

# BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

## The Birth of a New Financial Services Regulator

By Michael A. Benoit

*The new Bureau of Consumer Financial Protection is a massive new regulator with largely subjective standards.*

On July 21, 2010, President Obama signed into law the Wall Street Reform and Consumer Protection Act of 2010 (Act), the most far-reaching financial reform legislation since the Depression. Title X of the Act establishes the new Bureau of Consumer Financial Protection (BCFP or Bureau), a division of the Federal Reserve Board (FRB) that effectively will be an independent agency overseeing all aspects of consumer protection with respect to financial products and services.

### Purpose and Objectives

Section 1021 of the Act requires the BCFP “to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services” and that such markets are fair, transparent, and competitive.

It will take over as the primary enforcement authority for federal consumer financial law (discussed below) for the purposes of ensuring that:

- consumers are provided with timely and understandable information to make responsible decisions about financial transactions;
- consumers are protected from unfair,

deceptive, or abusive acts and practices and from discrimination;

- outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens;
- federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and
- markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

Much of the Act goes into effect on the “designated transfer date” (DTD), which as of this writing is July 21, 2011. The Treasury secretary may extend the DTD for an additional six months if he transmits to appropriate committees of Congress:

- a written determination that orderly implementation of Title X of the Act cannot be feasible accomplished by July 21, 2011;
- an explanation of why an extension is necessary for the orderly implementation of Title X; and
- a description of the steps that will be taken to effect an orderly and timely implementation of Title X within the extended time period.

### Governance and Funding

One striking aspect of the BCFP is the near-total lack of oversight to which it can be subjected. The first example of that is its governance structure. The BCFP will be headed by a single director who will serve for five years and who may only be removed from office by the President, and then, only for cause. This is a departure from other independent agency governance, where a commission is in charge and no more than 3 (assuming a five person commission) can be from the same political party.

Until the director is confirmed, Treasury has interim authority to do all that the director could. While the President has yet to appoint a director, he has appointed Professor Elizabeth Warren from Harvard, a noted consumer advocate, as a special assistant to the president in charge of getting the BCFP off the ground until a permanent director is confirmed. Given that the BCFP is Professor Warren’s brainchild, we can assume that she will be intimately involved in its activities during the Obama administration.

Second, the BCFP will not have to endure the appropriations process; the primary means Congress uses to keep independent agencies in check. Instead, the director may request, and the FRB must provide, up to 10 percent of its annual operating budget in the first year, rising to 12 percent over the next two years, and then adjusted thereafter for inflation. In year

one, the maximum amount the BCFP can obtain is estimated to be approximately \$550 million. To put that into perspective, the Federal Trade Commission budget is \$314 million; a budget that applies not only to its consumer protection mission, but all of its other activities (e.g., competition) as well.

Should the director determine that its portion of the FRB budget is insufficient for its operational needs, it may still avail itself of the appropriations process and obtain an additional \$200 million per year. Together, this could represent a budget of \$750 million in year one—more than enough for the BCFP to get its mission off the ground.

### Jurisdictional Authority

The BCFP has jurisdictional authority primarily over “covered persons” and “service providers.”

In general, a “covered person” is “any person engaged in offering or providing a consumer financial product or service.” “Consumer products and services” can include extending credit, data services, real estate services, stored value cards, deposit taking activities, etc., but does not include insurance activities or “electronic conduit” activities. While much of the focus has been on traditional financial institutions and nonbank mortgage lenders, the BCFP is mandated to define by rule classes of “non-depository covered persons” that will be subject to full BCFP authority. In other words, Congress has delegated authority to the BCFP to determine what sectors of the financial services industry it wants to regulate.

A “service provider” is “any person that provides a ‘material service’ to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service.” With such a subjective definition at its disposal, the BCFP will have significant reach into the financial services industry’s vendor ranks.

### Unfair, Deceptive, or Abusive Acts

The BCFP may take any action authorized under the Act to “prevent a covered person or service provider from commit-

ting or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.”

While we have years of jurisprudence from which providers may glean what acts or practices may be unfair or deceptive, the standard for “abusive” practices is new and untested. Specifically, an act or practice is abusive if it:

- materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- takes unreasonable advantage of
  - a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
  - the inability of the consumer to protect his or her interests in selecting or using a consumer financial product or service; or
  - the reasonable reliance by the consumer on a covered person to act in the consumer’s interests.

To provide some certainty and understanding to consumer financial services providers, clear regulatory guidance from the BCFP defining abusive acts and practices with more clarity will be necessary. Absent clear guidance, it would not be surprising to see providers somewhat reluctant to offer products and services directed to none but the least sophisticated consumers. On the other hand, history has shown the financial services industry to be adaptive to the environments imposed on it, and the same is likely to occur in this instance.

