ON THE DODD-FRANK ACT

U.S. Rep. Edolphus "Ed" Towns*

In 2008, the U.S. financial system was on the brink of a total collapse. The crisis was of a magnitude the U.S. had not seen since the 1930s. Americans at every social and economic level were angry with Wall Street and rightly so. While Americans made sacrifices and lifestyle changes, stories of Wall Street avarice and irresponsibility dominated the airwaves. To avert a total financial collapse, households that were enduring an historic collapse in real-estate value and facing double-digit unemployment rates were asked to bail out major financial institutions.

In the wake of these calamities, President Barack Obama signed the Dodd-Frank Act into law on July 21, 2010. Dodd-Frank is the most sweeping financial legislation to pass Congress since the Great Depression and has the goal of minimizing the structural weaknesses that brought the financial system to near collapse. The President and the 111th Congress were afforded an opportunity to fundamentally improve a broken financial system, and I believe we succeeded in reducing the potential for a future bailout or financial collapse.

Much of Dodd-Frank focuses on creating a framework that will effectively regulate derivatives, credit default swaps, and asset-backed securities. The extensive use of these instruments created a complex web of assets that was nearly impossible to untangle. When faced with the collapse of Bear Sterns, American International Group, and Lehman Brothers, the government discovered that the tools necessary to work with large firms to avoid a market collapse were not available. This dangerous reality forced policymakers to rethink how government interacted with the financial industry. Thanks to Dodd-Frank, the government now has tools to fashion a variety of measures that will mitigate the risk created by an ever-increasing web of interdependent institutions.

Perhaps the most important regulatory tool that Dodd-Frank created is the Financial Stability Oversight Council (FSOC), which is chaired by the Treasury Secretary. A core duty of the FSOC is identifying potential weaknesses in systemically important financial companies operating within the U.S. After identifying systemically important financial firms, the FSOC would recommend that the Federal Reserve Board (Fed) supervise the firms and, in some cases, liquidate them.

Given the complexity of the financial system, the FSOC is important because many of the vulnerabilities that became apparent during the crisis were due to a lack of transparency between closely linked institutions. With

* U.S. Rep. Edolphus "Ed" Towns served as a House conferee on the Committee of Conference that helped to reconcile differences between the House bill, H.R. 4173, and the Senate amendment, S. 3217, which was ultimately passed as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and signed into law by President Obama on July 21, 2010.

the FSOC and the Fed acting together as a central information gathering location, regulators now have the authority to comprehensively monitor financial market developments. We learned from the crisis that the market was slow in identifying large-scale weaknesses and that coordination between affected institutions was nonexistent. After Dodd-Frank, if an institution under the FSOC's supervision were to face liquidation, the market would be prepared to address the problem before it grew to a level that threatened the stability of the market.

In addition to the FSOC, the Volcker Rule is a key provision of Dodd-Frank. The Volcker rule prohibits banks from owning hedge funds and limits their proprietary trading. It also requires that institutions engaged in high-risk practices implement measures to strengthen capital. Discouraging banks from participating in high risk, short-term proprietary trading will encourage trading that is less speculative and more conducive to long-term growth and stability.

The restriction on proprietary trading was among the most hotly debated provisions during the conference committee. The loss of trust between the American public and traditional banks is one of the more troubling consequences of the financial crisis. Most depositors were unaware that speculators within banks were using taxpayer-insured deposits to gamble on investments that would not benefit the vast majority of bank customers. By restricting bank proprietary trading, the Volcker Rule goes a long way in closing loopholes that allowed banks to pursue deals in direct conflict with the interests of depositors.

Dodd-Frank also addresses compensation practices and corporate governance. Many market observers are convinced that Wall Street compensation practices encouraged executives to chase quick profits that led to an environment where excessively risky decisions became all too common. Under Dodd-Frank, a company's shareholders are able to cast a nonbinding vote to approve executive compensation. This has the desirable effect of increasing transparency.

Executive compensation has long been a lightning rod for shareholder outrage. The Dodd-Frank Act addresses this problem by requiring greater transparency and promoting shareholder involvement. These changes will lead to more reasonable compensation packages and align executive incentives with the long-term health of the company. To this end, at least once every three years, shareholders will have an opportunity to make a nonbinding vote on whether to reject or accept the terms of a given executive's compensation agreement. Although the shareholder vote is nonbinding, executives are likely to take measures to avoid the embarrassment of shareholders rejecting a compensation agreement. As a result of the nonbinding vote, transparency will increase and the flow of information to shareholders is likely to improve.

Furthermore, the Act stipulates that the SEC change its rules to require each public company to disclose the relationship between its executive com-

pensation and corporate financial performance. The measure is meant to give shareholders tools to judge their executive compensation against their company's corporate performance. The companies must disclose the median compensation of all employees, excluding executive salaries. A ratio of the executive compensation and the average employee salary must also be included in the report to the shareholders. The broadest impact of this provision would be to increase shareholder influence over executive compensation, allowing for an environment where more trust and cooperation can be built between investors and executive officers.

I believe that, after the implementation of Dodd-Frank, a strong framework will exist to give regulators tools to protect against a future threat to the financial system. Yet, many questions remain about how Dodd-Frank will affect future operations within financial markets and how its enactment will lead to sustained change within "too big to fail" companies. Appropriately, Dodd-Frank's implementation will continue to provoke serious questions. Answers to these questions will not come until the rulemaking process is completed.

The general contours of the regulators' new powers and their likely impact on Wall Street are completely clear. If diligently enforced, Dodd-Frank will significantly decrease the likelihood of a systemic failure of the financial system by limiting banks' credit exposure to their subsidiaries and affiliates. Regulators are equipped with the accoutrements necessary to strengthen oversight of derivatives markets. Further, liquidity requirements will improve the leverage ratio of "too big to fail" companies, thus ensuring they will have the means to survive future capital strain. Overall, Dodd-Frank creates a robust regulatory framework to protect taxpayers from the burden of expending resources to shepherd "too big to fail" companies through safe dissolution.

—U.S. Rep. Edolphus "Ed" Towns,
10th Congressional District of New York,
Member of the Dodd-Frank Conference Committee