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Financial Regulators Propose Incentive Compensation Rules under Dodd-Frank

On April 21, 2016, the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the National Credit Union Administration (collectively, the “Agencies”) proposed an interagency rule governing incentive-based compensation arrangements (the “Proposed Rule”) under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The Proposed Rule updates a prior proposal issued in 2011 to reflect, among other things, evolving incentive-based compensation practices and the supervisory experience that certain of the Agencies have gained in applying compensation-related rules.

The Proposed Rule imposes general requirements on covered institutions (including banks, broker-dealers, investment advisers, credit unions, Fannie Mae, Freddie Mac and other financial institutions that the Agencies may determine) that have at least \$1 billion in consolidated, proprietary assets and imposes additional requirements on covered institutions with assets in excess of \$50 billion and further requirements on covered institutions with assets in excess of \$250 billion. Under the Proposed Rule, all covered institutions are prohibited from establishing incentive-based compensation arrangements (broadly defined as any variable compensation, fees or benefits that serve as an incentive or reward for performance) that encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. Covered institutions are also required to establish internal compensation procedures with board oversight and to comply with new recordkeeping and regulatory disclosure requirements related to their incentive-based compensation arrangements.

As currently proposed, the new requirements would be effective no later than the first day of the first calendar quarter beginning at least 540 days (or approximately 18 months) after the publication of a final rule. Any incentive-based compensation arrangements with a performance period that begins before such effective date would be grandfathered.

We discuss the Proposed Rule in general terms, but note that in some instances a particular Agency may provide for specific provisions to apply only to its regulated entities.

Covered Institutions

The Proposed Rule applies to the following financial institutions with average total consolidated assets of at least \$1 billion (“covered institutions”):

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- Registered broker-dealers and all investment advisers (registered and unregistered) as defined in Section 202(a)(11) of the Investment Advisers Act.
 - State member banks, bank holding companies, savings and loan holding companies, Edge and Agreement Corporations, state-licensed uninsured branches and agencies of foreign banks, including U.S operations of foreign banking organizations.
 - State non-member banks, state savings associations and state insured branches of foreign banks.
 - Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Office of Finance of the Federal Home Loan Bank System.
 - Insured credit unions and credit unions eligible to apply to become an insured credit union.
 - National banks, federal savings associations and federal branches or agencies of foreign banks.

The asset size of the covered institution is determined by the average of the total consolidated assets reported for the last four consecutive quarters by the covered institution. For investment advisers, the average total consolidated assets is determined by the investment adviser's total assets shown on the balance sheet for the investment adviser's most recent fiscal-year end. Importantly, investment advisers would not include client assets under management in this calculation, regardless of whether such assets appear on the investment adviser's balance sheet. This method of calculation for investment advisers mirrors the reporting requirement in Item 1.O of Part 1A on Form ADV.

The Proposed Rule identifies three categories of covered institutions based on average total consolidated assets:

- Level 1: assets greater than or equal to \$250 billion;
- Level 2: assets greater than or equal to \$50 billion and less than \$250 billion; and
- Level 3: assets greater than or equal to \$1 billion and less than \$50 billion.

Level 1 or Level 2 institutions are subject to more stringent requirements with respect to incentive-based compensation arrangements, as described below. In addition, a Level 3 institution with assets between \$10 and \$50 billion may be required to comply with the more stringent rules if the applicable Agency determines that the institution has complex operations and incentive-based compensation arrangements that are similar to a Level 1 or Level 2 institution – or if it is involved in high risk businesses (*e.g.*, distressed lending or investing or trading in illiquid assets).

If a covered institution's average total consolidated assets increase, thereby moving the institution to a higher level, the institution will not be required to comply with the more stringent regulations until the first day for the first calendar quarter that is 540 days after the date the covered institution becomes subject to the new asset tier. If an institution's assets decrease so that it is in a lower category, it can begin complying with the regulations of the new category immediately.

A covered institution that is a subsidiary of another covered institution will generally be categorized as a covered institution at the same level as its parent, even if the subsidiary has fewer assets than the parent. However, it is important to note that the Proposed Rule does not consolidate subsidiaries of broker-dealers or investment advisers that are not subsidiaries of depository institution holding companies.

Covered Persons

The Proposed Rule applies to incentive-based compensation arrangements with "senior executive officers" at all covered institutions and "significant risk-takers" at Level 1 and Level 2 Institutions only ("covered persons"). "Senior executive officers" include employees who hold the title or perform the obligations of "president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer or head of a major business line or control function."