There is, however, a new twist to this standard that has not been seen before. That is, this “abusive” standard includes a fiduciary element unprecedented in the consumer lending industry, i.e., taking unreasonable advantage of the “reasonable reliance by the consumer on a covered person to act in the consumer’s interests.” In virtually all instances, the relationship of a borrower to a lender is adversarial

throughout the duration of the relationship. It is relatively easy to disclose to borrowers at application that they should not rely on the lender to act in their interests, and no borrower should ever assume that a lender has any obligation to do so. Each is looking to get the best deal possible for themselves at origination; query whether a borrower who needs a disclosure to understand this is competent to contract for financial services in the first instance?

It gets more complicated during the life of a loan. Lenders looking to enforce the contract at various points during the term may need to tread carefully. Those lenders who try to work with their borrowers who are experiencing difficulties making their payments may be less willing to do anything other than strictly enforce the contract terms if not doing so could make it difficult to enforce the contract when all efforts to help the consumer fail. Of course, they could disclose to the borrower in each interaction that they should not rely on the lender to act in their interest, but query how helpful that sounds to the borrower?

### Supervision

As of the DTD, the BCFP has will have exclusive rulemaking authority with regard its powers granted under the Act and the “enumerated” federal consumer financial laws (Enumerated Laws), e.g., the Truth in Lending Act and Regulation Z, the Consumer Leasing Act and Regulation M, the Equal Credit Opportunity Act and Regulation B, etc. The list of Enumerated Laws is long and comprehensive and can be found in § 1002(12) of the Act.

With some exception, the BCFP has exclusive examination authority and primary enforcement authority over any rules it promulgates, and will have the same authority with respect to the Enumerated Laws as of the DTD. It will also have the authority to collect information and the power to exempt classes of providers from the full reach of its authority.

In addition to depository institutions, the BCFP will supervise:

- all mortgage-related non-depository in-

stitutions (lenders, servicers, mortgage brokers, etc.);

- private student lenders;
- pay day lenders;
- service providers to non-depository institutions subject to the Bureau's supervision.

The BCFP may also exercise supervisory authority over "larger participants" of the market for other consumer financial products or services. Within one year after the DTD, it must issue a rule in consultation with the Federal Trade Commission (FTC) to define "larger participants." Finally, it may supervise other covered persons when it has "reasonable cause to determine that the covered person's offering or provision of consumer financial products or services conduct poses risks to consumers."

The BCFP will require reports from covered persons and conduct periodic compliance examinations. Its supervision will be risk-based, i.e., it will focus its resources on those providers or classes of providers whose products and service represent the greatest risk to consumers. Many of these providers will be state-regulated; the BCFP is required to coordinate its supervisory activities with the state agencies. Additionally, the BCFP may require specific record-keeping, as well as impose a requirement for background checks or other appropriate financial requirements as it sees fit.

### Enforcement and Remedies

Except for FTC, the BCFP will have exclusive enforcement authority for all transferred and newly promulgated rules. It must coordinate its enforcement with the FTC and negotiate protocol with FTC for initiation and notice of enforcement actions.

With respect to its power to prohibit unfair, deceptive, and abusive practices, the BCFP may bring investigations, and issue Civil Investigative Demands (CIDs) in connection with those investigations. It may conduct cease-and-desist administrative proceedings, and it may bring enforcement actions in U.S. district court.

A court, or the BCFP in the case of an

administrative proceeding, may "grant any appropriate legal or equitable relief with respect to a violation of Federal consumer financial law," including a violation of a rule or order under a federal consumer financial law. Such relief may include, without limitation,

- rescission or reformation of contracts;
- refund of moneys or return of real property, restitution;
- disgorgement or compensation for unjust enrichment;
- payment of damages or other monetary relief;
- public notification regarding the violation, including the costs of notification;
- limits on the activities or functions of the person; and
- civil money penalties.

State attorneys general are authorized under section 1042 of the Act to bring court and/or administrative actions to enforce the Act and any regulations promulgated thereunder. Existing limitations on states' enforcement activities with respect to the Enumerated Laws remain intact. However, if the Bureau, a state attorney general, or any state regulator is the prevailing party in an action to enforce any federal consumer financial law, it may recover its costs in connection with prosecuting such action.

### Final Thoughts

There is far more to the BCFP that may be covered in a simple column, and we will be learning new things about it every day. The BCFP is the new reality for both financial services providers and consumers.

Its primary goal is to protect consumers in financial transactions while keeping markets open and transparent, and ensuring that access to services and innovation is preserved. No doubt, achieving this goal will be no small feat. Achieving this goal without significantly increasing the costs of financial products and services for consumers is, more than likely, a statistical improbability.

All indications seem to be that the BCFP is interested in having an open dialogue with industry and consumers.

Building any new organization of this scope is a monumental task, one made easier by developing a clear understanding of the facts and realities affecting its mission. It would be easy enough for the regulatory pendulum to swing too far one way or the other, and there are plenty of reasons (e.g., economic stability, access to credit, etc.) to try to forge a middle path.

In an effective regulatory environment, balance and cost controls are the key components. Regulations should protect those whom they are meant to protect, while at the same time imposing as little burden as possible on those being regulated. Congress, in its efforts to ensure it addressed every financial woe possible, has created a massive new regulator with no track record and provided it with largely subjective standards to enforce while at the same time eliminating much of its own ability to oversee it effectively. So query: What will drive the balance and regulatory cost controls at the BCFP?

