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The Re-Proposed Rule on Incentive-Based Compensation at Financial Institutions: Overview and Observations

To date, five of the six federal regulators (the "Agencies") charged with promulgating rules under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") have approved a joint proposed rule (the "2016 Proposal") intended to curb inappropriate risk-taking at covered financial institutions.[1] Section 956 of Dodd-Frank requires the Agencies to issue jointly regulations or guidelines prohibiting at certain financial institutions incentive-based payment arrangements that the Agencies determine encourage inappropriate risks by certain financial institutions (1) through the provision of excessive compensation or (2) that could lead to material financial loss. In addition, Section 956 requires those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate Agency.

The 2016 Proposal's restrictions apply to banks and a broader range of financial institutions, including investment advisers, broker-dealers and credit unions. The 2016 Proposal will be applicable to these and other "covered institutions"[2] with average total consolidated assets of over $1 billion. More prescriptive requirements will apply to those institutions with average total consolidated assets greater than or equal to $50 billion but less than $250 billion, and the most rigorous requirements will apply to those covered institutions with average total consolidated assets of $250 billion or more. The 2016 Proposal refers to these larger institutions as Level 2 and Level 1 covered institutions, respectively.

1 The Agencies that have approved the 2016 Proposal are the (1) National Credit Union Administration ("NCUA"), (2) Office of the Comptroller of the Currency ("OCC"), (3) Federal Deposit Insurance Corporation ("FDIC"), (4) Federal Housing Financing Agency ("FHFA") and (5) the Board of Governors of the Federal Reserve System ("Board"). The remaining Agency is the Securities and Exchange Commission ("SEC"). The 2016 Proposal will be published in the Federal Register once all the Agencies have formally granted their approval.
The NCUA's draft of the 2016 Proposal can be found at: https://www.ncua.gov/About/Documents/Agenda%20Items/AG20160421Item2b.pdf.
The OCC's draft of the 2016 Proposal can be found at: http://www.occ.gov/news-issuances/news-releases/2016/nr-occ-2016-49a.pdf.
The FDIC's draft of the 2016 Proposal can be found at: https://www.fdic.gov/news/board/2016/2016-04-26_notice_dis_a_fr.pdf.
The FHFA draft of the 2016 Proposal can be found at: https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/Incentive-Based%20Compensation%20NPR_4-26-16.pdf.
The Board's draft of the 2016 Proposal can be found at: http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160502a2.pdf.
The Agencies have stated that published versions of the 2016 Proposal might differ from the approved drafts.

2 Each Agency will have its own definition of "covered institution" that describes the covered financial institutions that the Agency regulates. A list of covered institutions categorized by applicable Agency is attached as Appendix A.

The 2016 Proposal replaces a proposed rule that had been published by the Agencies in 2011 (the "2011 Proposal") and which generated over 10,000 comments. In the interim, the Agencies have been actively reviewing the incentive-based compensation practices in the financial services industry and providing supervisory guidance on how financial institutions can ensure incentive-based compensation arrangements do not encourage imprudent or undue risk-taking.[3] Resulting from this supervisory review is a proposed rule that incorporates many of the practices already implemented at large financial institutions but, in certain areas, imposes stricter requirements than what is commonplace. Other financial services institutions may find that implementation of the 2016 Proposal will require significant changes to both their incentive–based compensation programs and their risk governance processes.

Overall, the 2016 Proposal evidences the Agencies' effort to provide flexibility to the covered institutions in developing their incentive-based compensation programs while instituting certain bright-line requirements. In line with this approach, the 2016 Proposal places front line responsibility with the boards of directors and their committees, as well as with management of the covered institution, for implementation of the rule and its principles, while requiring more clearly delineated and documented procedures in each step of the decision-making process to allow Agency oversight and audit. Consistent with the trend both domestically and internationally, the 2016 Proposal imposes increased oversight and governance responsibilities on boards, their committees and management, which will require, in many cases, a rethinking of their organizational structures and procedures.

Compliance with the 2016 Proposal will be required no later than the beginning of the first calendar quarter that begins 540 days after a final rule is published in the Federal Register, but the rule, as proposed, would not apply to any incentive-based compensation plan with a performance period that began prior to that date. Comments on the 2016 Proposal must be received by the appropriate Agency by July 22, 2016.

