that is suitable for the investor. Registered Investment Advisers, on the other hand, are held to a higher code of ethics known as the Fiduciary standard. Under the Fiduciary standard, RIAs are required to provide investment advice that is in the client's absolute best interest. The hope was that a universal fiduciary standard would be imposed on all professionals in the financial services industry. However, under the bill, the SEC will conduct a 6 month study to determine if the average investor is already sufficiently protected by the suitability standard or if something stronger is necessary. At the conclusion of this 6 month study, the bill gives the SEC the authority to impose a universal fiduciary standard, should it deem one necessary.