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## Reforms to Australian Consumer and Credit Law

By Aviva Freilich and Eileen Webb

*The Australian consumer and credit law landscape is undergoing vast changes.*

Australian consumer law is experiencing its most significant upheaval since the introduction of the Australian Trade Practices Act in 1974 (the TPA). The new changes, introduced through a series of legislative innovations, will have a very significant impact on many areas of consumer law, including, among others, unfair contract terms, product liability law, and credit law.

This article summarises the two most significant developments:

1. The introduction of the Australian Consumer Law (ACL), a national, uniform state consumer law based on the provisions of the TPA, which will be applied as a law of the commonwealth, and of the Australian states and territories, and
2. The introduction of the National Consumer Credit Protection Package (NCCPP), in particular the National Consumer Credit Protection Act 2009 (Cth). The NCCPP introduces inter alia standard national regulation of consumer credit.

Both schemes are to be introduced in two phases. Legislation implementing the first phase of both schemes, has passed through the commonwealth Parliament. At the time of writing, the second phase of the ACL has been passed but Phase Two

of the NCCPP is still in development.

### The Current Australian Consumer Law Regime

#### *Lawmaking Power—Constitutional Implications*

To understand the scale of the reforms, it is helpful to know something about the current Australian consumer law regime, as well as the distribution of lawmaking power in Australia.

Australia is a federation comprised of a number of states and territories. The three levels of Australian government are similar though not identical to the levels of government of the United States. Under the Australian Commonwealth Constitution there are three levels of government; the federal or commonwealth government, the state and territory governments, and the local government. In relation to the formulation and enactment of Australian law, responsibility is shared between the commonwealth and the states and territories. The commonwealth Constitution states that certain powers can be exercised by the commonwealth and states/territories jointly or one or the other may have exclusive jurisdiction. Therefore, in many instances both the states and territories, and the commonwealth, can legislate in relation to a particular issue but, in the case of an inconsistency the commonwealth law will prevail. This apportionment of law-making power has been of

particular significance for Australian consumer and credit law.

#### *Constitutional Power and Australian Consumer Law*

The principal consumer protection statute, the Trade Practices Act 1974 derives its constitutional validity from commonwealth constitutional power, in particular from the corporations power and the trade and commerce power. Crucially, there are constitutional limitations on the commonwealth government's power to legislate in relation to natural persons, as opposed to corporations and other business entities. As a result, the *consumer* protection provisions of the TPA are applicable primarily to corporations. Given this irony, states and territories introduced their own consumer laws, the various Fair Trading Acts (FTAs) based on, but not completely identical to, the TPA provisions. This has led to some confusion because there has been considerable divergence and variation in these state laws, with some jurisdictions not adopting amendments to the TPA, and others amending the provisions of the FTA's to reflect local issues or concerns.

#### *Inconsistencies in Consumer Credit Law*

The states' regulation of consumer credit has been more uniform, thanks to the introduction of the Uniform Consumer Credit Code (UCCC). The UCCC is template legislation that was first enacted in

one state (Queensland) and later adopted elsewhere. Theoretically at least, there had to be consensus, so the UCCC was amended to ensure national consistency. Nevertheless, credit law in Australia has still been affected by numerous inconsistencies between commonwealth, state, and territory laws. These inconsistencies have led to confusion for consumers and business alike.

### Development and Implementation

On February 17, 2009, the then minister for competition policy and consumer affairs released an information and consultation paper (the Consultation Paper) titled *An Australian Consumer Law: Fair Markets—Confident Consumers*. The Consultation Paper was written in response to the flurry of activity surrounding Australian consumer law in 2008, in particular, the Productivity Commission's report into Australia's consumer policy framework and the Council of Australian Governments (COAG) agreement to a new consumer policy framework.

A priority was to introduce a single, national and consistent consumer law for application throughout Australia. Due to the constitutional limitations discussed above, the legislation will be enacted at commonwealth level and adopted by the states and territories.

The new law has been introduced in phases. Phase One, the Trade Practices Amendment Act (Australian Consumer Law) Act No. 1, 2010, commenced on July 1, 2010. It includes a national, uniform consumer law based on the provisions of the TPA, including:

- A provision to regulate unfair contract terms,
- Enhanced enforcement powers for the Australian Competition and Consumer Commission (ACCC) and the Australian Securities and Investment Commission (ASIC),
- Better redress mechanisms for consumers, and
- A new regime for regulating national product safety.

