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Dodd-Frank: The Spillover Impact On Nonprofit Healthcare

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Let's get this straight at the top: Dodd-Frank does not specifically apply to nonprofit healthcare. It wasn't written with the healthcare sector in mind. It does not directly affect the framework that regulates nonprofit healthcare. It was not enacted to address any practices or abuses that are prevalent in nonprofit healthcare. Unlike Sarbanes-Oxley, it does not contain any general provisions applicable to public and nonprofit companies alike.

So why should we care? Why read any further?

Well, we care for a bunch of fairly significant reasons. Ultimately, we care because it is a demonstration of Congress' ability to remake regulation of an entire industry in a breathtaking, sweeping manner—especially when there is a perception that the prior framework of industry regulation didn't work.

More specifically, we care because the Act has the potential to have a noteable spillover impact on at least four key areas of nonprofit hospital operations: enterprise risk management (ERM), corporate governance, corporate compliance and, perhaps most significantly, executive compensation. If history serves as any guide, the basic regulatory themes present in Dodd-Frank are likely to re-appear "somewhere down the road," in a manner that impacts nonprofit healthcare.

For those and other reasons, the Act is a worthwhile topic for a boardroom/"C-suite" review from the general counsel. Targeted, to-the-point board and committee presentations could focus on the following topics:

1. "The Big Picture"

The “Dodd-Frank Wall Street Reform and Consumer Protection Act,” enacted July 21, represents a broad-based legislative response to the perceived market excesses and regulatory inadequacies largely believed responsible for the “Great Recession” of 2008-2010. As such, the Act contains a sweeping series of core provisions intended to reform federal oversight of the financial services industry, with specific provisions amending existing laws governing consumer protection and the banking, derivatives, and securities industries. Yet, as with any epochal legislative or regulatory reform, the Act has the potential—through the extension of its core themes—to affect the broader public sector, and operationally sophisticated aspects of the nonprofit sector, as well. Sarbanes-Oxley demonstrated how legislation aimed at the public sector can ultimately manifest itself in nonprofit sector principles and “best practices.”

2. ERM

The Act’s central focus on monitoring and regulating systemic financial sector risk is likely to provide an indirect boost to the ERM activities of nonprofit hospitals, whether they be nascent or mature.

Many nonprofit hospital boards have already been strengthening organizational commitment to enterprise risk management in the wake of the recession. The series of thoughtful position papers by major public policy groups (e.g., The National Association of Corporate Directors and the Conference Board) promote the adoption of board-level ERM activity towards “best practices” levels.

Dodd-Frank adds considerably to the mix by its emphasis on the need to regulate (i.e., reduce or mitigate) systemic risk in a particular, critical economic sector (e.g., financial services). The Act also requires certain large, systemically critical financial services companies to establish risk committees responsible for organizational ERM activities. These committees must include a “to-be-determined” number of independent directors. The upcoming evolution of the new “Financial Stability Oversight Council” will serve to drive concepts of risk management more deeply into the consciousness of the boards of financially sophisticated organizations (both for-profit and nonprofit) and the agencies that regulate them.

Nonprofit hospital boards will want to build off this public dialogue, and the Act’s related provisions, to review the form and function of their own commitment to ERM.

3. Corporate Governance

From a general perspective, Dodd-Frank follows Sarbanes-Oxley as the latest effort of the federal government to regulate corporate governance, historically the province of the

states. A few corporate governance-related provisions of the Act may ultimately have particular implications for nonprofit hospital boards.

One is the direction to the Securities and Exchange Commission (SEC) to issue rules requiring proxy statement disclosure of certain board leadership issues (i.e., the rationale for combining or separating the positions of chair and CEO). As most health lawyers know, combining board leadership positions is not prevalent practice in the nonprofit sector. Yet, this new provision is at its core all about enhancing board independence—a significant issue in nonprofit governance. The thinking is that increased public disclosure requirements will prompt boards to give greater consideration to the independence of their leadership arrangements—a worthy governance practice in any sector.

Also noteworthy from a limited "duty of loyalty" perspective is the direction for federal rulemaking to reduce the potential for conflicts of interest arising between certain financial services employees engaging in research or analysis, and those participating in activities relating to trading or clearing activities. The message here is the value of nonprofit hospital boards being attentive to the emergence within the organization/its medical staff of material, non-traditional types of conflicts of interest; e.g., conflicts arising from non-financial interests, and from horizontal relationships between board members.

While it may be an extreme stretch, the "Say-on-Pay" provisions also are reason for pause, in a very limited sense. We've long been concerned with efforts to force nonprofit boards to more directly accommodate the views of community and constituent groups (as if the nonprofit was a public commission rather than a private company). To the extent the "Say-on-Pay" voting provisions are intended to allow shareholders to exercise greater influence on the board's executive compensation decisions, they could be used by nonprofit sector extremists to argue for a similar role for the hospital's community/consumers.

4. Corporate Compliance

Given the current post healthcare reform emphasis on increased corporate compliance, the Act's establishment of whistleblower incentives and protections are notable.

