



## Issue Brief: WALL STREET REFORM AND CONSUMER PROTECTION ACT (DODD-FRANK ACT)

*Updated July 2010*

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### **Background**

On July 21, President Obama signed the *Wall Street Reform and Consumer Protection Act* (known as the *Dodd-Frank Act*). The law brings sweeping changes to the nation's financial services industry, including new financial product consumer protection laws, new requirements for financial institutions, the regulation of previously unregulated financial markets (such as swaps), and new responsibilities for credit rating agencies.

The law will affect state and local governments in a variety of ways, both directly and indirectly. Most notably, it includes many provisions related to municipal securities, as well as new regulations for advisors hired by state and local governments – including public pension funds.

### **Highlights of the Act**

**Assesses a New Bond Fee to Pay for GASB.** A fee will be assessed on new bond issuances to provide a stable revenue stream to support the Governmental Accounting Standards Board (GASB). The amount remitted to the GASB cannot be greater than its annual budget, and the legislation states that the Securities and Exchange Commission (SEC) cannot directly or indirectly involve itself with the GASB's budget, its technical agenda, or the setting of generally accepted accounting principles. The Government Accountability Office (GAO) is also to complete a study on the role and importance of the GASB and the manner in which it has been funded. The GAO must consult with state and local government representatives, including finance officers, for this report.

**Limits Debit Card Interchange Fees.** The Act requires the Federal Reserve to develop and implement "reasonable and proportional" interchange fees for debit cards transactions, in an effort to limit the amount of fees that issuing banks can charge merchants for such transactions. There is a carve-out from these regulations for federal, state, and local government-administered payment programs that use prepaid debit cards. The Act also allows merchants to offer discounts to customers who pay with cash, checks, or debit cards.

**Requires the Use of Universal Rating Symbols by Credit Rating Agencies for All Securities.** The rating agencies must define and disclose each rating symbol, then apply the symbols uniformly to all securities (e.g., a AA corporate rating means the same thing as a AA municipal security rating). Furthermore, the rating must be based on the probability that an issuer will default or otherwise not make timely payments in accordance with the terms of the security.

**Changes the Board Composition of the MSRB.** Effective October 1, 2010, the Municipal Securities Rulemaking Board (MSRB) must consist of a majority of independent board members who are not associated with any broker, dealer, municipal securities dealer, or municipal advisor. Within the composition of the independent board members, at least one must be a municipal securities issuer, at least one must be an institutional or retail investor, and at least one must be a member of the public who has knowledge of or experience in the municipal securities industry.

**Regulates Financial Advisors.** Municipal financial advisors must now register and be regulated by the MSRB. Before this law, non-broker/dealer municipal financial advisors (including swap advisors, GIC brokers, and placement agents) have been unregulated.

**Puts Fiduciary Responsibility on Municipal Financial Advisors.** The MSRB will develop new fiduciary duty standards for municipal financial advisors (including swap advisors, GIC brokers, and placement agents), requiring that the interest of their clients rises above their own interest.

**Changes the MSRB's Mission.** Since its creation in 1975, the MSRB's mission has been to protect investors. Because of its new authority to regulate municipal financial advisors, its mission has changed to protect investors "and municipal entities or obligated persons."

**Creates New SEC Office of Municipal Securities.** The Act creates a new Office of Municipal Securities at the SEC whose Chief will report directly to the SEC chairman. The office will administer SEC rules related to municipal securities and coordinate rulemaking and enforcement activities with the MSRB.

**Provides Other Credit Ratings Provisions.** In an effort to deemphasize the reliance on credit ratings, the Act calls on the SEC to decrease its references to credit ratings within its regulations. The Act also imposes a new standard on ratings agencies that will allow investors to sue the rating agencies for "knowingly and recklessly" failing to conduct a reasonable investigation or secure, independent third-party verification of an issuer's information used to determine a rating. Additionally, within two years, the SEC must review and determine a new policy for the inherent conflict of interest between having the issuer pay for the rating it receives.

**Regulates the Derivatives Market.** All derivative contracts, including those that are entered into by state and local governments and public pension plans, will be regulated. Highlights of these provisions are as follows:

- New rules are in place only for contracts entered into 360 days after the date of enactment. The new rules do not apply to current contracts. It remains unclear if changes to current derivative contracts fall under the "grandfathered" contracts provision or will be considered a new contract.
- State and local governments may enter swap agreements only if they have more than \$50 million (\$25 million under current law) "invested on a discretionary basis" (including bond proceeds), or if the counterparty is a bank or broker/dealer.
- State and local governments and governmental pension plans effectively must obtain the services of a swap advisor for their transaction. The broker/dealer in the transaction must verify that the government/pension plan has an independent advisor.
- The swap advisor must provide a written presentation of the fair pricing and appropriateness of the transaction to the issuer.
- Broker/dealers must report all outstanding derivative contracts to a new repository. All new contracts must also be reported to a repository.
- Banks will be able to directly execute most swap contracts used by state and local governments (including interest rate swaps, foreign exchange swaps, and credit default swaps on cleared investment grade credits). Pension plans that use swaps for the primary purpose of hedging or mitigating risk directly associated with the operation of the plan are exempted from the new swap rules.
- State and local governments are expected to be excluded from the new swap clearing provisions.
- The Commodity Futures Trading Commission must develop "code of business conduct" rules for swap dealers that enter into contracts with states, localities, and pension funds (counterparties). Instead of a fiduciary duty, the code of conduct will state that the swap dealer must act "in the best interests" of the counterparty and make a reasonable determination that any swap it recommends is in the counterparty's best interest.
- Margin requirements for uncleared swaps will exclude all "end users," including state and local governments.

**Mandates Two Municipal Securities Studies.** Two studies must be completed by the GAO, one on the transparency of trading and pricing in the municipal securities market, and the other on issuer disclosure requirements and an examination of the Tower Amendment.

**Study on Fiduciary Duty Responsibilities for Broker/Dealers.** The SEC must conduct a study to examine the “effectiveness” of existing legal and regulatory standards of care applicable to broker/dealers and investment advisors and the existence of gaps in those standards. The SEC will consult with state and local governments on any eventual regulation.

### **Conclusions**

Regulations will need to be proposed and approved before many of these provisions are applied. The GFOA will continually update this overview and provide notice to our members when proposed regulations come forward in areas that are important to state and local governments.