Although the establishment of a single,

national consumer law is largely a positive development, it is unfortunate that the unfair contract terms provisions were considerably eroded. The commonwealth government decided not to extend unfair contract provisions to business to business transactions, nor make the legislation applicable to insurance contracts. Most crucially, the elements that must be proven to establish that a contract term is unfair now include a new third element, namely that a plaintiff must establish that the term of the consumer contract has *caused* detriment. A term in a consumer contract will be unfair in circumstances where:

1. The term would cause significant imbalance in the parties rights and obligations arising under the contract;
2. The term is not reasonably necessary in order to protect the legitimate interests of the party advantaged by the term; and (crucially in the writers' view)
3. The term would cause detriment to a party if it were to be applied or relied on. (emphasis added)

The need to establish that the term has actually *caused* detriment is a significant dilution of the original proposals and will make the task of establishing that a term in a consumer contract is unfair more onerous for consumers.

Some good news is that under the new regime, the relevant regulators, the ACCC, and the ASIC will have significant new enforcement powers.

Phase Two, the Trade Practices Amendment Act (Australian Consumer Law) Act No. 2, 2010 has recently passed through the commonwealth Parliament. In summary, Phase Two will:

- Change the name of the Trade Practices Act 1974 (Cth) to the Competition and Consumer Act 2010 (Cth);
- Implement new and incorporate and renumber existing general and specific consumer protections; and
- Introduce a new system of statutory consumer guarantees in relation to buying goods and services.

One particularly controversial provision

has been the statutory consumer guarantees, or what would be referred to in the United States as the sale of goods warranties. The proposed provisions will replace the implied conditions and warranties presently in Part V, Division 2 and 2A of the TPA and relevant state and territory laws. The consumer guarantees will provide redress for consumers where goods are acquired from Australian suppliers, importers, or manufacturers and the goods are not, among other things, of acceptable quality or fit for their purpose. Moreover, suppliers, importers, and merchants will be unable to exclude these guarantees by contract.

### Overview of the NCCPP

In 2008, the Council of Australian Governments (COAG) decided that the commonwealth government should take responsibility for the regulation of consumer credit. As a result, the NCCPP will see consumer credit products and services regulated by commonwealth legislation rather than the former state and territory based system pursuant to the UCCC. The legislation will be applicable to many different types of transactions, including home loans, personal loans, credit cards, overdrafts, and line of credit accounts, among other things. The Australian Securities and Investments Commission will administer the new legislation and become the national regulator for consumer credit and finance.

Again, these laws will also be implemented in two phases. Pursuant to Phase One, the commonwealth assumed responsibility for the UCCC, by enacting the National Credit Code (NCC) as commonwealth law. The National Consumer Credit Protection Act 2009 contains provisions that mandate responsible lending and require finance brokers and lenders to be licensed. All providers and brokers of financial services will be required to be members of an external dispute resolution scheme. Phase Two will address *regulation* of the provision of credit to small businesses, unsolicited credit card limit extension offers, interest rates, reverse mortgages, and Islamic finance, among other things. Some of these developments

could be useful to the United States in its continuing efforts to legislate consumer protection.

### **Conclusion**

Australian consumer law remains a moveable feast. Progress is steady but has, perhaps predictably, slowed since the announcement of the reforms and the proposals for their rapid introduction. Some of the gloss of the original proposals has been lost through the realities of ensuring that the legislation makes its way through both houses of the commonwealth Parliament. Nevertheless, by the end of 2010 the Australian consumer and credit law landscape will be vastly different from the past regime.

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## What's Really Wrong with Forced Consumer Arbitration?

By Richard M. Alderman

*Unilateral imposition of arbitration by business has shut consumers out of the civil justice system.*

For two decades the use of pre-dispute consumer arbitration, forced upon consumers in nearly every contract entered into, has been the subject of articles, litigation, and legislation. Authors, litigators, jurists, and legislators have discussed the enforceability of such clauses, the grounds for invalidating them, and the policy issue of whether arbitration is good or bad for consumers. With the exception of the Supreme Court, which routinely upholds the validity of consumer arbitration pursuant to the Federal Arbitration Act, most others disagree about when and if such clauses are valid and enforceable, and whether consumer arbitration is fair, efficient, or inexpensive.

This article will not discuss any of these issues. It is premised on one fact that is not debated—consumer arbitration is unilaterally imposed by the business, and can be imposed in as many situations as the business desires. In other words, the use of consumer arbitration can increase, and has been, at the whim of business. Therefore, consumer arbitration has the potential to become universal, almost eliminating the courts from the realm of consumer law. Regardless of whether arbitration favors individual consumers or businesses or is more or less efficient, the elimination of the judicial branch of

government from an entire area of law is its most serious shortcoming.

### Separation of Powers

We are all familiar with the phrase, “separation of powers”—the division between the legislative, judicial and executive branches of government—a system of checks and balances. Americans have long appreciated the way in which our founding fathers established an independent judiciary, and the important role courts play in the American system of law. We respect our right to trial by a jury, judicial review, and the common-law system by which courts can create and modify judicial rules.

But when it comes to our rights as a consumer, “separation of powers” may soon take on a very different meaning. Consumers may soon be “separated” out of the judicial branch of government. Mandatory, pre-dispute arbitration clauses found in most consumer contracts preclude the courts from being involved with consumer disputes, substituting a private system of justice. And unlike our civil justice system, arbitration has no judge, no jury, no appeal, and no ability to make a decision binding on anyone except the parties to the dispute.

