A DECADE LATER; COULD IT HAPPEN AGAIN?

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On September 15, 2008, Lehman Brothers declared bankruptcy, an event considered by many to mark the beginning of the credit crisis of 2008–2009 and the unprecedented public policy responses that followed. Much has been written about the multiple contributing factors to the crisis, ranging from predatory lending to Federal Reserve interest rate policy. However, one bipartisan policy failure stands above all others in explaining the magnitude of the crisis — the exemption of swaps from regulation in the Commodity Futures Modernization Act of 2000 ("CFMA") is the *sine qua non* for the depth and duration of the Great Recession. That misguided decision allowed for amplification of risk through a daisy chain of counterparties in a credit default swaps house of cards that ultimately imploded. Has the problem been fixed? This alert will address that important question by reviewing the policy responses to the credit crisis to date and where we go from here.

EMERGENCY RESPONSES

The Lehman Brothers bankruptcy ushered in an unprecedented injection of government capital and control into our capital markets. On the same day, October 3, 2008, the U.S. House of Representatives passed and President George W. Bush signed into law the Emergency Economic Stabilization Act of 2008 ("EESA," H.R. 1424, P.L. 110-343). Among other things, EESA authorized the Secretary of the Treasury to establish a Troubled Asset Relief Program ("TARP") to purchase troubled assets from financial institutions. Ten days later, as the crisis developed, the Department of the Treasury ("Treasury") announced its decision to use TARP funds to inject capital directly into banks in the form of preferred stock agreements. In the ensuing months, using TARP funds, in conjunction with access to the Federal Reserve discount window, the Treasury established a series of facilities to restore liquidity in the credit system.

THE DODD-FRANK ACT

As the credit markets stabilized, Congress set about the task of considering legislation to prevent the recurrence of such problems. On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). It was the most comprehensive reform of the U.S. regulatory framework governing the financial system since the Great Depression. Most of Dodd-Frank's key provisions are beyond the scope of this alert, but the centerpiece is Title VII, which established a new regulatory regime for the OTC derivatives market including swaps. Many of Dodd-Frank's other provisions are controversial and efforts at reform are ongoing as described below.

TITLE VII

Title VII of Dodd Frank authorized the Commodity Futures Trading Commission ("CFTC") and the Securities & Exchange Commission ("SEC") to write rules for the swaps and security-based swaps markets respectively and required them to coordinate to the extent possible. Both the CFTC and the SEC were given the authority to ban abusive swaps if they believe the swaps or security-based swaps would be detrimental to the stability of a financial market or participants in a financial market.

Most importantly, Title VII of Dodd-Frank requires the clearing of swaps and security-based swaps according to regulations promulgated by the respective agencies. If a swap cannot be cleared, then it must be reported to a swap data repository. Dodd-Frank also provides for exchange trading for standardized swaps and requires public reporting of swap transaction and pricing data. The CFTC, the SEC, and banking regulators were given authority to impose capital and initial and variation margin requirements on dealers and major swap participants with respect to uncleared swaps. Dodd-Frank also authorized regulators to establish position limits on certain contracts and prohibits market manipulation. Finally, Dodd-Frank provided an end-user exemption for certain counterparties who are not a financial entity and are using swaps to hedge commercial risk.

DODD FRANK REFORM EFFORTS TO DATE

The Trump Administration

The 2016 election was characterized during the campaign by Republican calls to "repeal and replace" Dodd-Frank. However, the Trump administration has taken a far more measured approach. On February 3, 2017, President Donald Trump issued Executive Order 13772 on Core Principles for Regulating the U.S. Financial System (the "Core Principles"). Following the Core Principles, the Treasury released a series of reports entitled "A Financial System That Creates Economic Opportunities." Each report reviewed a discrete area of the U.S. financial system and made recommendations for legislative and administrative reforms consistent with the Core Principles: (i) Banks and Credit Unions, (ii) Asset Management and Insurance, (iii) Capital Markets, and (iv) Nonbank Financials, Fintech, and Innovation. Recommendations from the Treasury reports have since been used as the foundation for rules proposed by the financial regulators and significant legislative reforms. For additional information about the Trump administration's reform agenda, please see the K&L Gates Alert entitled "Treasury Reports Continue to Inform Dodd-Frank Reform Efforts." None of these reports recommends significant alterations to the regulatory framework for swaps established by Title VII of Dodd-Frank.

The Financial CHOICE Act

On June 8, 2017, the House passed H.R. 10, the Financial CHOICE Act ("FCA"), by a party-line vote of 233-186. Introduced by House Financial Services Committee ("HFSC") Chairman Jeb Hensarling (R-TX), the FCA would comprehensively reform Dodd-Frank. The FCA serves as a legislative blueprint for Republican reforms. For example, one key notable reform would preserve the single-director structure of the Consumer Financial Protection Bureau (CFPB n/k/a Bureau of Consumer Financial Protection) while making the director removable at-will by the president. Another provision provided regulatory relief to "strongly capitalized, well managed banking organizations," which included an exemption from stress tests and Comprehensive Capital Analysis and Review.

The FCA also would have empowered the SEC to lead on the issue of fiduciary duties advisors owed to investors and, simultaneously, prohibited the SEC from requiring use of a universal proxy ballot. Chairman Hensarling continues to advance various provisions, many of which were originally contained in the FCA. Although that bill contained some controversial provisions, many — if not most — of these ideas enjoy at least some degree of bipartisan support. For additional information on the FCA, please see the K&L Gates Alert entitled "Dodd-Frank Reform; What Comes Next?"

