Commentary: Dodd-Frank Hits Wall Street and Main Street

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Financial services reform legislation, formally embodied in the "Dodd-Frank Wall Street Reform and Consumer Protection Act," is now the law of the land. The good news for equity traders is that there is nothing in the reform legislation that requires any more market structure changes. That said, the Securities and Exchange Commission (SEC), as well as other regulatory agencies, some of them new, are required by Dodd-Frank to adopt many new rules, which eventually will cause changes to the way things are done on trading desks.

While Dodd-Frank's primary mission is to reform the way business is done within the financial services industry, one of the most significant changes in regulation wrought by Dodd-Frank, in my opinion, hits "Main Street" in its most vulnerable spot. The provision takes up less than two pages in the Act and is buried in Section 971, which emerges as an afterthought about three-fourths of the way through the document. Under Subtitle G – Strengthening Corporate Governance, Section 971 provides that the SEC may promulgate a rule that requires public companies to include nominees submitted by their shareholders to serve on their board of directors.

Since the advent of the financial crisis, the press has been fond of distinguishing "Wall Street" from "Main Street." Dodd-Frank keyed into this distinction with its title -- "Wall Street Reform," but it's not clear what firms are meant to be included under either designation. The reform legislation has its most obvious impact on the commercial banking industry, which has branches on every Main Street in America. The derivatives industry, another large target of Dodd-Frank, is located throughout the world, but the center of that universe would seem to be Chicago, or maybe London. As for the other street, the lobbyists most vociferously touting the needs of "Main Street" seem to represent large public companies, not the small Mom-and-Pop businesses that the "Main Street" handle would imply.

Subtitle G, at least, clearly has nothing whatever to do with Wall Street. Instead, it deals with a matter of corporate law, which has always been the province of the fifty States.

A corporation's directors are elected by shareholders. In turn, directors choose managers to run the company. Shareholders may exercise their right to vote for

directors by attending a meeting of shareholders and submitting a ballot. Another way to vote is to provide a proxy to someone else who will attend the meeting and vote your shares for you. Most of the votes for public companies are submitted through proxies.

The rights of shareholders to vote are spelled out in every state's corporate law. These corporate statutes allow shareholders to solicit other shareholders' proxies at their own expense. However, none of these statutes requires a corporation to permit shareholders to submit their own nominees using the corporation's own proxy machinery, or otherwise requires a corporation to facilitate shareholder nominees. Most of the corporations who will now be required to deal with shareholder nominees and the resulting "public directors" are not part of the financial services industry. Federal regulation of the proxy process fundamentally regulates the way business is done on "Main Street," or whatever street it is that the U.S. Chamber of Commerce represents.

As it happens, over the past decade or so, the SEC has several times proposed rules that would permit shareholders to use an issuer's proxy machinery to plant directors on the issuer's board. Each of these proposals has encountered fierce opposition from the "Main Street" business community.

Opponents of shareholder nominees have contended that the SEC lacks the authority to require a corporation to use its proxy machinery to solicit votes for board nominees proposed by public shareholders. And the business community has threatened to overturn, by litigation in the federal courts, any SEC rule that would allow public shareholders access to the nomination process.

There is little question that, if it wants to, Congress has the authority to federalize corporation law under the Constitution's Commerce Clause. It follows that Congress can authorize the SEC to intrude into state corporation law by requiring public companies to provide board seats for shareholder nominees. By providing specific legislative authority for the SEC to make rules on this topic, therefore, Dodd-Frank effectively removes the most powerful weapon in the arsenal of the business lobby as it seeks to prevent this intrusion into the corporate boardroom.

As is often the case, it's all about money. Up to now, it has been relatively easy for a public company's management to ensure that board seats are staffed by people friendly to management and relatively sympathetic to management's desire for generous exeutive compensation packages. Sometimes, in order to obtain financing, companies are required to seat board members who may irritate management by objecting to certain aspects of executive compensation, but that is usually as bad as it gets. By contrast, a shareholder specifically nominated and elected to represent the interests of public shareholders is likely to be quite hostile to what she may perceive to be overly generous compensation packages.

Public shareholders also tend to be much more enthusiastic about the prospect of acquisition proposals than management, who stand to lose their jobs in the process. Management generally is able to convince the board to implement anti-takeover devices, including the tactic of requiring acquirers to pay hefty "golden parachute" severance packages to departing executives, which make acquisitions less profitable. It can be expected that public directors will be much less likely to support efforts to implement anti-takeover devices and parachute payments.

The SEC's current proposal would only require a corporation to nominate one public director. It is true that such a public director will only have one vote on a board. Moreover, the experience in England, where English companies have made board seats available to public shareholders for some time now, is that there has been no obvious impact on executive compensation.

However, the dynamic in the United States is quite different, because our access to (and enthusiasm for) litigation against corporate fiduciaries is much higher. Public directors in the United States are likely to be quite cooperative with plaintiffs' attorneys, who are very willing to bring class action suits against directors for breach of fiduciary duty. Such suits are virtually unknown in Europe. This feature of US law will make the voice of the public director very loud on the board.

This tiny provision in Dodd-Frank is likely to be more effective in restraining executive compensation than any restriction that Congress might devise through the tax laws or otherwise. Is this a good thing? Will we be better off? Will the "business community" find a way to limit the impact of the public director? To quote Yogi Berra, "it's tough to make predictions, especially about the future."