The Impact of Financial Reform: Banking, the Volcker Rule, Executive Compensation, and Corporate Governance

The long-anticipated financial overhaul is now law. As expected, the Senate legislation largely survived the conference with the House, but critical compromises and new twists marked the process. The legislation reorders the federal regulatory landscape and significantly increases governmental authority.

Important matters have been left to agency rulemaking. Expect intense action at the agency level for many months to come. That said, the large pieces of the overhaul are substantially in place. Here are some key elements of the new regime.

The Volcker Rule

The legislation has found a home for the Volcker Rule in a new Section 13 of the Bank Holding Company Act. A "banking entity" is generally prohibited from engaging in proprietary trading or acquiring or retaining ownership interests in hedge funds and private equity funds or from sponsoring such entities (*e.g.* serving as their general partner or managing member). A "banking entity" is any insured bank or thrift, a company that controls an insured bank or thrift, a company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate of such an entity. With the rulemaking authority provided to the regulators, it will be a while before the full impact of the Volcker Rule is understood. However, the broad outlines of significant change are in place.

- **Proprietary Trading Prohibition**

  Subject to certain exceptions, proprietary trading is barred for banking entities and any nonbank financial companies regulated by the Federal Reserve Board. Proprietary trading means engaging as a principal for the "trading account" in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any other security, derivative or contract, or any security or financial instrument that the regulators may by rule determine. "Trading account" refers to any account used for acquiring or taking positions in the securities or other instruments described above principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) and any such other accounts as the regulators may by rule determine. It is not hard to imagine that rules will add some further dimension to these definitions. The exceptions, all subject to the absence of any material conflict of interest, are numerous and will require rules to better understand. Among the fuzzier exceptions are (i) risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings that are designed to reduce the specific risks in connection with and related to such positions, contracts, or other holdings, and (ii) trading activity in connection with underwriting and market-making reasonably expected to meet the near term demands of clients, customers, or counterparties. Even trading that is generally permitted is barred if it involves a material conflict of interest, results in exposure to high-risk trading or assets, or poses a threat to an entity's safety and soundness or to the financial stability of the United States. As noted above, rules clarifying what this means are also to follow.

- **Private Equity and Hedge Fund Investment and Sponsorship Prohibitions**

  Investment in, or sponsorship of, private equity and hedge funds is prohibited under the legislation.

The general prohibition on investment in, or sponsorship of, private equity and hedge funds is subject to an important exception: a banking entity may organize and offer (including sponsor) a private equity or hedge fund to which it provides *bona fide* trust, fiduciary or other advisory services if the fund is organized and offered only in connection with the provision of such services and only to persons who are customers of the banking entity for such services and so long as the banking entity does not acquire or retain more than a *"de minimis* investment" in the equity interest, partnership interest or other ownership interest in the fund. *"De minimis* investments" include: (a) the banking entity's "seed investment" in the fund and (b) other investments in the fund provided that: (i) the banking entity actively seeks third party investment to dilute its investment, (ii) the banking entity reduces its investment in the fund to 3% or less of the fund's total ownership interests within one year after the fund's establishment, (iii) the investment is "immaterial" to the banking entity and (iv) the aggregate of all the banking entity's *de minimis* investments does not exceed 3% of its core capital. Further, transactions with any such fund would be prohibited if in the nature of a covered transaction (extension of credit) under Section 23A of the Federal Reserve Act and would also be subject to Section 23B restrictions. No guarantees may be issued in favor of such funds, no similar names may be used, and participation by executives in equity ownership is limited to those directly involved in providing investment advice or other services to the fund.

The above outlined exception would seem to be large enough, with perhaps some restructuring of relationships between the bank entity and its customers, to accommodate the ownership of a "fund of funds" division and the ownership of a noncontrolling investment in a company that is itself a private equity or hedge fund sponsor. The coming rules will shed more light on the scope of permitted private equity and hedge fund activities.

