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Eight Director-Relevant Highlights from the Dodd Financial Reform Proposal

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Highly publicized frauds on investors and the federal government's bailout of some of the nation's leading financial institutions have, thus far, not been enough to prompt Congress to act on financial reform and mid-term elections are looming. Momentum may now be building for the passage of a financial reform package. On March 15, 2010, Senate Banking Committee Chairman Christopher Dodd (D-CT) released his financial reform proposal. Last November, Sen. Dodd's reform proposal debuted as a discussion draft, and after its "soft opening" was quickly shut down in the midst of heavy criticism. The new proposal has a menu with a similar range of offerings, but is less ambitious than its progenitor in an effort to appeal to a greater number of legislative palates.

The Senate action will occur against the backdrop of the H.R. 4173, a financial reform bill passed by the House along party lines late last year. The Dodd proposal breathes new life into the debate, but, in all likelihood, will emerge from committee seeking a few important Republican supporters in the Senate, which means there are likely to be substantive changes made on the floor of the Senate. But by bargaining with himself for a few months, Dodd has made many of the hard choices already and addressed many significant criticisms of his earlier attempt. In doing so he has fashioned a bill more palatable to moderate Republicans and less attractive to more liberal members of his own party. As a result, this is legislation worthy of note.

In a bill that is more than 1,300 pages in length, what do directors need to know about the Dodd financial reform proposal?

1. Executive Compensation and Corporate Governance. Senator Dodd's proposals to enhance corporate governance and accountability in the executive suite may already be familiar to many directors because they are largely unchanged from those that appeared in last November's discussion draft. Gone is the proposal that would require shareholder approval for classified boards. Under the new Dodd proposal: (1) shareholders will have a say on pay with the right to a non-binding vote on executive pay; (2) the SEC will adopt regulations giving shareholders proxy access to nominate directors; (3) listing standards will require that directors in uncontested elections win by a majority vote; (4) listing standards will require that compensation committees be comprised of only independent directors and have authority to hire compensation consultants; and (5) listing standards will require public companies to establish policies that claw back executive compensation if it is awarded based on financial statements that materially fail to comply with applicable accounting standards. And no reform proposal would be complete without requiring the SEC to once again retool compensation disclosure, so the Dodd proposal wants to see charts that compare executive compensation to stock performance over a five-year period.

The Dodd proposal also would authorize the Federal Reserve to prohibit any bank holding company compensation plan that provides excessive executive compensation, fees and benefits, or could lead to a material loss to the bank holding company. This provision moves bank level compensation considerations, which already exist under the Federal Deposit Insurance Act, up the food chain to the parent company. By doing so, it alters to some extent the legal standard, now set by applicable state law, for compensation decisions by a bank holding company's board of directors.

2. Regulating the Supersized. Directors should look for one of the new chapters in financial regulation to be about the effective management of counterparty and interdependence risks. Regulators otherwise unequipped or ill-prepared to deal with the cascading impact of the Lehman collapse had to resort to governmental bailouts to prevent other large and complex institutions from failing. The financial reform proposal seeks to address these inadequacies. Senator Dodd's elixir for avoiding the problems created by faltering supersized financial institutions is the creation of an interagency Financial Stability Oversight Council, the equivalent of a financial "Joint Chiefs of Staff," chaired by the Treasury Secretary. The Council's job would be to identify, monitor and address systemic risks posed by large, complex financial firms and products and activities connecting separate firms to the same risks. The Council would make recommendations to the regulators on appropriate standards for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity, with significant requirements on companies that pose risks to the financial system.

Importantly, by a two-third's vote, the Council could subject any nonfinancial company that it views as a threat to financial stability to regulation by the Federal Reserve. Similarly, by a two-third's vote, the Council could order the partial break-up of a bank holding company with more than $50 billion in assets or a nonbank financial company supervised by the Federal Reserve that it views as posing a risk to the nation's financial stability. The Dodd proposal would also prevent a bank holding company with more than $50 billion in assets that received government assistance from escaping regulation by dropping its bank holding company registration. The proposal would make such an entity a nonbank financial company subject to regulation by the Federal Reserve. Making the list of the financially significant is no prize. If the condition of one of the nonfinancial company behemoths causes distress signals to be sent to the US economy, the Dodd proposal would permit regulators and a panel of bankruptcy judges to subject it to an "orderly liquidation."