This publication highlights significant provisions of the 2016 Proposal and some of the challenges covered institutions may face when designing an incentive-based compensation program that balances the rule's focus on safety and soundness with the desires of shareholders to see pay for performance.

3 For example, beginning in 2009, the Board, OCC and FDIC participated in "horizontal reviews" of incentive-based compensation arrangements at large banking organizations and, in 2010, promulgated "Guidance on Sound Incentive Compensation Policies" (the "2010 Guidance").

Highlights and Observations

- Requires all incentive-based compensation payable to a "senior executive officer" or "significant-risk taker" at a Level 1 or Level 2 covered institution to be subject to a 7-year clawback requirement.
- Requires a substantial portion of incentive-based compensation payable to a "senior executive officer" or "significant-risk taker" at a Level 1 or Level 2 covered institution to be deferred and subject to the risk of forfeiture (up to 60% for "senior executive officers" at Level 1 covered institutions and 50% at Level 2 covered institutions, and up to 50% for "significant risk-takers" at Level 1 covered institutions and 40% at Level 2 covered institutions).
  - Awards that vest solely on the basis of continued employment are not considered incentive-based compensation.
- Expands the group of executives considered "senior executive officers" under the rule.
- Prohibits Level 1 and Level 2 covered institutions from accelerating the incentive-based compensation that is required to be deferred, other than in the event of death or disability.
  - Although Level 1 and Level 2 covered institutions may waive continued service requirements when negotiating a separation from service, they may not shorten the deferral period.
- Limits the amount of incentive-based compensation payable to "senior executive officers" and "significant risk-takers" at Level 1 and Level 2 covered institutions for the attainment of performance measures in excess of target measures (to 125% and 150% of target for "senior executive officers" and "significant risk-takers," respectively).
- Requires Level 1 and Level 2 covered institutions to implement an independent risk-monitoring framework.
- Imposes new governance requirements on boards of directors, including requiring the board of directors (or a board committee) to approve all incentive-based compensation payable to "senior executive officers" and to maintain records documenting guidelines for the utilization of discretion in implementing incentive-based compensation-related decisions.
- Replaces the proposed annual reporting requirements of the 2011 Proposal with a 7-year recordkeeping requirement.

Key Terms

Incentive-based Compensation[4]

"Incentive-based compensation" is any variable compensation, fees or benefits that serves as an incentive or reward for performance. Compensation, fees or benefits that are awarded solely for, and the payment of which is solely tied to, continued employment would not be incentive-based compensation.[5]

Level 1 and Level 2 Covered Institutions

As stated above, each covered institution will be placed into one of three categories—or Levels—based on its average total consolidated assets:[6]

- Level 1 covered institutions are those with average total assets of $250 billion or more;
- Level 2 covered institutions are those with average total assets of at least $50 billion and less than $250 billion;[7] and
- Level 3 covered institutions are those with average total assets of at least $1 billion but less than $50 billion.

The 2016 Proposal includes more prescriptive requirements for Level 1 covered institutions and Level 2 covered institutions.[8] These additional requirements are discussed throughout this publication.

Further, to the extent a subsidiary of a covered institution is also a covered institution (including the requirement to have $1 billion in assets), the subsidiary will be defined to be at the same level as the parent, regardless of the size

[4] The 2016 Proposal also contains certain related definitions. An incentive-based compensation plan is a document setting forth the terms and conditions governing the opportunity for and the payment of incentive-based compensation payments to one or more covered persons. An incentive-based compensation arrangement is an agreement between a covered institution and a covered person, under which the covered institution provides incentive-based compensation to the covered person, including incentive-based compensation delivered through one or more incentive-based compensation plans. An incentive-based compensation program is a covered institution's framework for incentive-based compensation that governs incentive-based compensation practices and establishes related controls. A covered institution's incentive-based compensation program would include all of the covered institution's incentive-based compensation arrangements and incentive-based compensation plans.

[5] Examples of this type of compensation, fees or benefits would include so-called "time-based" restricted stock or restricted stock units which vest solely on the basis of continued employment.

[6] Average total consolidated assets means, for institutions other than investment advisors, the average of a regulated institution's total consolidated assets, as reported on the regulated institution's regulatory reports, for the four most recent consecutive quarters. For investment advisors, average total consolidated assets would be determined by the investment advisor's total assets (exclusive of non-proprietary assets) shown on the balance sheet for the advisor's most recent fiscal year end.