"Significant risk-takers" are individuals (including employees, directors or 10% or greater shareholders who receive incentive-based compensation at a covered institution) not covered by the definition of senior executive officer, but due to their responsibilities may cause material financial risk to a Level 1 or Level 2 institution. There are generally two tests for determining a significant risk-taker:

- The first test is whether the individual receives at least one-third of his or her compensation through incentive-based compensation arrangements and is in the top 5% of compensated individuals for a Level 1 institution or the top 2% of compensated individuals for a Level 2 institution.
- The second test is whether the individual has "the authority to commit or expose 0.5% or more" of the covered institution's capital. This second "exposure test" extends to individuals who are voting members of a committee that has the decision-making authority to commit or expose 0.5% or more of the capital of an institution.

The Agencies have some flexibility in determining who is a significant risk-taker, *e.g.*, an Agency may add employees as significant risk-takers if it determines that they can expose the covered institution to material financial loss; or an Agency can apply the 2% Level 2 institution threshold to a Level 1 institution if it determines that threshold to be appropriate.

No Excessive Compensation or Material Financial Loss

The Proposed Rule prohibits all covered institutions from providing incentive-based compensation arrangements that encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. The incentive-based compensation arrangements must be viewed holistically and must reflect factors that reduce the risk of inappropriate actions by covered persons.

Compensation will be considered excessive when it is unreasonable or disproportionate to the value of the services rendered when considering all appropriate factors, including: (i) the value of all compensation, fees and benefits provided; (ii) the covered person's compensation history and the compensation history of individuals with similar expertise at the covered institution; (iii) the covered institution's financial condition; (iv) compensation practices at comparable financial institutions; (v) if a post-employment benefit, the projected cost and benefit to the covered institution; and (vi) any fraud or omission, breach of trust or fiduciary duty or other insider abuse by the covered person.

Incentive-based compensation arrangements must: (i) appropriately balance risk and reward, (ii) be compatible with effective risk management and internal controls and (iii) be supported by effective corporate governance, so as not to be considered to encourage inappropriate risk that could lead to material harm to the covered institution. To properly balance risk and reward, an incentive-based compensation arrangement must include: (i) financial and non-financial factors (including appropriate considerations of risk-taking); (ii) non-financial factors (such as risk-taking) that may outweigh financial factors; and (iii) adjustments to reflect actual losses, inappropriate risks taken, compliance deficiencies and other aspects of financial and non-financial performance. An incentive-based compensation arrangement should have measures that assess the risks taken by the covered persons.

Additional Requirements for Level 1 and Level 2 Institutions (Including Requirements for Deferral, Forfeiture and Downward Adjustment and Clawback)*Deferral*

Broadly stated, the Proposed Rule is built around the idea that incentive-based compensation should not be fully paid out when the performance goals are achieved and the earned compensation measured ("awarded" in the regulatory vocabulary); rather, some portion of the awarded compensation must be subjected to additional vesting (risk of forfeiture) requirements, with the earned compensation to be paid no sooner than when those additional vesting requirements are met. The additional vesting requirements generally reflect the passage of time without the occurrence of specified negative events. Incentive-based compensation arrangements for Level 1 and Level 2 institutions must include deferral periods, whereby certain portions of the compensation vest *pro rata* after the performance period ends, effectively lengthening the vesting period of such compensation. During the deferral period, the compensation owed can vest and be paid no more rapidly than *pro rata* starting on the first anniversary of the deferral period.

During the deferral period, there can be no acceleration of payments except in very limited circumstances, such as death or disability (for example, payment may not be accelerated upon termination of employment) or any increase in the amounts payable other than as a result of a change in share value, interest rates or the payment of a rate of return or interest as specified at the award date.

For Level 1 institutions, 60% of the senior executive officer's incentive-based compensation must be deferred subject to further vesting and 50% of the significant risk-taker's incentive-based compensation must be deferred subject to further vesting. For Level 2 institutions, the minimum deferral rate is 50% and 40%, respectively.

Incentive-based compensation arrangements that are for a performance period of less than three years (*e.g.*, annual performance periods) must be deferred for four years for Level 1 institutions and three years for Level 2 institutions. If an incentive-based compensation arrangement is considered long term, *i.e.*, the performance period is three years or more, the compensation must be deferred for two years for a Level 1 institution and one year for a Level 2 institution.

The deferred incentive-based compensation for Level 1 and Level 2 institutions should include both cash and equity for appropriate risk management. Stock options, if granted, may not be used to satisfy the minimum required deferred compensation amount in excess of 15% of the amount of total incentive-based compensation at Level 1 and Level 2 institutions.

