Finalization of the 2010 Dodd-Frank Executive Compensation Rules

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ESG (Environmental, Social, Governance) and DE&I (Diversity, Equity, and Inclusion) have dominated boardroom conversations in recent years. Statutory changes to executive compensation took a backseat, but the SEC under Chair Gary Gensler has announced plans to refocus on these issues; they are included in the public calendar of high-priority issues. In an unusual move, the SEC also provided a target date for when to expect regulations—April 2022.

Dodd-Frank: A Review

In the wake of the 2008 financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The statutes were designed to add additional security to markets and improve accountability in the financial system. Several statutes relate specifically to executive compensation. For example, in 2012, the SEC adopted six independence rules designed to identify potential conflicts of interest among compensation committee members and advisers. (As a compensation consultancy, Meridian is also subject to these rules.)

Eleven years have passed since Dodd-Frank, but the SEC has yet to finalize regulations for two material elements of compensation plan design: clawbacks and pay-for-performance. The SEC proposed regulations in 2015, only to receive so much negative feedback that the process of finalization remains unfinished. The regulations offer some clues as to what the SEC will expect, but parameters around clawbacks and pay-for-performance remain vague.

The clawback statute is only three sentences long. Many companies added clawback policies to their compensation programs, with an added caveat—that the policies were intended to fulfill Dodd-Frank requirements. But without finalized rules, there is no way to verify compliance. The pay-for-performance statute, two sentences long, also provides significant room for interpretation. They do not establish specific definitions for pay or performance, but they do outline new disclosure expectations.

2015 Regulations: Clawbacks

Between the two unfinished Dodd-Frank rules, the clawback is by far the most significant. It will impact nearly every public company in the US. Clawback rules date back to the 2002 Sarbanes-Oxley Act (SOX). SOX clawback regulations only applied to the CEO and CFO, extended back one year, and required evidence of negligence. It was determined that these rules were not sufficient, leading to the inclusion of new proposed regulations in Dodd-Frank.

The clawback statute in Dodd-Frank is brief. First, clawback policies now apply to all current and previous executive officers. Second, in the event of a financial restatement, incentive compensation is clawed back only to the extent to which excess was paid above and beyond what should have been paid. Lastly, clawbacks should be “no-fault,” meaning they can be applied irrespective of an executive’s responsibility for the trigger event. However, this statute offers little guidance on designing and executing clawback policies. All the necessary rules and requirements (e.g., which incentives are clawed back and the processes committees should take) fall under regulation, so the SEC must provide direction on how this statute should be interpreted and applied.

2015 Regulations: Pay-for-Performance

The pay-for-performance statute in Dodd-Frank was intended to shine a light on potential issues rather than regulate them. Like the clawback statute, it provides little actionable guidance. The statute requires companies to disclose pay for named executive officers and associated performance outcomes, but it does not explicitly define pay or performance. In 2015, proposed regulations specify a new table in the proxy statement that shows the CEO as an individual line item with their pay compared to performance. This data should show the relationship that incentives have with company performance.

The proposed regulations provide some clues as to the SEC's position on pay-for-performance issues, but in their unfinalized state, they create more challenges than they resolve. For example, 2015 proposed regulations modified the definition of long-term incentive stock options and pension disclosures. That means that the pay represented in the new table (described above) is different from the pay disclosed in the summary compensation table within the same proxy statement.

The regulations also manufacture a transition period by establishing disclosure timeframes that do not align. Proxy disclosures for named executive officers only go back three years, but regulations call for disclosure of CEO pay as it relates to TSR over a five-year period (with a transition period).

Regarding performance, the regulations focus on total shareholder return (TSR), i.e., stock price performance plus dividends. However, they do not take into account the variety of ways to measure performance. In some industries, stock price is not the best metric, or it may be one of several metrics. Pay-for-performance requires external benchmarks to determine the real value of an executive's compensation and relative performance. The regulations require the creation of a peer group to help evaluate performance, but do not require pay information for peer CEOs.

Preparing for Finalization

The above summary demonstrates how complicated it is for companies to design compensation programs that are actionable, compliant with SEC regulations, and competitive in the marketplace in the absence of official rules and regulations. There is some good news—without final rules, the proposed pay-for-performance regulations are not yet a required disclosure. At this time, compensation professionals must simply wait for the approval of final regulations.

Clawbacks should be a top priority as compensation committees prepare for the finalization of Dodd-Frank regulations. At Meridian, we recommend that committees hold off on changing or modifying policies in anticipation of the SEC's April 2022 target date. They should take a full inventory instead. Clawback provisions can be found in bonus plans, equity and long-term cash award agreements, change-of-control documents, and more. A thorough inventory identifies where clawback provisions exist, how they can be executed, and the process by which the board, governance committee, and compensation committee determine the necessity of a clawback.

Conclusion

Though we have been waiting for more than a decade, finalizing these regulations for executive compensation is not a complicated process. The statutes became law upon the passage of the Dodd-Frank Act in 2010. The last step is simply for the SEC to post final regulations in the Federal Register. After a 60-day comment period and another 30 days for the SEC to consider feedback, the rules should be finalized.

There is no requirement for the SEC to release regulations at a specific date, but the April 2022 announcement has motivated companies to reexamine compensation strategies quickly. Because there are still too many uncertainties around what final regulations will entail, Meridian

recommends that companies prioritize taking a comprehensive inventory of existing policies and wait to modify existing policies until finalization.

Once final rules are available, the real work begins. It will be time for compensation committees to review and revise clawback policies for compliance. Established parameters for formal disclosure of pay-for-performance measurement should provide consistency in how companies disclose this relationship.