### Consumers and the Courts

There is perhaps no entity or area of law that relies more on the judicial system than consumers and consumer law. Nearly

every consumer protection law is primarily enforced through private litigation, and the courts have long been involved in the creation of common-law doctrines designed to protect consumers. Although it is often said that arbitration is merely an alternative forum for disputes, it is in fact, a matter of substance not forum. Businesses do not impose arbitration to provide consumers with an easier and more efficient way to resolve disputes. They impose arbitration to keep the courts out of the business of consumer protection. Arbitration allows business to effectively opt-out of our civil justice system and replace it with a system of private justice. A recent law review article shows that, in fact, arbitration is not mere forum shopping, it is result shopping. In *W. Scott Simpson, Stephen J. Ware, and Vickie M. Willard, The Source of Alabama's Abundance of Arbitration Cases: Alabama's Bizarre Law of Damages for Mental Anguish*, 28 AM. J. TRIALADVO. 135, 177 (2004), the authors note that the auto and home industries in Alabama divorced themselves from the civil justice system, because of the fear of “unfair” awards:

The auto and home industries, fearing catastrophic verdicts before Alabama juries, now require customers, nearly across-the-board, to enter into pre-dispute binding arbitration agreements as a condition of doing business. These industries have effectively divorced themselves from the Alabama civil justice system in hopes

of obtaining fairer and more just awards before arbitrators.

Instead of appealing through the courts, working through the legislative process to enact change, or using the political process to elect different decision makers, car dealers and home builders simply included a short clause in their contracts, opting out of the civil justice system. A simple clause in a take-it-or-leave-it boilerplate contract enacts major substantive changes in the substance and application of the law.

And the business that includes an arbitration clause can also unilaterally decide when to exclude the clause and again require the consumer to resort to the courts. I assume that when a friendlier judiciary is elected, the auto and home industries in Alabama will stop using arbitration to take advantage of the friendlier forum. When it comes to consumer arbitration one thing is clear, only the business gets to decide whether disputes will go to court or an arbitrator. For example, Bank of America recently stopped requiring consumer arbitration, stating, "We think arbitration is a very fair way to resolve the issue. A lot of our customers did not feel the same way, so we decided to make a change." For the time being, this appears to be a good change for consumers. Of course, as the bank's quote indicates, "we" [the bank] may impose arbitration at any time in the future. While the bank recognizes its customers' feelings, it also made it clear that the ultimate decision rested solely with the bank.

#### Arbitration and the Common Law

Although consumer attorneys have had some success defeating forced, pre-dispute arbitration clauses, individual litigation is time consuming, expensive, and doesn't address the real issue—should consumers have resort to the courts? Under the current system it appears inevitable that consumer arbitration will eventually replace litigation. As courts uphold the validity of such clauses, and increase the authority of arbitrators, perhaps even eliminating class actions, business will surely choose to arbitrate as often as possible. As consumer dispute resolution is fully privatized, the

development and application of consumer law gradually will be skewed toward those who control the process. A system of private justice will always favor those who control access, procedures and the purse strings. As noted above, this is explicitly recognized in Alabama, where auto dealers and homebuilders have chosen to opt-out of the civil justice system to obtain the substantive benefits of arbitration.

Whether individual arbitrations are fair to consumers, or more efficient and less expensive, effectively eliminating courts from the development of consumer law is the most egregious aspect of the widespread use of pre-dispute consumer arbitration. Our courts serve the role of providing remedies for those injured or wronged by others, often supplementing our justice system through the creation of common-law rules and principles. It is the judicial system in the United States that protects the individual from the unreasonable exercise of legislative power, provides a forum for those who lack the ability to exercise significant influence over the legislative process, and provides a mechanism for an individual to seek redress from abuses in the marketplace. As Justice Marshall long ago recognized in *Marbury v. Madison*, 5 U.S. 137, 163 (1803), "the very essence of civil liberty certainly consists in the rights of every individual to claim the protection of the laws, whenever he receives an injury." The common-law tradition of this country is inconsistent with universal arbitration. Many consumer doctrines such as unconscionability, strict products liability, habitability, and good and workmanlike performance have been created, modified, limited, and extended by our courts to protect consumers and ensure a fair bargain. Arbitrators cannot create or modify the common law. Arbitrators decide only the case before them, creating no precedent, binding no subsequent arbitrator faced with the identical facts. To the extent they are bound by law, arbitrators follow existing legal doctrine, essentially freezing the common law of consumer transactions, denying courts the ability to develop and adapt the law. Even worse, the fact that arbitrators decisions are generally secret

and not subject to appeal means that consumers with identical claims and circumstances may be treated differently, by arbitrators unable to create precedent or establish consistent legal doctrine. Forced consumer arbitration is simply contrary to our basic system of government and fundamental fairness.