Forfeiture and Downward Adjustment

Incentive-based compensation arrangements for Level 1 and Level 2 institutions must be subject to forfeiture and downward adjustment. Forfeiture occurs after the compensation has been awarded, but before it has vested, such that if a material financial event arises due to the actions of the covered person, the covered institution may take back the compensation. A downward adjustment occurs during the performance period if the risks the covered person takes harm the covered institution and the covered institution determines the compensation should be reduced before it is awarded.

Forfeiture or downward adjustment must be considered if: (i) deviation from risk parameters causes poor financial performance, (ii) inappropriate risk-taking occurs regardless of the impact on financial performance, (iii) material risk management or other internal controls fail or (iv) non-compliance results in legal or regulatory actions against the covered institution.

In determining the amount of forfeiture or downward adjustment, the Level 1 or Level 2 Institution must consider factors including: (i) (a) the senior executive officer or significant risk-taker's intent to operate outside the approved risk governance framework or other policies and procedures; (b) level of participation in, awareness of, and responsibility for, the events triggering the forfeiture and downward adjustment; and (c) actions, or possible actions, of the officer or risk-taker's part, to prevent the events

triggering the forfeiture and downward adjustment; (ii) the causes (including any decision-making by other individuals) and financial and reputational impact of the events triggering the forfeiture and downward adjustment, including the magnitude of any financial loss and the cost of known or potential subsequent fines, settlements and litigation; and (iii) any other relevant information, including past behavior and past risk outcomes attributable to the officer or risk-taker.

Clawback

A Level 1 or Level 2 institution must, for a period of seven years following the vesting of the incentive-based compensation, be allowed to recover or clawback any compensation that has vested. Circumstances in which a clawback would be appropriate, as determined by the covered institution, include: (i) significant financial or reputational harm caused by the actions of the covered person, (ii) fraud or (iii) intentional misrepresentations.

Other Requirements

The Proposed Rule includes the following additional requirements:

- Incentive-based compensation arrangements cannot be increased during the performance period in excess of 125% of the initial target (in contrast, many existing arrangements provide for up to 200% of the initial target), which must be determined prior to the beginning of the performance period for senior executive officers or 150% of the initial target for significant risk-takers.
- Performance reviews under incentive-based compensation arrangements should not be based solely on industry peer performance comparisons or on transaction or revenue volume, without regard to transaction quality or compliance with sound risk management.
- Institutions may not purchase hedging instruments to offset any changes to incentive-based compensation. As discussed above, the compensation may not be increased more than the prescribed level during the performance period.

Governance and Institutional Requirements

Risk Management and Internal Controls

The Proposed Rule would require all Level 1 and Level 2 institutions to: (i) have a risk management framework for their incentive-based compensation programs that is independent of any lines of business; (ii) include an independent compliance program that provides for internal controls, testing, monitoring and training with written policies and procedures; and (iii) be commensurate with the size and complexity of the covered institution's operations. In addition, Level 1 and Level 2 institutions must:

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- Give individuals in control functions appropriate authority to influence the risk-taking of the business areas they monitor and ensure that covered persons engaged in control functions are compensated independently of the performance of the business areas they monitor; and
 - Provide for independent monitoring of: (i) incentive-based compensation plans to identify whether the plans appropriately balance risk and reward; (ii) events related to forfeiture and downward adjustment and decisions of forfeiture and downward adjustment reviews to determine consistency with the Proposed Rule; and (iii) compliance of the incentive-based compensation program with the institution's policies and procedures.

Board of Directors

The administration of incentive-based compensation arrangements at all covered institutions would also be regulated. The board of directors or a committee thereof would be required to establish and conduct oversight of the covered institution's incentive-based compensation program. Once the board established the program, the senior executive officers would administer the program in accordance with the guidelines established by the board of directors. The board of directors would also be responsible for approving incentive-based compensation arrangements for senior executive officers and any material exceptions to the covered institution's compensation program.

The board of directors for Level 1 and Level 2 institutions would be required to establish an independent compensation committee to create the guidelines of the compensation program in such a way as to limit inappropriate risk. The senior executive officers would be required to submit to the compensation committee, at least annually, a written assessment of the effectiveness of the institution's incentive-based compensation programs and related compliance and control processes. The compensation committee would also be required to obtain an independent written assessment of the institution's incentive-based compensation program and related compliance and control processes from the internal audit or risk management function.

Recordkeeping

The Proposed Rule contains certain recordkeeping requirements for all covered institutions. The records must track the compensation policies and describe how they comply with the Proposed Rule, be created annually and be maintained for seven years and made available to the applicable Agency upon reasonable request. The Agencies would view the records as nonpublic information and they would be kept confidential to the extent permitted by law.

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This memorandum is not intended to provide legal advice and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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