As part of its consumer and investor protection provisions, the Act seeks to promote reporting of insider trading and similar securities law violations. It increases the rewards available to a whistleblower providing "original information" leading to a successful enforcement action (under certain circumstances). Further, a retaliating employer may now be directly sued by the whistleblower in federal court, without having to exhaust available administrative remedies.

The hospital's compliance committee should note these pro-whistleblower incentives and protections as an "environmental perspective." There are already substantial incentives in place for healthcare whistleblowers under the False Claims At, selected Internal Revenue Code provisions, and other regulations. Yet, the compliance committee should be aware of the extent to which Congress seeks to support whistleblowers as part of Dodd-Frank. From a broad perspective, these new provisions enhance a general compliance culture that incentivizes corporate insiders to "run to the government" in the first instance, rather than seeking first to address concerns within organizational channels.

5. Executive Compensation

The Act can be expected to have a noticeable, if indirect, spillover impact on the executive compensation practices of nonprofit hospitals. This will come primarily from those provisions addressing compensation committee and adviser independence; additional executive compensation disclosure; mandated "clawback" policies; and even—to a limited extent—the "Say-on-Pay" provisions.

- The Act requires publicly-held companies to report the ratio of the total compensation of the CEO to the median employee total compensation. Numerous articles and studies have identified a growing gap between what the CEO is paid and the pay of the typical employee, with this situation viewed by some as a sign of increasingly inequitable pay distributions. This phenomenon is occurring in the nonprofit healthcare sector as well.

  Given the attention this ratio statistic is likely to receive, the media along with certain stakeholder groups (organized labor, regulators, politicians) will be interested in this statistic in the nonprofit healthcare sector. The general counsel may wish to recommend that the nonprofit monitor this pay relationship within its own organization. It also may be helpful to monitor the ratio of CEO total compensation to that of other executives internally, and compare it to such ratios based on industry market norms. Finally, this statistic and related commentary should be incorporated in the organization's media response plan.

- Public companies will be required under listing standards to adopt and implement "clawback" policies to recover unearned incentive payments to current or former executive officers during a three-year look-back period if the company is required to prepare an accounting restatement based on inaccurate financial data due to material non-compliance with any financial reporting under federal securities law. Unlike Sarbanes-Oxley, this regulation applies to *all* executive officers (i.e., those

with policy-making authority), not merely to the CEO and CFO; does not require evidence of "misconduct"; and imposes a longer three-year look-back period.

"Clawback" provisions are thus moving closer to the executive compensation mainstream. Prudent governance requires that nonprofit healthcare organizations retain the ability to recoup payments paid to executives in error. While this provision applies specifically to incentives, compensation committees of nonprofit providers may wish to discuss the extent to which its executive contracts permit the recapture of any compensation paid in error to key executives, whether intentional or unintentional.

- The Act requires the SEC to issue rules that the members of a public company's compensation committee meet additional, more rigorous, independence standards similar to those required of audit committee members. This serves as an important reminder that the compensation committees of nonprofit providers satisfy the independence standards under the Internal Revenue Service Intermediate Sanctions regulations.

  The Act also requires that prior to engaging executive compensation advisors, the compensation committee evaluate those factors that may impact the independence of the advisors. Such factors include (a) fees from other services provided to the company, (b) personal/business relationships with executives, committee members, or the company, and (c) income streams received that are related to the advisors' recommendations. The Act, however, does not require that the advisors retained by the committee be independent or mandate that the committee cannot rely on related legal advice from the corporation's legal counsel.

  As health lawyers know, a conflicted advisor can easily taint the best executive compensation determination process. All advisors to the executive compensation approval body should be assessed periodically by the general counsel to evaluate potential conflicts in regard to the services that they provide. In addition, it may be useful to inquire whether advisors have policies in place to ensure conflicts are avoided.

- The Act mandates that organizations describe the relationship between the level of executive compensation and its financial performance, with a focus on share price, dividends and other shareholder return. This type of requirement could increase the pressure on nonprofit providers to demonstrate a "pay for

performance" relationship regarding executive compensation. Although the sector lacks a stock-based metric, and performance is much broader than financial results, nonprofit organizations would be well-served to be able to demonstrate that upper quartile compensation is supported by upper quartile organizational performance using accepted metrics.

The increasing scrutiny of executive compensation practices in the nonprofit sector enhances the risk that any one or more of these Dodd-Frank compensation themes may prove attractive to charity regulators and to legislators. Accordingly, they are worthy of at least a brief introduction at the compensation committee level. The Act builds off concepts introduced in the "TARP" legislation of 2009, and emphasizes the willingness of the federal government to limit executive compensation.

6. Conclusion

It's not the stretch that it might otherwise seem; it's not a case of over-analysis, of seeking to fill a gap that doesn't exist. Major themes of the seminal Dodd-Frank Act can be expected to have a limited but nevertheless noteable spillover effect on the nonprofit hospital sector. This is principally with respect to enterprise risk management, executive compensation, corporate governance and corporate compliance. The nonprofit hospital's general counsel is well situated to share this important message with board and executive leadership.

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