#### A Simple Solution

The real issue is simple: Should the more powerful party to a certain category of transactions be able to deny the other party access to the courts? The answer, as Congress has recognized in the case of the Motor Vehicle Franchise Fairness Act, and the Servicemembers Access to Justice Act of 2008 is clearly "no." Steps must be taken to insure consumers retain the right to voluntarily decide whether to pursue a claim in court or through arbitration. Business should not be allowed to simply opt-out of the judicial system. The most direct way to do this is through enactment of the Arbitration Fairness Act. The Act prohibits the use of pre-dispute binding arbitration clauses in consumer and employment contracts.

For many years we have recognized the importance of alternative methods of dispute resolution. The concept of "alternative dispute resolution," however, assumes that the civil justice system is the *primary* method of resolving disputes, and that *alternatives* should be established and encouraged. In light of the widespread, continued and increased use of arbitration, enactment of the Arbitration Fairness Act or similar legislation is the most effective way to insure that consumers have alternatives, and that one of them is the civil justice system. Consumers and businesses that wish to enter into post-dispute arbitration agreements should be encouraged to do so, but compelling all consumers to give up their right to a fundamental branch of government is inconsistent with our current system of government.

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## Training for Tomorrow

### DIRECTOR INDEPENDENCE AND CORPORATE GOVERNANCE

By Bruce Dravis

*This article summarizes the role of independent directors in corporate governance, and describes recent material governance law changes enacted in 2010.*

Since the turn of the millennium, independent directors have become the focus of corporate governance. In this still-developing corporate governance environment, the work, time commitment, and responsibilities of independent directors have increased significantly.

This increased focus started with the massive corporate scandals and failures of the early 2000s (e.g., Enron), which propelled the passage of the Sarbanes-Oxley Act of 2002 (SOX). The financial crisis of 2007–2008 resulted in the federal government adopting the nearly \$1 trillion Troubled Asset Relief Program (TARP), and in a renewed focus on the role of independent directors in evaluating corporate strategy, risk, and compensation. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) included many corporate governance provisions.

Both SOX and Dodd-Frank emphasize the importance of independent directors in the governance process.

#### What is Governance Good For?

The term “governance” refers to a combination of state and federal legal requirements (including statutes, regulations, and case law) and developing doctrines

regarding the control of corporations.

For example, the law sets certain minimum requirements regarding how directors and officers are selected, what decision-making processes they must use, and how corporate financial reporting systems are structured and their accuracy verified. At the same time, institutional investors and their advisors are advancing an evolving set of “best practices” governance recommendations that represent standards beyond the legal minimum.

Compared to governance practices prior to 2000, there is now more active oversight of corporate management by the board and by committees of the board. On some matters, such as the authority to engage the company’s auditors or advisors to the compensation committee, decisions have been taken out of management’s hands entirely.

It is important to note, however, that corporate governance describes a decision making process, but does not guarantee favorable results. Moreover, directors are not guarantors of the successful outcome of their business decisions. Such a burden would prevent anyone from serving on a board. Courts recognize this and do not second-guess business decisions by boards, if those decisions have been made with due care and without a conflict of interest.

Good corporate governance practices are aimed at addressing the risk that corporate managers, who have control

over the corporate resources on a day-in, day-out basis, will be tempted to use those resources for their own gratification, rather than in the best interests of the investors. As boards actively monitor executive performance, the role of independent, nonemployee directors has necessarily expanded.

#### Director Independence

The underlying assumption is that, in the absence of oversight, management will be tempted to use corporate resources in its own self-interest. The board acts as a check on management, and it will perform its role more effectively if its members are not part of management or financially beholden in some way to management.

The term “independent director” means a director who does not have employment, family, or other significant economic or personal connections to the corporation other than serving as a director. It is often used interchangeably with the term “disinterested director,” which means a director who, for purposes of voting on a specific transaction or arrangement with the corporation, does not have an economic or personal interest in that transaction or arrangement.

The two terms overlap substantially, but they are not identical. Independent directors will be “disinterested directors,” but not all disinterested directors will be independent. For example, it would be possible for the CEO, as a nonindependent

director, to be a “disinterested director” and to vote on a transaction in which another director had a financial or personal interest.

The basic definition of “independence” for directors is derived from SOX, Dodd-Frank, SEC rulemaking, and the listing requirements for the New York Stock Exchange (NYSE) and NASDAQ. In some circumstances, such as participation on the audit committee or the compensation committee, or participation in a special litigation committee, independent directors have to meet additional independence requirements.

### Increased Control by Federal Law

Corporations are created under state law, not federal law. State corporate law defines the specific duties of directors, but the general principle that directors have a fiduciary duty to act in the best interest of shareholders is consistent from state to state.

With SOX, and again with Dodd-Frank, Congress federalized certain elements of corporate governance for publicly traded corporations. In 2011, Dodd-Frank will require public companies to turn substantial control over the executive compensation decision to independent directors and advisors, give shareholders a non-binding vote on executive compensation (“say on pay”), and increase executive compensation disclosures. Under Dodd-Frank, the SEC will provide a process by which shareholders can use the company proxy statement for director candidates nominated by shareholders.

