Preparing for Financial Reform: Banking, Corporate Governance and Executive Compensation

Final language and remaining details of long-awaited financial reform legislation will be ironed out by a House and Senate conference committee in the coming weeks. The process will be aided by significant input from the Obama Administration. Those manning the battle stations on the ship of state know that they will receiving heavy incoming fire in this fall's mid-term elections.

The two proposals are more alike than they are different, but there are those political battles to be fought. The House proposal was passed last fall, but the Senate version was only passed last week. The Senate proposal therefore reflects a more recent diagnosis of what might be needed to reduce anti-incumbent fever by the fall. The Senate bill is likely to fare quite well in conference. Incumbents in both parties who are facing serious opposition in the fall are especially eager to pass a law that is tough on banks and Wall Street. Bank executives are watching for resolution of issues in 6 key areas.

1. Watching out for the next financial iceberg. Both chambers propose creating a new uber-committee of financial regulators who will be charged with looking ahead to help us avoid another financial calamity. The Senate's has nine members and the House asks for eleven. The scope of the committee's authority could be significant, and the details that emerge from conference will be scrutinized carefully. Among the likely authority of the new body is its ability to assert jurisdiction over an erstwhile unregulated company that could create grave systemic risk and its ability to require a company subject to its jurisdiction that poses grave systemic risk to become smaller.

2. Consumer protection. Each of the proposals makes significant strides to bring greater focus to consumer protection for financial products. The House created an independent agency to champion consumer protection for financial products. The Senate created a bureau within the Fed that will consolidate enforcement of existing rules under one roof. Consumer advocates, prizing the independence of a watchdog, are looking for the House bill to prevail. Bankers would rather have a consumer regulator that is more accountable to the other banking regulators. Aside from the organizational difference, the two versions are similar, except the House excluded car dealers from the jurisdiction of the financial product consumer regulator. The House and Senate both excluded a lengthy list of other potential targets of the regulation, including those subject to the regulation of the SEC, CFTC, state insurance regulators and securities commissions, as well as lawyers, accountants and tax preparers, and real estate agents and brokers. It would not be surprising to see the Senate version emerge, adding the car dealer exemption.

3. Capital requirements. Political sentiment is firmly directed at requiring banks to hold more capital against their risks. Exactly what to require makes experts squirm, so it is not surprising that Congressional efforts to wade into the subject have sounded alarms in the industry and among the regulators. Both House and Senate provisions would target tougher capital requirements on the largest banks. A late stage amendment adopted in the Senate has stirred controversy by calling into question whether trust preferred securities, a mainstay in the capital structure of most large banking organizations, would continue to qualify as Tier 1 capital. Bankers are holding their collective breadth until they see where the dart lands on capital questions.

4. The Volcker Rule. The Senate, borrowing from the Obama Administration's proposed Volcker Rule, requires bank regulators to develop regulations that would 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 impose capital requirements and quantitative limits on systemically significant nonbank financial companies over which it has jurisdiction which engage in proprietary trading. A potentially seismic shift in the business activities of many regulated banking entities, this provision has withstood a storm of opposition. There is no similar provision in the House legislation. Whether or not the Volcker Rule finds its way into law, the support of the Obama Administration for its principles are likely to make landfall on how regulators view the wisdom of proprietary trading, and private equity and hedge fund risks to which banking entities are exposed.

5. Corporate governance. The House and Senate proposals would federalize many corporate governance and executive compensation requirements for U.S. public companies. The Senate would give the SEC authority to prohibit the listing of any company that fails to adopt the new standards. Differences remain between the House and the Senate proposed reforms. For example, the Senate would require exchanges to impose a majority vote standard in uncontested director elections and would place additional limitations on broker discretionary voting, while the House would do neither. The Senate would also authorize the SEC to promulgate rules permitting shareholders to include their own director nominees in an issuer's proxy materials, while the House would require the SEC to adopt proxy access. These and other corporate governance differences will be sorted out in conference committee over the coming weeks as the legislation works its way to the President's desk.

6. Executive compensation. Regulation of executive compensation continues to be a top priority for both the House and the Senate and they are in lockstep on certain reforms. Within six months of enactment both the House and Senate proposals require issuers to include an annual nonbinding vote to approve executive compensation in any proxy statement where executive compensation disclosure is required. Each of the proposals also directs the exchanges to impose additional independence requirements on compensation committees. In addition, the Senate would direct exchanges to require listed companies to maintain policies permitting the claw back of any incentive-based compensation paid to a current or former executive officer if it is later determined that financials must be restated. The Senate also went further than the House on disclosure requirements of executive compensation, including requiring disclosure of the relationship between executive compensation and financial performance, the pay disparity between the median total compensation of all employees and the CEO and whether employees and directors are permitted to enter into hedging transactions with respect to the issuer's equity securities.

We are monitoring the progress of financial reform legislation, especially those changes that may affect the investment management, banking, hedge and private investment fund, and derivatives businesses. If you have questions concerning **Financial Reform Matters**, please contact any of the attorneys listed below or the Ropes &Gray attorneys with whom you regularly work.

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