THE WALL STREET MONEY MACHINE

From Dodd-Frank to Dud: How Financial Reform May Be Going Wrong

Some fear the grandest ambitions of the law passed last year to reform the nation's financial system are being undermined in the rule-making process.

by Jesse Eisinger and Jake Bernstein, June 3, 2011, 8:16 a.m. EDT

Early last year, as they weighed whether to bar banks from speculative trading with their own money, congressional staffers turned to a key regulator for advice.

The response from Julie Williams, the chief counsel of the Office of the Comptroller of the Currency, was startling, according to people familiar with the conversations. Williams insisted new rules were unnecessary since this type of trading did not play a major role in the financial meltdown.

Congressional Democrats went ahead and wrote the trading prohibition into Dodd-Frank, the sweeping overhaul of the nation's financial rules pushed through last July.

But now, behind closed doors, financial agency powerbrokers are jockeying over how to implement the law, a process turning out to be as bitterly contentious and politicized as passing Dodd-Frank in the first place.

Government officials -- including Williams and the OCC -- are inserting exemptions as they formulate rules to enforce the law. Some regulators, facing severe budget constraints, caution that they may not be able to carry out some of its key provisions. Foes of the law in Congress, and even some former friends, are voicing concern that aspects of the law could erode American competitiveness. Wall Street is mounting a determined lobbying campaign to blunt provisions it failed to defeat on the floors of the House and Senate.

To some, the emerging roadblocks reinforce a fear that Dodd-Frank, which was intended to touch on almost every aspect of the American financial system, may never provide the sweeping reform it promised.

"It was doomed at the outset and nothing can possibly salvage it. We might even have been better off without it," said Arthur Levitt, a former chairman of the Securities and Exchange Commission.

Dodd-Frank is so sprawling -- the legislation runs to more than 2,000 pages -- that the law firm Morrison & Foerster dubbed the tracker it created to monitor the implementation process "FrankNDodd."

The law laid out principles but often left it to regulators to write the actual rules. Those would be the same regulatory agencies that failed to prevent the financial crisis and that, in some cases, view the banks they oversee, not taxpayers, as their primary constituents.

Dodd-Frank requires 387 different rules from 20 different regulatory agencies. The Byzantine, tedious rulemaking process has occasionally pitted regulator against regulator and proved a bonanza for lobbyists.

"The decisions that are coming down are not promising," said Ted Kaufman, the former Democratic senator from Delaware who worked on the legislation. "The regulators are not making the hard decisions. If the Congress would not make the hard decisions, how can you expect the regulators to make them?"

Regulatory agencies also are caught between Republicans who complain they are moving too fast and Democrats who urge them to comply with the deadlines set in the law.

Congress set aggressive deadlines for regulators to make rules to enforce the law, and, unsurprisingly, they are failing to meet them. The agencies missed each of the 26 deadlines they were supposed to meet for April. So far, regulators have finalized 24 rules and missed deadlines on 28, according to the law firm Davis Polk.

Treasury officials are sanguine about the delays. "If we have to sacrifice a little bit of time to get to the right answer, that's the right thing to do," said Mary Miller, the assistant secretary for financial markets.

The law's defenders say most aspects of the implementation process are going well. Among the successes they point to: The Consumer Financial Protection Bureau, a new agency created to protect consumers from dangerous financial instruments they don't understand, is coming together, though the Obama administration has yet to appoint a person to head the agency. Rules have been agreed upon for portions of Dodd-Frank that give shareholders a say on executive pay, register municipal advisers and create a program to reward whistle-blowers.

"The first set of rules are going to be good ones," said the law's namesake, Rep. Barney Frank, D-Mass. "These regulators are on the right side."

Still, while the process is far from complete, the early signs suggest that several of Dodd-Frank's most critical elements are in danger, an outcome that could increase the chances of another financial crisis.

"I am concerned that we are not putting in place the things that we need to do to prevent this from happening again," says Kaufman.