The regulators are authorized to impose additional capital requirements and quantitative limits that will protect the safety and soundness of any organization engaged in an otherwise permitted activity.

Although the hedge and private equity fund ownership provisions of new Section 13 do not apply to "nonbank financial companies" regulated by the Federal Reserve Board, the Federal Reserve Board is required to impose additional quantitative limits on the investment in such funds by any nonbank financial companies it regulates. Consequently, it is possible that some nonbank financial companies regulated by the Federal Reserve Board may also be required to divest certain of their hedge and private equity fund holdings in the future.

- **Implementation**

The new limits will not be implemented immediately. Regulators have up to two years to issue regulations. Banking entities and non bank financial companies regulated by the Federal Reserve Board must comply with Section 13 within two years after the requirements become effective. The Federal Reserve Board may delay the compliance deadline for up to three years, and may also grant a five-year extension for the divestiture of "illiquid funds." The Federal Reserve Board will issue regulations to to further clarify implementation by January 21, 2011.

While natural attrition may stave off a mass exodus from these investments, many banking entities will eventually be required to divest themselves of a portion of their holdings in hedge funds and private equity funds. For both investors and funds, now is the time to examine organizational documents and fund-related contracts (including letter agreements) to determine the starting point for any discussion about the sale and transfer of fund interests that may have to be moved.

Too Big to Fail Bailouts and Resolutions

The legislation imposes significant restrictions on the Federal Reserve Board's ability to bail out individual failing institutions, no matter how systemically significant. Instead, a complex mechanism for unwinding failed financial giants has been enacted, with significant roles for the Treasury and the Federal Reserve Board and actual liquidation responsibility held by the FDIC. The FDIC can borrow from the Treasury to cover liquidation costs, but the monies are to be recouped through liquidated assets, assessments on certain claimants that received additional amounts in the course of the liquidation, and a risk-based assessment on remaining large financial institutions, *i.e.,* bank holding companies and any other financial companies with at least $50 billion in assets. Shareholders and unsecured creditors of the failed institution will not be made whole. Former senior executives and directors of the liquidated financial company could be pursued for compensation paid within two years if the compensated individuals are alleged to be "substantially responsible" for the failure. Please see The Impact of Financial Reform: Framework Established for Liquidating Failed Financial Companies for further information on the liquidation process.

The new mechanism for liquidating failing financial giants is complex and suitable only for extraordinary situations. For reasons of policy and practicality, it is anticipated that most non-bank financial institution failures will be conducted in regular bankruptcy proceedings.

Systemic Risk Regulator Established

The legislation creates the Financial Stability Oversight Council ("the Council"). The Council will include representatives of all major federal financial institution regulators (10 voting members) and is charged with preventing another financial crisis. The Council will be chaired by the Secretary of the Treasury. It will be able to subject non-bank financial companies to bank-like regulation (including capital requirements) by the Federal Reserve Board. This will only be the case, however, for firms found so important that their failure would pose a threat to the financial stability of the United States. The Council may make recommendations to the Federal Reserve Board concerning the establishment of prudential standards and reporting and disclosure requirements with respect to such firms. Such new standards and requirements, if adopted by the Federal Reserve Board, could be applicable to both non-bank financial companies regulated by the Federal Reserve Board and to large, interconnected bank holding companies. The standards and requirements would be in addition to those already in place under existing law or regulations. The Council may also recommend to other financial institution regulators the establishment of heightened standards and safeguards with respect to financial activities or practices that could pose systemic risks. Please see The Impact of Financial Reform: Effects on Investment Companies and Investment Advisers of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 for futher information on the Council.

Bureau of Consumer Financial Protection

The legislation creates a new regulator, the Bureau of Consumer Financial Protection (Consumer Bureau), that will be responsible for all consumer financial protection measures at the federal level. The Consumer Bureau will be housed in the Federal Reserve, but is intended to operate in an independent manner. It will write and enforce its own regulations, as well as enforce existing federal consumer-related provisions. The debate over the Consumer Bureau's authority was particularly intense and the Bureau's jurisdiction is a complex matter that reflects that process. In provisions justified as protective of Main Street, the Consumer Bureau would not be able to examine banks and credit unions with assets under $10 billion. Also in this vein are exceptions for Main Street industry groups such as auto dealers.