[7] Under the FHFA's draft of the 2016 Proposal, a Federal Home Loan Bank would always be a Level 2 covered institution (so long as it had assets of at least $1 billion).

[8] Each Agency may require a Level 3 covered institution with an average total consolidated assets of at least $10 billion to adhere to some or all of the provisions applicable to Level 1 and Level 2 covered institutions depending on the activities, complexity of operations, risk profile and compensation practices of the Level 3 covered institution (or any other relevant factors).

of the subsidiary.[9] These subsidiaries, however, would be in compliance with the rule if the parent organization complies in such a way that causes the subsidiary to comply with the requirements.

Senior Executive Officers and Significant Risk-Takers

A number of the additional requirements apply to two subgroups of covered persons, [10] "senior executive officers" and "significant risk-takers."

- Senior Executive Officer. A senior executive officer is a covered person who holds the title or, without regards to title, salary or compensation, performs the function of one or more of the following positions for any period of time during the relevant performance period: (1) president, (2) chief executive officer, (3) executive chairman, (4) chief operating officer, (5) chief financial officer, (6) chief investment officer, (7) chief legal officer, (8) chief lending officer, (9) chief risk officer, (10) chief compliance officer, (11) chief audit executive, (12) chief credit officer, (13) chief accounting officer or (14) head of a major business line or control function.
- Significant Risk-Taker. A significant risk-taker is any covered person at a Level 1 or Level 2 covered institution who (1) received incentive-based compensation equal to at least 1/3 of the annual base salary and incentive-based compensation received and (2) satisfies either the "relative compensation test" or the "exposure test." For purposes of the 1/3 test, compensation is taken into account if it was received during the calendar year that ended 180 days before the beginning of the performance period for which the significant risk-takers are being identified.[11]
  - Relative Compensation Test. For Level 1 covered institutions, a covered employee is a significant risk-taker if the individual is among the highest five-percent of all covered persons (excluding senior executive officers) in annual base salary actually paid and incentive-based compensation of the Level 1 covered institution.[12] For Level 2 covered institutions, the covered person must be among the highest two-percent.[13] As is the case with the 1/3 test, this determination is made on the basis of the

9 This provision would not apply to covered institutions regulated by the SEC unless the parent is a depository institution holding company. In addition, for the US operations of a foreign banking organization, the level would be determined by the total consolidated US assets of the foreign banking organization (including any of its branches and agencies, as well as its subsidiaries or operations held pursuant to Section 2(h)(2) of the Bank Holding Company Act). The level of an OCC-regulated federal branch or agency of a foreign bank would be determined with reference to the assets of the federal branch or agency.

10 A "covered person" is broadly defined to include any executive officer, employee, director or principal shareholder that receives incentive-based compensation.

11 For purposes of the 1/3 test and the relative compensation test, incentive-based compensation will be counted to the extent it was awarded for a performance period that ended during that calendar year, regardless of when the performance period began.

12 The OCC, Board, FDIC and SEC would also include any "Section 956 affiliates" of the covered institution that are also covered institutions. Each Agency will have its own definition of "Section 956 affiliate."

13 With respect to Level 1 covered institutions, each Agency may substitute 2% for 5% if it determines that the covered institution's activities, complexity of operations, risk profile and compensation practices are similar to a Level 2 covered institution.

compensation that was paid during the calendar year that ended 180 days before the beginning of the performance period for which the significant risk-takers are being identified.

- Exposure Test. A covered person would be a significant risk-taker with regard to a Level 1 or Level 2 covered institution if the individual was able to commit or expose 0.5% or more of the capital of the covered institution, or in the case of the OCC, the Board, the FDIC and the SEC, any “Section 956” affiliate of the covered institution (regardless of whether the individual is employed by that affiliate), during the same calendar year used to determine whether the covered person meets the 1/3 test. An individual is considered to be in the position to commit or expose capital if the individual has the right to put the capital at risk of loss due to market or credit risk.

Preventing Inappropriate Risk

Pursuant to the 2016 Proposal, all covered institutions would be prohibited from establishing or maintaining an incentive-based compensation arrangement that encourages inappropriate risk. An incentive-based compensation arrangement that encourages inappropriate risks is one which (1) provides a “covered person” with excessive compensation, fees or benefits or (2) could lead to a material financial loss to the covered institution.