Here are a few areas where followers of the process see the most cause for concern:

The Volcker Rule

What Dodd-Frank does: Colloquially named after Paul Volcker, the former head of the Federal Reserve who championed it, the rule bars banks from an activity known on the Street as "proprietary trading" -- making investments on their own behalf, rather than for clients.

The reason for the rule: During the credit bubble, highly leveraged investment banks speculated heavily in mortgage-backed securities. When those securities went bad, banks like Merrill Lynch and Citigroup were crippled. A report by the United States Senate Permanent Subcommittee on Investigations detailed how proprietary trading "led to dramatic losses in the case of Deutsche Bank and undisclosed conflicts of interest in the case of Goldman Sachs."

To comply with the law, Morgan Stanley and Goldman Sachs and other banks have jettisoned their internal hedge funds and private equity firms.

Stumbling blocks: Regulators are haggling about complicated, but vitally important, definitions.

The OCC is pushing for banks to have wider latitude in making trades to balance and manage their assets and liabilities. Dodd-Frank specifies

Treasury securities as suitable for this purpose; the OCC has suggested in private negotiating sessions with fellow regulators that banks be allowed to invest in other securities as well, according to people familiar with the talks.

As currently written, the Volcker rule allows banks to trade in securities for existing clients but blocks them from doing so for future clients. The OCC has advocated lifting that restriction in the negotiating sessions, according to people familiar with the conversations.

Critics fear that adding the provisions sought by the OCC would mean banks could make almost any trade and claim an exemption, rendering the rule meaningless.

Last year, Volcker himself reached out to Acting Comptroller of the Currency John Walsh to express worry that Julie Williams, the agency counsel, was trying to weaken the rule. Walsh took umbrage at the suggestion, according to a person familiar with the conversation.

Frank said he and other lawmakers were so concerned about Williams, who has held her position since 1994 and has served as the acting comptroller twice, that they inserted a provision in the financial reform legislation that strips her job of civil-service status. "I disagree with her very strongly," Frank said.

The provision was stripped out in the bill's conference committee.

OCC officials would not comment specifically about the agency's efforts in regard to the Volcker rule. The agency didn't respond to detailed questions about Williams' role and declined to make her available.

"We're working on an interagency basis to implement the Dodd-Frank Act in a way that is faithful to congressional intent," an OCC spokesman said. "It would not be appropriate to discuss confidential interagency deliberations regarding the formulation of pending rulemaking."

Derivatives

What Dodd-Frank does: Aiming to remake this multitrillion-dollar shadow arena into a transparent, regulated market, the law calls for most derivatives to be traded on exchanges.

Reason for the rules: Congress had prevented regulation of derivatives, which involve side bets on anything from currencies to commodities to corporate bonds, which exacerbated the losses at AIG and other banks during the financial crisis.

Stumbling blocks: Bringing order to the unregulated derivatives market has turned into one of the most difficult challenges in Dodd-Frank implementation. The rulemaking process has sparked a barrage of opposition, even from previously supportive legislators.

In late April, the Treasury Department proposed that some foreign exchange derivatives be exempted from the requirement that derivatives trade on exchanges. This could allow many transactions in the derivatives market to remain out of easy sight of participants, possibly encouraging banks to structure noncurrency trades to fit the definition of a foreign exchange swap in order to qualify for the exemption.

Treasury Department officials defend the exemption, which isn't final. "Just to say everything should be painted with the same brush is not effective," said Miller, the assistant secretary for financial markets. This part of the market "worked very well through the financial crisis."

On May 17, New York lawmakers -- including Democratic Sens. Charles Schumer and Kirsten Gillibrand, who voted for the original law -- wrote a letter to regulators and the Federal Reserve warning that aspects of the new derivatives rules impose "significant competitive disadvantages" on U.S. banks.

Another area where regulators have lagged is in the creation of data repositories mandated by the law. These repositories are supposed to make the industry less opaque to regulators and, thus, easier to oversee.