Dodd-Frank mandates that the compensation committee—made up solely of independent directors—shall have sole discretion over the selection of compensation consultants, legal counsel, and other advisors (each, an “outside compensation advisor”) that it uses, and may only select outside compensation advisors that are independent of the company in accordance with SEC rules.

The compensation committee is responsible for the appointment, compensation, and oversight of the work performed by its outside compensation advisors. Dodd-Frank does not require a committee to

obtain an outside compensation advisor, and it expressly provides that the compensation committee may make or implement decisions that are not consistent with the advice provided by the outside compensation advisor.

Subject to SEC rulemaking, Dodd-Frank will also require additional executive compensation disclosures in the proxy statement, including the ratio of CEO salary to the average pay of company employees, and a comparison of the CEO’s salary to the company’s performance.

Beginning in 2011, Dodd-Frank mandates that public companies must provide shareholders the opportunity to vote on whether they approve of the compensation packages provided to the corporation’s executives at least once every three years. The “say on pay” votes are advisory, and not binding.

The legislation specifies that the shareholder vote on compensation shall not overrule a compensation decision by a company or its board, shall not be construed as changing or increasing the fiduciary duty of the company or its board of directors, and shall not restrict the ability of shareholders to make proposals for inclusion in proxy materials relating to executive compensation.

Nonetheless, a negative vote by shareholders against an executive compensation arrangement would be information that the board and compensation committee would want to consider as it makes compensation decisions on an ongoing basis.

Unhappy shareholders will have the opportunity to use the company proxy statement to advance the nominations of their own candidates (proxy access). Section 971 of Dodd-Frank provided the SEC with express authority to adopt rules regarding inclusion of shareholder nominees in company proxy materials.

Prior to receiving the express authority under Dodd-Frank, the SEC had proposed, but not adopted, proxy access rules. As finally adopted, the proxy access rules require that director nominations from shareholders that have certain shareholder size and longevity profiles would be required to be included in company proxy materials. In October 2010, the SEC de-

layed implementation of the proxy access rule in light of pending court challenges.

The practical effect of proxy access is that a shareholder that might previously have been dissuaded from incurring the expense of preparing and distributing proxy materials to offer its own nominee for director may be able to use the company’s proxy materials for that candidate. The proxy access rules are not the exclusive method by which shareholders can nominate directors. Traditional proxy contests would remain available to shareholders.

### Conclusion

A decade of corporate governance law changes has placed greater autonomy and responsibility in the hands of independent directors. More governance changes will be unveiled during 2011 as a result of Dodd-Frank, most of them directed at executive compensation questions.

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## Keeping Current: Securities

### NEW MD&A INTERPRETIVE RELEASE

By Stuart Gelfond, Andrew Barkan, and Eugene Drozdetski

On September 17, 2010, the SEC issued an Interpretive Release Nos. 33-9144; 34-62934 (the Interpretive Release) intended to improve discussion of liquidity and capital resources in management's discussion and analysis (MD&A) in order to facilitate the understanding by investors of the liquidity and funding risks facing companies. In particular, the Interpretive Release provides guidance on the presentation of liquidity, leverage ratio and contractual obligations table disclosures within MD&A. The Interpretive Release is the latest in a series of SEC releases on improving the quality of specific aspects of MD&A. Concurrently, the SEC also issued proposed amendment release Nos. 33-9143; 34-62932 (the Companion Release) which would require both financial and non-financial companies to disclose additional information in registration statements and periodic reports about intra-period short-term borrowings as a supplement to disclosure about period-end amounts. The proposed rule changes contained in this Companion Release would require a registrant to provide, in a separate MD&A subheading, a comprehensive explanation of its short-term borrowings, including both quantitative and qualitative information for short-term borrowings during the interim period, instead of simply disclosing material changes since the previous balance sheet date. The new disclosure requirements proposed by the SEC are similar to short-term borrowing

disclosure currently applicable to bank holding companies pursuant to Industry Guide 3, Statistical Disclosure by Bank Holding Companies.

#### Liquidity

In the Interpretive Release, the SEC acknowledges that companies have undertaken increasingly diverse and complex types of financing activities and have expanded the kinds of funding methods and cash management tools they use. Accordingly, the Interpretive Release not only revisits prior guidance and rulemaking initiatives that the SEC has issued in the past with respect to MD&A—such as the importance of discussing trends and analyzing the business from management's perspective—but also provides new guidance with respect to the following areas of liquidity disclosure within MD&A:

- trends and uncertainties relating to liquidity;
- intra-period variations in liquidity;
- repurchase agreements that are accounted for as sales; and
- cash management and risk management policies.

Although this guidance has not been codified per se within SEC rules, it is nevertheless important for companies as they prepare MD&A because it highlights certain SEC concerns. As many companies know from their SEC comment letters,

liquidity has been a key focus of the SEC comment process in the past several years.

