Despite Claims, Reform Law Provides Plenty of Exemptions

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WASHINGTON — Although the Obama administration sought to avoid granting carve-outs as part of the regulatory reform bill, the final law is riddled with them.

Virtually every industry achieved some form of exemption while some specific companies, such as General Electric and Fidelity Investments, scored individual wins that will likely prevent them from being considered a threat to the economy, a status that would subject them to higher capital requirements.

While large banks received the fewest carve-outs, even they won some flexibility to work around certain provisions, and observers said more opportunities for further carve-outs are likely.

"It's sort of riddled with exemptions and loopholes and carve-outs," said Raj Date, the chairman and executive director of the Cambridge Winter Center for Financial Institutions Policy.

Throughout the legislative process, the administration repeatedly warned it would veto a bill that exempted certain industries or companies from the law's toughest requirements. For example, the administration said it would reject a bill that exempted auto companies from oversight by the Consumer Financial Protection Bureau.

But the final law, which the president signed and praised, included just such an exemption, in addition to dozens of others.

"It never had credibility," said Mark Calabria, director of financial regulations studies at the Cato Institute, of the veto threat. "It was a joke and everyone knew it. I'm of the philosophy that you should not make hollow threats that you cannot follow through. You just lose credibility."

Ed Yingling, the president and chief executive of the American Bankers Association, said the loopholes were to be expected with such a massive bill.

"In some cases, the regulations just on public policy should not apply to institutions, and in other cases it's just pure classic log rolling to get the bill passed," he said.

Although they are hard to spot in the legislation, some specific companies appeared to win exemptions from key parts of the bill. For example, some analysts say GE could be excluded from systemic-risk designation.

The law defines a nonbank systemic company as one that is predominantly engaged in financial activities, a definition that includes whether the annual gross revenues derived by the company and all of its subsidiaries from activities that are "financial in nature" represent 85% or more of the consolidated annual gross revenues of the company.

Analysts said GE has a ratio closer to 83%, which means they are unlikely to be designated as systemically important.

Similarly, Fidelity also seemed to win an exemption from systemic-risk requirements.

Given the nearly $1.3 trillion in mutual fund assets under its management, some observers had expected the Boston firm to be considered systemically important.

But the final bill said any such determination must turn on how interconnected a firm is with other institutions. As a result, Fidelity is likely to escape such a designation.

The exemptions were made at the behest of individual lawmakers in order to help ensure the bill had enough necessary support to pass. Fidelity's fate, for example, was important to Sen. Scott Brown, R-Mass., a key GOP swing vote who was critical to the bill's passage.

The exemptions "are a result of political horse trading," said Kip Weissman, a partner at Luse Gorman. "Some of them make sense and some of them don't."

The more obvious exemptions in the law are broad ones directed at different industries.

For example, in addition to auto dealers, the law exempted plenty of other industries from oversight of the CFPB, including real estate brokers, broker-dealers, investment advisers, accountants, tax preparers and lawyers.

The auto dealer exemption, in particular, struck many as inappropriate.

"There is no reason to create a consumer bureau that doesn't cover auto dealers," Date said.

Lawrence White, a professor at Stern School of Business at New York University, said auto dealers argued they shouldn't be included because they did not cause the crisis.

"My view is they aren't any better than anyone else on consumer issues, so if you thought it was about consumer issues the auto dealers shouldn't have been exempted," he said.

Community banks with assets of less than $10 billion are also exempt from CFPB enforcement, but they must comply with the agency's rules and can be subject to backup examinations.

Some in the industry see that as a big win for smaller banks.

"It's a culmination of decades of work we've done to differentiate the community banks in terms of its regulation from the larger institutions," said Steve Verdier, senior vice president and director of congressional relations for the Independent Community Bankers of America.

But Yingling argued it was not much of a carve-out.

"It's not an exemption," he said. "You are still subject to all the rules and they have very broad backup authority."

Small banks also won critical exemptions on provisions related to capital, executive compensation, derivatives regulations and internal controls.

For example, the law says that trust-preferred securities can no longer count as Tier 1 capital but grandfathers existing trust-preferreds at firms with less than $15 billion of assets. Banks with less than $500 million of assets would be totally exempted from the new rule.

Small banks were also ostensibly exempted from restrictions on interchange fees for debit cards. The Dodd-Frank Act requires the Federal Reserve Board to ensure such fees are "reasonable and proportional," but exempts card issuers with $10 billion or less of assets in addition to debit cards issued by a government entity and prepaid cards.

But some said that exemption could end up being meaningless.

"The interchange exemption is an example of a small-bank exemption which may be eroded by market forces," Weissman said.

The final law also provides exemptions to the Volcker Rule to ban proprietary trading and investing in hedge funds or private equity. Although it was contemplated as a total ban, the final measure allows banks to own as much as 3% of the interests of a fund, with a collective cap that cannot exceed 3% of a bank's Tier 1 capital.

The law also exempts several items from the prop trading ban, including government obligations, underwriting or market-making related activities, risk-mitigating hedging activities, insurance activities and Small Business Administration small-business investment company investments.

The law even adds exemptions to existing regulations.

Although the law reinforces a ban that prohibits a bank from buying another institution if it results in it controlling more than 10% of domestic deposits, Dodd-Frank provides an exemption if the institution being purchased is in danger of default.

The law also leaves regulators with substantial leeway to create more exemptions.

For example, although Dodd-Frank expands the Fed's 23a provision restricting bank transactions with affiliates, it lets the federal banking regulators grant case-by-case exemptions.

New derivatives regulations also include a long list of carve-outs, with regulators able to provide even more flexibility if necessary.

"It's almost to be expected with such an enormous amount of discretion given to the regulators," said Joseph Engelhard, senior vice president of Capital Alpha Partners LLC.

"Particularly in the area of systemically important nonbanks when you try to impose a bank regime on insurance companies, hedge funds you have to leave room for exemptions and toughening of the rules."

White said he expected the Fed to use its leeway to grant exclusions.

"If somebody can come in and tell a really convincing story, I think the Fed will listen and sometimes act on it," he said.

Bill Longbrake, a former vice chairman of Washington Mutual who is now an executive-in-residence at the University of Maryland, said the rulemaking implementation of the bill provides for further loopholes.

"It will go through the rulemaking process, so they will have to spell out in the rulemaking process the criteria they will use to grant exemptions," he said. "At least then there will be opportunity if the exemptions were intended for the law."

But he said some flexibility is necessary.

"I'm not particularly concerned one way or another on the exemptions," he said. "That's a part of the process. In my past experiences when legislation was written too tightly it has often led to problems."

But some said it could weaken the intent of the bill.

Daniel Crowley, a partner at K&L Gates, said the Volcker Rule was "paired back for political necessity."

"The regulations have tremendous discretion for further exemptions," he said.

When lawmakers, as expected, take up a corrections bill to amend the law, some see more opportunities for further carve-outs.

"The corrections will add exemptions because there are probably still people who got hurt by this and didn't get what they wanted from lobbying," Calabria said.

"Some of the exemptions will probably be clarified but I really would not be shocked if more is added rather than deleted. The people who got something are going to fight for it."

Jaret Seiberg, an analyst with Concept Capital, agreed.

"It probably would be impossible to do a massive corrections bill and not address the exemptions," Seiberg said.

"You'll see tweaking along the edges but our general view on corrections is it is going to be a movement to loosen some of the most onerous provisions."