Though Dodd-Frank requires that most derivatives trade on exchanges there is an exception: Trades can also be conducted on another platform, known as a "Swap Execution Facility." Watchdogs worry that such facilities wouldn't make information on the prices at which some investors were offering to buy and sell, known as bids and offers, available to all participants. Nevertheless, the Securities and Exchange Commission has issued an initial rule, subject to finalization, that such facilities can conduct derivatives trades if they have the capacity to show participants that information, not that they do so.

"It seems like some of the regulators accepted the argument from many market participants that they should be able to continue business as usual," said Heather Slavkin, the senior legal and policy adviser for the AFL-CIO's Office of Investment. Some regulators have said that they "don't want to disrupt current market practice -- but hold on a second. The purpose of Dodd-Frank was to change market practices."

Credit Rating Agencies

What Dodd-Frank does: Creates a new regulatory structure to oversee credit ratings agencies.

Reason for the rule: Credit rating agencies were compromised by their relationships with their paying customers -- investment banks -- and issued unduly optimistic ratings on mortgage-backed securities. When the ratings proved erroneous, investors who had relied on them suffered billions of dollars in losses.

Stumbling blocks: The SEC has yet to fully staff a new office to oversee credit rating agencies. Instead, for budgetary reasons, it has opted to add personnel to existing offices to perform examinations on the rating agencies.

The SEC has created a special part of its website just to list elements of Dodd-Frank that "were deferred due to budget uncertainty, and are currently being reassessed in light of the [Fiscal Year] 2011 budget."

The SEC also has indefinitely tabled a provision that holds credit rating agencies legally liable for their ratings if they are included in securities offering documents.

The full credit rating agency reform envisioned under Dodd-Frank is turning out to be difficult to put into practice. Credit ratings have been hardwired into legislation governing everything from pension funds to municipal bonds. The law calls for more disclosure on how ratings are created, stricter supervision of the agencies by regulators and the scrubbing of legislation or rules that mandate them. But credit ratings are integral to so many investment products that it may take some time to strip from applicable laws the requirement that they be used and find suitable replacements. "[Congress] should have done the work on the front end," says Barbara Roper, director of investor protection for the Consumer Federation of America.

Resolution Authority

What Dodd-Frank does: Gives regulators the power to seize and unwind "too big to fail" financial institutions that are on the brink of failure.

Reason for the rule: Regulators hope to avoid another economically disruptive situation like the collapse of Lehman Brothers, where government officials contend their only option was to put the company into bankruptcy.

Stumbling blocks: Some wonder if Congress ordered regulators to do more than they could feasibly and legally accomplish.

Take Citigroup. It has more than 260,000 employees, operations in 160 countries and jurisdictions, over 200 million clients, and more than 170 subsidiaries worldwide. It's the poster child for the classic "too big to fail" institution. Unwinding a company the size and complexity of Citigroup in a way that preserves value and does not harm the economy may well be impossible.

"How do you put together resolution authority for these banks that have $2 trillion in assets? How do you do it across country lines?" Kaufman said.

Frank and Treasury Department officials acknowledge the potential difficulty in successfully winding down these huge institutions, but they argue that there is no other alternative.

"It's not easy, but it's not optional," Miller said.

Correction, June 3, 2011: *This story incorrectly stated that the Dodd-Frank law had stripped the position of chief counsel at the Office of the Comptroller of the Currency of its civil service status protection, based on erroneous information provided by Rep. Barney Frank. The provision was included in the House bill, but was excluded in the final version of the law.*

Jesse Eisinger

Jesse Eisinger is a senior editor and reporter at ProPublica.

Jesse.Eisinger@propublica.org @eisingerj

Signal: 718-496-5233

Jake Bernstein

Jake Bernstein was a business and financial reporter for ProPublica.

Jake.Bernstein@propublica.org @Jake_Bernstein