Federal Insurance Office

The legislation establishes the Federal Insurance Office, a new unit of the Treasury. This office, initially confined largely to studies and recommendations, can be seen as a first step of the federal government's long-anticipated entry into the insurance regulation—long an exclusive preserve of the States.

Bank Regulatory Jurisdiction

The only significant change in primary regulatory jurisdiction over depository institutions and their holding companies is the absorption of the Office of Thrift Supervision into the Office of the Comptroller of the Currency (supervision of thrift depository institutions themselves) and the Federal Reserve Board (supervision of thrift holding companies). Despite considerable pressure, the Federal Reserve Board retained its jurisdiction over state-chartered Federal Reserve Member banks and all bank holding companies. Moreover, the Federal Reserve Board will not be subject to the ongoing Office of Management and Budget (OMB) audits favored by many in Congress. It will be subject to a one-time OMB audit of the much resented Wall Street bailout.

Risk Committees

The legislation requires the Federal Reserve to establish rules requiring public non-bank financial companies under its supervision and bank holding companies with assets of $10 billion or more to establish a risk committee of the board of directors. The risk committees will be charged with overseeing the enterprise-wide risk management practices of the company and must include such number of independent directors as may be required by the Federal Reserve and at least one risk management expert with experience identifying, assessing and managing risk exposure of large, complex firms.

Non-Bank Regulatory Jurisdiction (Shadow Banking and Private Equity)

The legislation requires all hedge fund and private equity managers at or over a $150,000,000 assets under management threshold to register with the Securities and Exchange Commission (SEC). This will allow for data gathering that could be preliminary to future attempts to establish more substantive regulation in this area. Please see The Impact of Financial Reform: Private Fund Investment Adviser Registration for further details on these provisions. The legislation also requires that many types of over the counter derivative securities be exchange traded and centrally cleared. Over the counter derivatives will thus be subject to regulation (depending on type) by either the SEC or the Commodity Futures Trading Commission. Please see The Impact of Financial Reform: The Federal Regulation of OTC Derivatives for further information on these new requirements.

The Lincoln Amendment

The "Lincoln Amendment," another attempt to insulate banks from non-traditional risks, requires portions of a bank's swap trading activities to be conducted in a separately capitalized affiliate. Swap trading related to traditional banking investments or engaged in by a bank to hedge its own risk are exempt. While, like the Volcker Rule, the Lincoln Amendment was modified in the course of intense lobbying and negotiation, it survived repeated attempts to eliminate it altogether. The provision will have a real effect, particularly on the very largest of banks that dominate this section of the financial industry.

Expanding Deposit Insurance

The legislation permanently increases federal deposit insurance from $100,000 to $250,000. This ensures that a temporary measure now in place will not expire. The provision is intended to assist community banks in competition for this inexpensive funding source.

Executive Compensation

The legislation includes a number of provisions that will affect the executive compensation practices of U.S. public companies.

- **Say on Pay**

  The legislation requires that shareholders be given a non-binding say on pay vote to approve the compensation of an issuer's named executive officers at least once every three years. In addition, shareholders must be given a separate non-binding vote at least once every six years to determine whether the say on pay vote should occur every one, two, or three years. Say on pay will be effective for the first annual or other meeting of shareholders that occurs after January 21, 2011. At this first annual meeting, issuers will need to include both say on pay votes described above. Given the effective date, most public companies will be required to include say on pay proposals in their 2011 proxy statements. The inclusion of either or both of these proposals will mean that an issuer will need to file a preliminary proxy statement with the SEC at least 10 calendar days prior to mailing its definitive proxy statement to shareholders, in the absence of SEC rulemaking or guidance to the contrary.