*Trends and Uncertainties Relating to Liquidity.* The SEC once again emphasized the importance of focusing on the discussion of trends in the context of liquidity, stating that Item 303(a)(1) of Regulation S-K requires registrants to disclose “known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way,” as well as to “identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquid assets.” The SEC then suggests that some additional important trends that should be discussed may include difficulties accessing the debt markets, reliance on commercial paper or other short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral, and counterparty risk. Companies are being encouraged by the SEC to update their disclosure about risks, uncertainties, trends, and commitments, particularly as circumstances change with time. In light of this, the company's finance and treasury teams should revisit their disclosure and consider the impact of these factors set forth by the SEC.

*Intra-Period Variations in Liquidity.*

If the registrant's financial statements do not adequately convey its financing arrangements during the accounting period covered by the filing, or the impact of those arrangements on intra-period liquidity, additional narrative disclosure should be considered. For example, depending on the registrant's circumstances, if borrowings on specific dates during the reporting period are materially different than the period-end amounts recorded in the financial statements, disclosure about the intra-period variations is required to facilitate investor understanding of the registrant's liquidity position. This is an area where many companies may need to supplement their existing liquidity disclosure in response to this new guidance. In fact, the amendments proposed by the Companion Release would require registrants to provide tabular information about its intra-period short-term borrowings, as well as a narrative discussion about those short-term borrowings. As proposed, registrants would be required to provide (1) the amount of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings, (2) the average amount of short-term borrowings for the reporting period and the weighted average interest rate on those borrowings, (3) for registrants that meet the definition of a "financial company," the maximum *daily* amount of short-term borrowings during the reporting period and (4) for all other registrants, the maximum *month-end* amount of short-term borrowings during the reporting period.

*Repurchase Agreements that are Accounted for as Sales.* The Interpretive Release focuses on certain repurchase agreements that are accounted for as sales, as well as other types of short-term financings not otherwise fully captured in period-end balance sheets, such as securities lending transactions, off-balance sheet arrangements, or certain transfers of financial assets. Where a transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets, disclosure in MD&A may be required in connection with a repurchase transaction, particularly if the registrant

does not otherwise include such information in its off-balance sheet arrangements or its contractual obligations table.

*Cash Management and Risk Management Policies.* The SEC believes that companies should consider describing cash management and risk management policies that are relevant to an assessment of their financial condition. Banks, in particular, should consider discussing their policies and practices in meeting applicable banking agency guidance on funding and liquidity risk management, or any policies and practices that differ from applicable agency guidance. In addition, a company that maintains or has access to a portfolio of cash and other investments that is a material source of liquidity should consider providing information about the nature and composition of that portfolio, including a description of the assets held and any related market risk, settlement risk, or other risk exposure.

#### Leverage Ratio

In the Interpretive Release, the SEC stresses the importance of including a clear explanation of the calculation methodology behind any ratio (such as a capital or leverage ratio) or other measure included in SEC filings when there are no regulatory requirements prescribing the calculation of that ratio, or where such ratios are calculated using a methodology that is modified from its prescribed form. The Interpretive Release states that registrants should first determine whether the ratio is a financial measure, and if it is a financial measure, the registrant should determine whether it falls within the scope of requirements for non-GAAP financial measures, which may then require reconciliations to the nearest GAAP measures as well as the other requirements of Regulation G and/or Item 10(e) of Regulation S-K.

In the Interpretive Release, the SEC suggests disclosure regarding:

- the treatment of any inputs that are unusual, infrequent or non-recurring;
- if applicable, how the financial measure differs from other measures commonly used in the registrant's industry;

- the registrant's reasons for presenting the particular financial measure; and
- why the measure is useful to understanding the registrant's financial condition.

In addition, although no formal rules have been proposed yet, the SEC is soliciting comments in the Companion Release on whether to extend leverage ratio disclosure requirements to companies that are not bank holding companies and the scope of any such potential disclosure requirement.

#### Contractual Obligations Table

In the Interpretive Release, the SEC notes that since adopting rules for the contractual obligations table in 2003, divergent practices have emerged in connection with the preparation of this tabular disclosure. However, the SEC states that the rules in fact permit the flexibility to tailor the presentation to suit the company's business and encourages registrants to develop a presentation method that is clear, understandable, and appropriately reflects the categories of obligations that are meaningful in light of the registrant's capital structure and business. The SEC is reluctant to provide guidance on addressing specific questions that have been asked of them regarding the contractual obligation requirement, as these tend to be fact-specific and closely related to a particular registrant's business and circumstances. Instead, registrants should prepare the disclosure consistent with the objective of providing aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve transparency of a registrant's short-term and long-term liquidity and capital resources needs and of providing context for investors to assess the relative role of off-balance sheet arrangements. Footnotes to the table, as well as additional narrative disclosure outside of the table, are encouraged to provide more information to help investors understand the tabular data presented.

From time to time the SEC issues various interpretive guidance related to MD&A, and these releases emphasize

areas of disclosure where the SEC will be focused in their regular reviews of companies' public filings. Therefore, it is important for companies to revisit the liquidity and capital resources sections of their MD&A in light of the Interpretive Release. Similarly, the Companion Release proposes significant disclosure related to intra-period short-term borrowings, which if adopted, will impact MD&A for all registrants.

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