The Economic Growth, Regulatory Relief, and Consumer Protection Act

On May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155; Pub. L. No. 115-174). Although the passage of S. 2155 marked a milestone in revising Dodd-Frank, it was narrowly tailored to achieve the bipartisan support necessary for Senate passage. Among the most notable aspects of S. 2155 was Section 401, which increased the systemically important financial institution threshold and, thus, the application of enhanced prudential standards to bank holding companies from $50 billion to $250 billion. In addition to Section 401, S. 2155 also contained provisions enhancing consumer access to residential mortgage loans, furnishing tailored regulatory relief to community banks, and requiring certain regulatory agencies to study and report to Congress on cybersecurity threats and algorithmic trading. For additional information about S. 2155, please see the K&L Gates Alert entitled "Dodd-Frank Reform Efforts Intensify."

The JOBS and Investor Confidence Act of 2018

The politics surrounding consideration of S. 2155 precluded amendments and left out many of the FCA's proposed reforms, despite bipartisan support for many of its individual provisions. Consequently, dozens of the House proposals have been incorporated into the "JOBS and Investor Confidence Act of 2018" (S. 488), which is commonly being referred to as "JOBS Act 2.0." Specifically, S. 488 includes thirty-two (32) House provisions, each of which received substantial bipartisan support in either the HFSC or the full House. Several of these bills received nearly unanimous support, including the "Fair Investment Opportunities for Professional Experts Act" (H.R. 1585) and "Encouraging Public Offerings Act of 2017" (H.R. 3903), both of which amend the Securities Act of 1933. The first would codify the qualifications necessary to be an accredited investor and the second would expand the use of confidential draft registration submissions. Additional proposals include the "Family Office Technical Correction Act" (H.R. 3972), which would further clarify the definition of an accredited investor, and the "Financial Institution Living Will Improvement Act" (H.R. 4292), which would reform Dodd-Frank's living will process. Given the limited number of legislative days Congress has before the end of the year and an agenda that includes a Supreme Court nomination, government funding, and several expiring pieces of legislation that will need to be reauthorized or extended, S. 488 will likely serve as guidance for reform efforts in 2019. Alternatively, some or all of these provisions could be included in broader must-pass legislation before the end of this year.

What Happens Next?

Enactment of S. 2155 was only the first step in efforts to revisit, refine, and reform Dodd-Frank that we expect will continue into 2019. Dozens of additional House measures enjoy bipartisan support, as well as meaningful legislative history, which make them viable for enactment in the current Congress. That said, the number of legislative days are dwindling and the demands on Senate Floor time are extraordinarily high.

Any year end legislative activity to further address Dodd-Frank, whether as part of an appropriations package, a lame duck session, or otherwise will likely involve negotiation at the Congressional Leadership level to determine which of the House-passed provisions will be included. As is always the case in such scenarios, stakeholders will need to be particularly attentive to late-breaking and likely fast-moving developments. Whatever the outcome this year, it is clear that these efforts will set the stage for further bipartisan revisions to Dodd-Frank in the years ahead. The K&L Gates global financial services policy team is available to assist interested stakeholders wishing to engage in the debate related to these reform efforts.

Additionally, the financial regulators have a new mandate to engage in rulemaking under S. 2155. With new proposals, regulations, and laws coming from regulators in the U.S., as well as in the EU and elsewhere, the K&L Gates Regulatory Action Detection and Response ("R.A.D.A.R.") keeps our clients up to date by providing a comprehensive guide on financial regulatory developments in the U.S., the EU, and the major international financial regulators.

A Decade of Consensus on Swaps Reform

Importantly, none of the legislative proposals currently being considered would materially alter the framework for regulation of swaps established by Title VII of Dodd-Frank. Indeed, no fundamental alteration of this new regulatory regime was included in even the most ambitious proposals to revisit Dodd-Frank, including the Financial CHOICE Act. Omission of any serious effort to reform Title VII reflects an implicit bipartisan acknowledgment that the previous bipartisan decision to exempt swaps from regulation in the CFMA was a policy mistake of nearly catastrophic proportions.

CONCLUSION

Asset price bubbles are a natural occurrence in a market based economy, and certainly there will be others. When such bubbles burst, investors are harmed, sometimes significantly. However, it was the failure to regulate swaps in 2000 that greatly magnified the impact of the bursting residential housing price bubble that led to the Great Recession. In the years leading up to the bankruptcy of Lehman Brothers, issuers of securities backed by mortgages and other assets were able to offload risk to counterparties through the use of credit-default swaps ("CDS"). This incentivized the creation of additional, increasingly risky securitizations. These swaps were in turn transferred to other investors, who sold them to other investors and so on, creating a daisy chain of risk that in many cases proved impossible to unwind in the crisis. Among other important reforms, Title VII of Dodd-Frank limited such counterparty risk by mandating centralized clearing of swaps transactions, which prevents recreation of the CDS house of cards that was at the core of the 2008–2009 credit crisis. These reforms, coupled with others in Dodd-Frank including enhanced capital requirements and macro-prudential standards for banks, have made our regulatory system far more robust and in all probability preclude a future crisis of the same type.

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