- **Approval of Golden Parachutes**

  The legislation requires that the transaction-related compensation arrangements for named executive officers be disclosed in any proxy or consent solicitation in which shareholders are asked to approve a merger or other corporate transaction. Shareholders will have a non-binding vote on these compensation arrangements unless they have previously been subject to a say on pay vote. This provision will become effective for shareholder meetings occurring after January 21, 2011.

  The SEC has the authority to exempt certain issuers from the general and parachute-related say on pay requirements described above.

- **Disclosure of Say on Pay and Golden Parachute Votes**

  Each institutional investment manager subject to the reporting requirements under Section 13(f) of the Securities Exchange Act of 1934, as amended, will be required to disclose annually how it cast its say on pay and golden parachute votes.

- **Additional Executive Compensation Disclosure**

  Issuers must provide proxy statement disclosure on the relationship between the compensation paid to named executive officers and the issuer's financial performance, taking into account any change in the value of the issuer's shares, dividends, and other distributions. A chart may be used to show the required information.

  In addition, each issuer must disclose the median annual total compensation of all employees of the issuer (other than the CEO), the annual total compensation of the CEO, and the ratio of one to the other. Total annual compensation of employees is to be determined in the same manner as for named executive officers under Item 402 of Regulation S-K as in effect on July 20, 2010.

- **Clawbacks**

  The scope of the clawback provisions contained in Sarbanes-Oxley has been expanded by the legislation, which requires the SEC to establish rules to direct the national securities exchanges to prohibit the listing of an issuer's securities unless the issuer develops and implements a policy providing (i) for the disclosure of its policies regarding incentive-based compensation that is based on financial information required to be reported under securities laws, and (ii) that, if the issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, it will recover from any current or former executive officer who received incentive-based compensation (including stock options) during the three-year period prior to the date that the issuer was required to prepare the restatement the excess of what the executive received based on the erroneous data and what he or she would have received based on the accounting restatement.

- **Compensation Committees**

  The legislation requires the SEC to establish rules to direct the national securities exchanges to prohibit the listing of an issuer's securities (other than a controlled company and certain other exempted entities) if the issuer's compensation committee is not composed entirely of independent directors. The securities exchanges must consider certain factors when defining independence including the source of any compensation paid to a board member (which would include any consulting, advisory or other fees) and whether the board member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer. In addition, the compensation committee is given authority to retain its own compensation consultant, independent legal counsel and other advisers, and the law mandates that each issuer provide appropriate funding to its compensation committee to pay for these advisers. In determining whether to engage an adviser, a committee will have to take into account certain considerations to be identified by the SEC, which will include: (i) the other services, if any, provided to the issuer by the person that employs the consultant, counsel, or other adviser, (ii) the amount of fees received from the issuer by the person that employees the consultant, counsel, or adviser, as a percentage of total revenue, (iii) the policies and procedures of the person that employs the consultant, counsel, or other adviser that are designed to prevent conflicts of interest, (iv) any business or personal relationship of the consultant, counsel or other adviser with a member of the committee and (v) any stock of the issuer owned by the consultant, counsel, or other adviser. The SEC is to conduct a study of the use of compensation consultants and submit a report to Congress no later than July 21, 2012.

Each issuer must disclose in any proxy statement for an annual meeting occurring on or after July 21, 2011 whether its compensation committee retained or obtained the advice of a compensation consultant and whether the consultant's work has raised any conflicts of interest—and if so, the nature of the conflict and how it was addressed.

The SEC may exempt certain issuers from the new requirements related to compensation committees. No later than July 16, 2011 the SEC will direct the national securities exchanges to prohibit the listing of the securities of a non-exempt issuer that is not in compliance. The SEC is required to establish procedures to allow an issuer a reasonable opportunity to cure any defects in complying with these requirements prior to delisting.

