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Dodd-Frank Act Section 956: European-Style Compensation Reforms Coming to a Bank Near You

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Earlier this month, six federal agencies each released a re-proposal of rules (the New Rules) on incentive compensation reforms under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The New Rules from the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Credit Union Administration and the Securities and Exchange Commission (SEC) (collectively, the Agencies) build on rules proposed in 2011, but they go much further. The New Rules proposed by each Agency are largely similar, with differences chiefly related to the entities regulated by the Agencies, though the SEC rules differ with respect to treatment of subsidiaries, as discussed below.

Under Section 956, the Agencies are required to jointly prescribe regulations or guidelines that prohibit incentive-based payment arrangements that, the Agencies determine, encourage inappropriate risks by a covered financial institution (i) by providing an executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits or (ii) that could lead to material financial loss to the institution.

Speeches in October 2014 by Daniel Tarullo, a member of the Board of Governors of the Federal Reserve System, and William Dudley, the president of the Federal Reserve Bank of New York, foreshadowed the release of New Rules.

The New Rules contain a set of general prohibitions regarding incentive-based compensation arrangements and a series of specific requirements concerning the structure of these arrangements. In addition, the New Rules would require that new governance mechanisms and monitoring systems be implemented to ensure compliance. It is possible that the Agencies could propose additional rules in this area, such as addressing the public registration of “bad actors.”

Following is a high-level summary of the New Rules.

Effective Date; Comment Period

The New Rules would require compliance by a covered institution as to its incentive-based compensation plans no later than the beginning of the first calendar quarter that begins at least 540 days after the final rules are published in the Federal Register.

Comments on the New Rules are due by July 22, 2016.

Incentive-Based Compensation

The New Rules would apply to “incentive-based compensation,” meaning any variable compensation, fees or benefits that serve as a reward for performance. Plans and individual agreements or other arrangements providing for such compensation, fees or benefits would be regulated under the New Rules.

A plan or other arrangement where compensation, fees or benefits are awarded solely on account of continued employment would not constitute incentive-based compensation. For example, short- or long-term bonus plans tied to a covered institution’s financial performance or other metrics would generally be governed by the New Rules, while a restricted stock award or restricted stock unit that vests or becomes payable solely if an employee remains employed to a specified future date would be exempt.

Institutions Covered By the New Rules

The rules apply to certain federally regulated entities. Each covered institution is assigned to one of three categories under the rules based on its total consolidated assets, referred to as "levels."

<table>
<tr><th>Type of Institution or Entity</th><th colspan="2">Average Total Consolidated Assets</th></tr>
<tr><td rowspan="3">• Banks and bank holding companies
• Registered broker-dealers
• Investment advisers
• Credit Unions
• Fannie Mae & Freddie Mac
• Certain other domestic operations of foreign entities</td><td>$250 billion or more</td><td>Level 1</td></tr>
<tr><td>$50 billion up to $250 billion</td><td>Level 2</td></tr>
<tr><td>$1 billion up to $50 billion</td><td>Level 3</td></tr>
</table>

In general, subsidiaries that are covered institutions would be subject to the same rules that apply to the parent entity, although each Agency has proposed its own definition of what constitutes a subsidiary. The SEC's proposal would not apply this consolidation principle to covered subsidiaries of covered institutions.

General Prohibitions

Like the 2011 proposal, the New Rules would prohibit covered institutions from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk by providing "covered persons" (generally, anyone who receives incentive-based compensation) with excessive compensation or that could lead to material financial losses.

The New Rules would require that the incentive-based compensation arrangements:

- appropriately balance risk and reward;
- work in the context of risk management and control procedures; and
- be supported by effective governance.

In addition, to be deemed to balance risk and reward, incentive-based compensation arrangements would be required to:

- utilize financial and nonfinancial performance metrics;
- provide that nonfinancial metrics be able to override financial metrics when appropriate; and
- reflect losses, inappropriate risks taken, compliance issues or other financial or nonfinancial performance measures.

Minimum Deferral Requirements for Incentive-Based Compensation

The New Rules would require covered institutions to defer certain percentages of incentive-based compensation awarded to "senior executive officers" (SEOs) and "significant risk takers" (SRTs). These terms are explained below. The extent of the required deferrals would correspond to the size of the covered institution, as indicated in the following table:

Level of Covered Institution	Required Deferrals (Percentage of Incentive-Based Compensation) for SEOs	Required Deferrals (Percentage of Incentive-Based Compensation) for SRTs
Level 1	60%	50%
Level 2	50%	40%
Level 3	Not required	Not required

In addition, the New Rules would require that deferred incentive-based compensation include substantial portions of both deferred cash and equity-like instruments throughout the deferral period.

Minimum Deferral Periods

For Level 1 and Level 2 covered institutions, amounts deferred would be subject to the following minimum deferral periods under the New Rules:

Type of Incentive-Based Compensation	Description	Minimum Deferral Period		Permitted Acceleration
		Level 1	Level 2	
Qualifying incentive-based compensation	Any incentive plan other than a long-term incentive plan	4 years	3 years	• Death or disability • Payment of income taxes due on deferred amounts (only for institutions regulated by National Credit Union Administration)
Long-term incentive plan	Any incentive plan whose performance period is at least 3 years	2 years	1 year	

Annual *pro rata* vesting would be permitted in all cases.

