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Dodd Frank Regulatory Update: Signals from Financial Regulators' Spring Agendas

In 2018, it is not expected that any of the outstanding Dodd-Frank proposals will be finalized including – Pay Versus Performance, Clawbacks, Hedging, or Incentive-based Compensation Arrangements. The CEO Pay Ratio is presently in effect and applies to fiscal year 2017, which will show up in proxy statements filed for 2018 annual shareholder meetings.

Several key U.S. financial regulators have issued their spring 2018 semiannual regulatory agendas with the key message that they are backing away from several post financial crisis rule proposals, most notably the outstanding compensation regulations of Dodd-Frank Act Title IX ("Dodd-Frank" or the "Act"). The proposed rules discussed in this alert have not been finalized, and thus, are not effective at the present time.

Financial Institution Proposal: Each of the federal regulatory agencies (except the Federal Reserve) charged with jointly implementing incentive-based compensation rules for financial firms, as required by § 956 of the Dodd-Frank Act, neglected to include reference to this proposed-but-unfinished rule. This provides insight into how the new Administration's regulators are setting priorities and declining to advance proposed regulations that preceded their tenure.

- What does this mean? First, if the regulators were to ever implement § 956, there is an 18 month delay from its effective date. Thus, if it were finalized today, it would be effective for firms with calendar based fiscal years beginning 18 months after August, 2018 or January 1, 2020. We do not expect any activity on this regulation in the foreseeable future.

- Where does this leave incentive compensation regulation? Due to the lack of activity on § 956, banking institutions are left with Sound Incentive Compensation Policies per the de facto regulatory guidance in effect today. Active since June 25, 2010, this guidance applies to all banks regardless of size. Each banking institution that currently utilizes incentive compensation arrangements should have processes in place. These plans are then reviewed for risk-versus-reward and approved by the compensation committee. Please see our client alert on this topic click here.

All Public Company Proposals: The SEC also left several other proposed, but un-finalized Dodd-Frank Act corporate governance rules off its agenda. This specifically includes Clawbacks (§ 954), Hedging (§ 955), and Pay-Versus-Performance (§ 953(a)). The CEO Pay Ratio (§ 953(b)), which is also discussed below, has been finalized, and the compliance date is fast approaching.

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Background to Regulatory Change: This development on the Dodd-Frank proposals is consistent with recent hints from regulators and the financial press, and may be taken as a chapter in an ongoing story whereby many perceived that the post-crisis legislation overreached in terms of corporate governance. The result saw a subsequent pull back from some of the more onerous corporate governance terms for newly public companies (JOBS Act). With the present change in the Presidential Administration, legislative efforts to repeal or curtail these corporate governance requirements (H.R. 10, the Financial CHOICE Act) have been stalled. Additionally, there has been a partial pullback from the regulatory agencies charged with implementing these mandates.

- The apparent regulatory pullback is not entirely surprising. In his first speech as Chairman of the SEC in early July, Jay Clayton remarked:
  - *“The Dodd-Frank Act of 2010 required the SEC to complete an unprecedented array of congressionally mandated rulemakings — all on top of the agency’s usual work. Under Chair White’s leadership, the Commission made great strides, adopting a number of the rules with which it was charged. Admittedly, there are still Dodd-Frank mandates to be completed. But I have inherited an agency with considerably more discretion over its agenda.”*

- Earlier this year, former Chairman Michael Piwowar opened a file seeking public comments on the much-maligned Pay Ratio rule, remarking:
  - *“It is my understanding that some issuers have begun to encounter unanticipated compliance difficulties that may hinder them in meeting the reporting deadline….. I have also directed the staff to reconsider the implementation of the rule based on any comments submitted and to determine as promptly as possible whether additional guidance or relief may be appropriate” (emphasis added).*

- The spring agendas are not binding and only offer a “soft” indication of the agencies’ priorities. It is not uncommon to include issues that will never materialize in regulatory agendas. The exclusion of Dodd-Frank Act mandated rules, however, presents a somewhat more compelling picture of regulatory priorities, given each of these rules required implementation by Congress and are long overdue. In other words, the agencies’ exclusion of these rules from their regulatory agendas is the clearest indication to date that the agencies are turning the page on Dodd-Frank. The remaining unfinished rules have given way to new priorities that have arisen in the seven years since the Dodd-Frank Act’s passage.

Each proposal, which is no longer on the regulatory agendas, is summarized below:

- **Incentive-Based Compensation, § 956:** In April 2016, as required by § 956 of the Dodd Frank Act, the SEC, Federal Reserve, FDIC, OCC and NCUA, and FHFA proposed regulations with respect to incentive-based compensation practices at financial institutions with $1 billion or more in assets, and includes more stringent requirements for larger institutions. Under the proposed regulations, covered financial institutions would be subject to a general restriction on incentive compensation arrangements that encourage inappropriate risks by providing a covered person with excessive compensation that could lead to material financial loss. Some financial institutions’ incentive compensation arrangements would also require a mandatory deferral, forfeiture and downward adjustment reviews, and clawbacks. Though rules under § 956 do not appear to be advancing, that does not indicate that all financial firms will avoid the core mandates of the rule—the proposed § 956 rules closely mirror the Banking regulators’ 2010 Interagency Guidance on Sound Incentive Compensation Policies, to which most banks are still subject.

- **Pay-Versus-Performance, § 953(a):** The SEC proposed a rule to implement the Dodd-Frank mandated Pay-Versus-Performance requirement in 2015. The proposed rule would require disclosure of a table comparing four figures over a five-year period: 1) compensation "actually paid" to the CEO; 2) average of compensation "actually paid" to the company's other four named Executive Officers; 3) company's cumulative TSR; and 4) cumulative TSR of a peer group selected by the company.

- **Clawbacks, § 954:** In 2015, the SEC proposed rules directing the National Securities Exchanges to implement listing requirements for companies to adopt a clawback policy. This would require recoupment of incentive compensation from current or former officers, without a finding of fault, following a material restatement of financials.

- **Hedging, § 955:** In 2015, the SEC proposed rules requiring companies to disclose in their annual proxy statement whether they permit employees or directors to engage in transactions. This would hedge or offset any decrease in the market value of company stock granted to or owned by an employee or board member.

Lastly, the CEO Pay Ratio, which is currently in effect, is summarized below:

- **CEO Pay Ratio, § 953(b):** The SEC adopted its final Dodd-Frank Act CEO Pay Ratio rule in 2015, with its first disclosures set for the 2018 calendar year. Under the rule, companies must reveal the ratio of the CEO's annual total pay to the annual total pay of the median employee. This is a highly complex calculation that many industry professionals believe would have little, if any, benefit for investors. Because this rule is final, its "omission" from the SEC's regulatory agenda is not surprising. However, recent signals from the SEC regarding "reconsideration" of the rule suggest that some action, perhaps in the form of informal guidance or additional compliance and disclosure interpretations (C&DI's), may be forthcoming. If that's the case, it's likely to occur prior to October 1st, the first date upon which the Pay Ratio calculation may be based.

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