- **Enhanced Disclosure for Financial Institutions**

  "Covered financial institutions" must disclose to "appropriate Federal regulators" no later than April 21, 2011 the structure of all incentive-based compensation arrangements that they offer to determine whether the structure provides an executive officer, employee, director, or principal shareholder of the financial institution with excessive compensation or benefits or could lead to a material financial loss to the institution. No later than April 21, 2011, the appropriate Federal regulators are to prescribe, jointly, regulations that prohibit any type of incentive-based payment arrangements or any feature of such arrangements that the regulators determine encourage inappropriate risks by the institution by providing an executive officer, employee, director, or principal shareholder of the institution with excessive compensation or benefits or that could lead to a material financial loss to the institution. No reporting of actual compensation will be required. The law requires that the "appropriate Federal regulators" ensure that the standards for compensation are comparable to the standards established under the Federal Deposit Insurance Act for insured depository institutions and take into consideration the compensation standards described in Section 39(c) of the Federal Deposit Insurance Act (standards specifying when compensation is excessive and prohibiting certain employment arrangements that are deemed unsafe and unsound). "Covered financial institutions" refers to bank holding companies, registered broker-dealers, investment advisers, and any other financial institution that the appropriate regulators jointly determine should be treated as a covered financial institution. "Appropriate Federal regulators" means the Board of Governors of the Federal Reserve, the Office of the Comptroller of Currency, the Board of Directors of the FDIC, the Director of the Office of Thrift Supervision (until transfer of its authority to OCC and Federal Reserve Board), the National Credit Union Administration Board, the SEC, and the Federal Housing Finance Authority.

We have in the past updated you on various matters relating to executive compensation as they were developing that are now covered by the new legislation. If you would like to see these prior Alerts, go to Treasury Proposes Legislation on Say-on-Pay and Compensation Committee Independence, House Proposal Could Regulate Private Fund Compensation, SEC Proposes Rule Addressing "Pay to Play" Practices Involving Investment Advisers, and SEC Adopts Final Rules on Disclosure about Risk, Compensation and Corporate Governance.

Corporate Governance and Proxy Matters

The new law left most of the difficult details of the proposed legislation relevant to corporate governance and proxy matters to another day, requiring SEC rulemaking in many cases to implement the intent of the pertinent provisions. And notably, the Senate's proposal to require a majority voting standard in director elections was dropped altogether. The provisions of the new law relevant to corporate governance and proxy matters are described below.

- **Proxy Access**

  The legislation authorizes the SEC to adopt proxy access rules. Proxy access rules would require an issuer to include in its proxy materials shareholder nominees for election to the issuer's board of directors. The new law does not mandate minimum holding periods or ownership thresholds for shareholders in order to gain proxy access and instead leaves the terms and conditions to the SEC. As a result, the SEC is free to pick up where it left off with proposed Rule 14a-11 regarding proxy access and will likely issue final proxy access rules before the 2011 proxy season.

- **Discretionary Voting by Brokers**

  The legislation prohibits the exercise of discretionary voting by brokers, that is, voting in the absence of direction from beneficial owners, on director elections, executive compensation, and other significant matters (with those significant matters to be determined by the SEC). The limitations on discretionary voting by brokers follows the amendment of the NYSE rules approved by the SEC in 2009, potentially broadening those rules as applied to executive compensation matters.

- **Disclosure of Hedged Positions**

  Under the legislation, the SEC must issue a rule mandating that an issuer disclose in its annual proxy statements whether any employee or director of the issuer is permitted to hedge against any decrease in the market value of the issuer's equity securities granted to such individual as part of his or her compensation or otherwise held directly or indirectly by such individual.

- **Chairman and CEO Structure Disclosure**

  Under the legislation, no later than January 17, 2011, the SEC must issue rules requiring an issuer to disclose in its annual proxy statements the reasons the issuer has chosen to combine or separate the role of chief executive officer and chairperson of the board of directors. However, because in December 2009 the SEC adopted amendments to the proxy rules requiring such disclosure, there will likely be little additional impact.

We continue to evaluate the impact of financial reform legislation, especially those changes that may affect the investment management, banking, hedge and private investment fund, private equity, 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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