Major Reforms to Affect Companies, Financial Institutions

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The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") represents the most ambitious reform of the laws governing the financial industry and corporate America since the Great Depression. The Act touches every domestic financial institution and affects most companies as well. While most of the Act's provisions are aimed at large financial institutions and public companies, smaller institutions and companies are affected by many of the regulatory changes as well.

A full summary and discussion of the Act's provisions and their impact on the business landscape would fill volumes and be premature. Presently, we know enough to make broad assumptions about the impact of the Act and to point out some of its key provisions, but we are still several years away from seeing all of regulations to be promulgated under the Act and understanding their direct and indirect effects on businesses and financial institutions. With that in mind, the following is an overview of many of the Act's most important provisions and a discussion of the effect these provisions may have on domestic businesses.

Consumer Financial Protection Provisions of the Act:

One of the centerpieces of the Act involves the creation of a new consumer protection agency called the Consumer Financial Protection Bureau (the "CFPB"). The CFPB is an independent entity housed within the Federal Reserve and is charged with the task of ensuring consumers are protected from "unfair, deceptive, or abusive" acts or practices. To accomplish its mission, the CFPB is granted the authority to promulgate consumer protection rules for banks and nonbank financial firms offering consumers financial services and products. The CFPB also has examination and enforcement authority over banks with greater than $10 billion in assets, all mortgage-related businesses (lenders, mortgage servicers, and mortgage brokers), and large nonbank financial businesses (payday lenders, debt collectors, and consumer reporting agencies). If the CFPB determines that an institution has violated federal consumer protection laws, the CFPB has the authority to issue a notice to the institution to appear before it and contest the issuance of a cease and desist order. The CFPB may also pursue civil sanctions against the institution.

The Act contains additional provisions affecting institutions engaged in lending and servicing mortgages. For the first time, mortgage originators are required to make a good faith determination that at the time a loan is underwritten, the consumer has a reasonable ability to repay. This determination must be based upon documentation of the consumer's credit history, current obligations, and employment status. The Act carves out a safe harbor for compliance with the "reasonable repayment requirement" for originators that underwrite loans that meet the requirements of a "qualified mortgage." Some of these requirements include verifying and documenting the income and financial resources of the borrower and avoiding mortgages where regular payments do not result in an increase in principal.

The creation of the CFPB, with its mandate to curb unfair and abusive practices coupled with its rule-making and examination authority, implies that businesses and financial institutions will face constraints in the financial products and services institutions may offer to their customers. These institutions will face significant hurdles in creating and marketing new and innovative products and services. In addition, the "reasonable repayment requirement" forces originators to take considerable steps to ensure that a person taking out a mortgage can repay it. The qualified mortgage safe harbor encourages originators to reduce the types of mortgage products offered to their clients and instead focus on "plain vanilla" mortgages, such as fixed-rate mortgages instead of interest only and adjustable rate mortgages. Consequently, the availability of credit could be constrained as lending practices become more limited and institutions face a greater risk of investigation and enforcement activities from the CFPB and other federal and state agencies.

Changes to Corporate Governance and Executive Compensation Disclosures:

The Act also contains several provisions affecting corporate governance and compensation practices and disclosures for public companies and financial institutions. The Act authorizes the Securities and Exchange Commission (the "SEC") to adopt proxy access rules permitting shareholders to use a company's annual proxy materials to nominate individuals to serve on the company's board of directors. The SEC pursued this policy last year, but questions arose regarding the SEC's authority to promulgate such rules. The Act puts to rest these questions. The Act further requires public companies to disclose additional details regarding executive compensation, including descriptions of the relationship between executive compensation paid and the financial performance of the company and of the relationship between CEO compensation and the median employee compensation. The Act directs the SEC to promulgate "say on pay" rules requiring companies to provide shareholders with a nonbinding advisory vote on executive compensation.

In an effort to discourage risky practices on the part of executives, the Act requires public companies to adopt policies allowing the company to recover erroneously awarded compensation (also known as "clawback" policies). This provision states that a company must adopt "clawback" policies to recoup incentive compensation paid to executives if the company is required to prepare an accounting restatement due to noncompliance with any financial reporting requirement under the securities laws. If a company fails to adopt a "clawback" policy, the company will be delisted from its stock exchange.

The Act also will usher in a new, more "shareholder-centric," environment for public companies. The combination of the proxy access rules and "say on pay" requirements puts pressure on company boards to make shareholder relations a priority. These provisions grant shareholders greater voice on the actions of companies, and a company's board must respond by ensuring that shareholders understand the board's actions. Further, it is likely that shareholder advisory firms will enjoy a disproportionate influence on the operations of companies, as many institutional shareholders depend on the opinions of these firms to determine how they will vote their shares. Finally, it is likely that company boards will take an increasingly short-term view with respect to company projects and operations as a result of annual director elections becoming more contested.