If financial reform is passed, one of its elements will be some sort of expansion of the regulatory toolbox for financial disaster aversion and planning.

3. Hedge Fund Adviser Registration. The Dodd proposal regarding investment advisers has not changed much from what was in last November's discussion draft. The private adviser exemption from registration is eliminated, but only hedge fund advisers would be required to register with the SEC as investment advisers, and must provide information about their trades and portfolios to help regulators assess systemic risk. Trading data will be shared with the systemic risk regulator and the SEC will report to Congress annually on how it uses this data to protect investors and market integrity. The AUM threshold for federal regulation of investment advisers is increased from $25 million to $100 million, which places many more investment advisers under the jurisdiction of states. The SEC will adopt new rules that require registered investment advisers to safeguard client assets over which such adviser has custody, including verification of such assets by an independent public accountant. While the private adviser exemption is gone, venture capital and private equity fund advisers, as they will be defined by the SEC rulemaking, will continue to be exempt from registration.

4. The "Volcker Rule." The Dodd proposal accommodates the Obama administration's Volcker Rule. The new Financial Stability Oversight Council would be required to study the Rule and make recommendations that bank regulators would need to implement. This means bank regulators would be required to prohibit bank holding companies, banks and their respective affiliates from engaging in proprietary trading, investment in and sponsorship of hedge funds and private equity funds, and limit relationships with hedge funds and private equity funds. The Federal Reserve would also be authorized to curb such activities by nonfinancial companies. A potentially seismic shift in the business activities of many regulated banking entities, this proposal and the lack of certainty associated with it, is likely to meet with a storm of opposition. There is no similar proposal in the House legislation. Whether or not the Volcker Rule finds its way into legislation, the support of the Obama administration for its principles may yet make landfall on regulatory views of the wisdom of proprietary trading, and private equity and hedge fund risks to which banking entities are exposed.

5. Consumer Protection. Feeling burned by subprime mortgages, Main Street wants better consumer protection for financial products. Protecting consumers against unfair and deceptive practices and financial products is a theme common to all leading reform proposals, but how that will happen is the greatest area of difference among the competing options. The Dodd proposal creates a bureau within the Federal Reserve, rather than a wholly independent agency that is created by the House reform bill and favored by the Obama administration. Dodd's consumer bureau chief would be a presidential appointee subject to Senate confirmation, and the bureau would have the ability to write its own rules. This is, apparently, not enough independence to appease consumer protection advocates who do not regard the Federal Reserve as a champion of consumer rights. Bankers are understandably nervous about becoming the wishbones of primary bank regulators and a truly independent consumer watchdog. If a reform bill becomes law, some form of new consumer protection will be an element of it. (Now if only Congress had a good proposal that would protect all of us from ourselves!)

6. Costing Shifting. Stung by the vociferous outcry against federal bailouts, the Dodd proposal follows the House legislation in mandating an industry funded liquidation pool. This pool, set at $50 billion in the Dodd bill, is intended to cover the costs of liquidating the types of non-depository financial institutions formerly in the "too big to fail" category. This direct financial burden on the largest financial institutions will be in addition to real, but less direct, costs to financial firms that would be driven by the legislation. A substantial portion of these new costs is likely to be passed along to consumers of banking products and services.

7. SEC Self Funding. The Dodd bill would provide the SEC with a self- funding mechanism. Advocates have long argued that this will allow the SEC to operate more effectively. This is because, like the banking agencies, the SEC will have more reliable funding than currently enjoyed under the annual congressional appropriation process.

8. Counterparty Risk. The Dodd bill would significantly limit the ability of Federal regulations to bailout individual financial institutions. As recent events have demonstrated, Federal bailouts are widely viewed as bad public policy (fostering moral hazard) and certainly are painful to taxpayers. However, regulatory bailouts have often been lifesavers for a failing institution's counterparties. To name just one recent and vivid example, the AIG bailout saved many credit default swap counterparties from very serious losses. With the possibility of future bailouts of individual firms in doubt, counterparty risk assessment by bank and nonbank market participants is more important than ever.

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