Senior Executive Officers

Under the New Rules, senior executive officers (SEOs) are individuals who (i) receive incentive compensation and (ii) hold the title or perform the functions of one or more of the following positions at a covered institution:

President	Chief Lending Officer
Chief Executive Officer	Chief Risk Officer
Executive Chairman	Chief Compliance Officer
Chief Operating Officer	Chief Audit Executive
Chief Financial Officer	Chief Credit Officer
Chief Investment Officer	Chief Accounting Officer
Chief Legal Officer	Head of Major Business Line or Control Function

Significant Risk Takers

The New Rules also are designed to cover SRTs, meaning individuals who are not SEOs but who still may expose a covered institution to significant losses. Level 1 and Level 2 covered institutions would need to perform the following two separate tests to determine which individuals would be considered SRTs:

Level of Covered Institution	Relative Compensation Test for Determining Who Would Be an SRT	Exposure Test for Determining Who Would be an SRT
Level 1	Step 1: Determine top 5% of highest compensated persons based on base salary and incentive compensation Step 2: Any person identified in Step 1 whose compensation is at least one-third incentive-based would be an SRT	Any person (i) with authority to commit or expose 0.5% or more of covered institution’s capital or total net worth and (ii) whose compensation is at least one-third incentive-based would be an SRT
Level 2	Step 1: Determine top 2% of highest compensated persons based on base salary and incentive compensation Step 2: Any persons identified in Step 1 whose compensation is at least one-third incentive-based would be an SRT	

Downward Adjustment and Forfeiture

The New Rules would require all incentive-based compensation and deferred amounts to be subject to both downward adjustment and forfeiture, as specified in the following table:

<table>
<tr><th>Action as to Incentive-Based Compensation and Deferred Amounts</th><th>When It Occurs</th><th>Triggering Event(s)</th><th>Factors in Determination of Amount Reduced or Forfeited</th></tr>
<tr><td>Downward adjustment</td><td>During performance period</td><td rowspan="2">• Poor financial performance due to deviation from risk guidelines
• Inappropriate risk taking
• Material risk management or control failures
• Statutory, regulatory or supervisory noncompliance that results in legal action by Agencies or financial restatement
• Other poor performance or misconduct</td><td rowspan="2">• Intent of SEO or SRT to operate outside of risk guidelines or covered institution’s policies
• SEO’s or SRT’s level of participation in, awareness of and responsibility
• Actions of SEO or SRT or actions SEO or SRT could have taken
• Financial and reputational harm
• Causes of triggering event
• Any other relevant information, including past behavior of SEO or SRT</td></tr>
<tr><td>Forfeiture</td><td>During deferral period</td></tr>
</table>

Clawbacks

Following the vesting of deferred incentive-based compensation, covered institutions would be required under the New Rules to subject the amounts paid to a seven-year clawback standard. Covered institutions would be required to consider clawing back amounts in the event of:

- misconduct that results in significant financial or reputational harm;
- fraud; or
- intentional misrepresentation of information used to determine amounts paid under an incentive-based compensation arrangement.

Additional Requirements

Maximum Incentive-Based Compensation	• No absolute dollar limitation • Level 1 and Level 2 SEOs maximum payouts capped at 125% of target • Level 1 and Level 2 SRTs maximum payouts capped at 150% of target
Hedging	• Covered institutions prohibited from utilizing hedging products to protect against downward adjustment, forfeiture and clawback
Relative Performance Measures	• Incentive-based compensation arrangements may not be based exclusively on relative performance measures, such as total shareholder return
Volume-Driven Awards	• Incentive-based compensation arrangements based solely on volume, such as number of mortgages originated, would be prohibited

Risk Management, Policies, Recordkeeping and Corporate Governance

The New Rules would require Level 1 and Level 2 covered institutions (and possibly Level 3 covered institutions) to implement risk management control mechanisms that:

- are independent from the lines of business they cover;
- include independent compliance, testing, monitoring and training policies; and
- are commensurate with the size and complexity of the organization.

In addition, Level 1 and Level 2 covered institutions would be required to develop policies and procedures that are consistent with the requirements of the New Rules and that:

- specify the substantive and procedural criteria of forfeiture and clawbacks, including the process for determining the amount of incentive-based compensation to be clawed back.
- require maintenance of final downward adjustment, forfeiture and clawback decisions.
- specify the substantive and procedural criteria for acceleration of deferred amounts.
- identify and describe the role of any employees, committees or groups authorized to make incentive-compensation decisions.
- describe how discretion is expected to be exercised to balance risk and reward.
- require maintenance of documentation of the establishment, implementation, modification and monitoring of incentive-based compensation arrangements.
- describe how incentive-based compensation arrangements are monitored.
- specify the substantive and procedural requirements of the independent compliance program.
- ensure appropriate roles for risk management, risk oversight and other controls.

Under the New Rules, compensation committees of Level 1 and Level 2 covered institutions would have to obtain:

- input from the risk and audit committees of the board of directors (or groups performing such functions) on the effectiveness of risk measures and adjustments used to balance risk and reward in incentive-based compensation arrangements;
- at least annually, written assessments of the effectiveness of the incentive-based compensation programs and related compliance and control processes in providing risk-taking incentives that are consistent with the risk profile of the institution; and
- at least annually, an independent written assessment of the effectiveness of the covered institution's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the institution's risk profile.

Finally, covered institutions would have to create the following records on an annual basis and retain these records for seven years:

- Documentation of the structure of all incentive-based compensation arrangements
- A list of all SEOs and SRTs by job function, organizational hierarchy and line of business
- A list of all incentive-based compensation arrangements for SEOs and SRTs
- The deferral percentages for all SEOs and SRTs
- Downward adjustment / forfeiture / clawback reviews and decisions for SEOs and SRTs
- Any material changes to incentive-based compensation arrangements and policies