Although, as discussed below, more prescriptive requirements apply to Level 1 and Level 2 covered institutions, the general requirements of the 2016 Proposal do not establish a rigid test to determine whether a particular arrangement provides excessive compensation or could lead to a material financial loss. The 2016 Proposal does, however, provide standards for a covered institution to determine if its incentive-based compensation arrangements provide excessive compensation. In addition, the 2016 Proposal provides minimum requirements that must be met before a covered institution can determine that an arrangement does not encourage inappropriate risks that could lead to a material financial loss.[14]

The rule expands on the concepts of excessive compensation and material financial loss, as follows:

- Excessive Compensation. Compensation is excessive when the amounts paid are unreasonable or disproportionate to the value of services performed by a covered person, taking into account all relevant factors, including: (1) the combined value of all compensation (including benefits) provided to the covered person; (2) the covered person’s compensation history and the compensation history of individuals with comparable expertise at the covered institution; (3) the financial condition of the covered institution; (4) the compensation practices at comparable institutions; (5) the projected total cost of post-employment benefits; and (6) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse.

[14] Section 956 of Dodd-Frank provides that the Agencies must ensure that the standards for evaluating incentive-based compensation arrangements are comparable to the standards established under Section 39 of the Federal Deposit Insurance Act (12 USC 1831p-1(c)). The excessive compensation standards in the 2016 Proposal mirror the standards under for excessive compensation provided for in Section 39. Section 39, however, does not provide minimum requirements for determining if an arrangement could lead to material loss. Therefore, the Agencies drew from the principles contained in the 2010 Guidance, as well as other relevant materials from groups such as the Financial Stability Board, in addressing the use of arrangements that could lead to a material financial loss.

- Material Financial Loss. An incentive-based compensation arrangement will be deemed to encourage inappropriate risks that could lead to a material financial loss unless it (1) appropriately balances risk and reward, (2) is compatible with effective risk management and controls and (3) is supported by effective governance.

As a result of the excessive compensation provision, incentive-based compensation arrangements may violate Section 956 of Dodd-Frank and the 2016 Proposal solely on the basis of the amount of the arrangement within the context of the relevant factors, regardless of whether the arrangement does in fact encourage inappropriate risk-taking. The 2016 Proposal does not prescribe a dollar limitation on bonuses or a bright-line bonus cap, but instead employs a principles-based approach applicable to all employees.

The second prong of the 2016 Proposal, which focuses on preventing material financial loss, is addressed in detail by establishing three requirements necessary to avoid having an incentive-based compensation arrangement that is viewed as encouraging inappropriate risk that could lead to a material financial loss. Each requirement is discussed below under its own heading, including the general principles applicable to all covered institutions, and the additional measures that Level 1 and Level 2 covered institutions must employ in order to be in compliance.

Preventing Material Financial Loss: Balancing Risk and Reward

In General

A major concern of the Agencies is that performance measures in incentive-based compensation arrangements that are closely tied to short-term revenue or profit generated by a business would fail to take into account the longer-term risks associated with the business generated. Therefore, the Agencies provide that an incentive-based compensation arrangement will appropriately balance risk and reward only when the amount of the compensation received by the covered person depends on both the attainment of performance measures and on the risk taken in achieving this performance. With respect to risk, the incentive-based compensation arrangement would have to take into account the full range of current and potential risks that a covered person's activities could pose for a covered institution.[15]

In their 2010 Guidance, the banking Agencies offered four methods that banks could utilize to make compensation more sensitive to risk: (1) risk adjustments of awards, (2) deferral of payment, (3) longer performance periods and (4) reduced sensitivity to short-term performance. These methods are reflected in the following requirements of the 2016 Proposal.

Performance Measures

In order to ensure a proper balance of risk and reward, the 2016 Proposal includes specific requirements related to performance measures that are applicable to all covered institutions, and additional requirements for Level 1 and Level 2 covered institutions. For all covered institutions, the incentive-based compensation arrangement would not be considered to appropriately balance risk and rewards unless: (1) the arrangement includes financial and non-financial measures of performance that are relevant to a covered person's role and to the type of business in which

[15] These risks include credit, market (including interest rate and price), liquidity, operational, legal, strategic and compliance risks.

the covered person is engaged, and that are appropriately weighted to reflect risk-taking, (2) it allows non-financial measures of performance to override financial measures when appropriate and (3) it subjects any amounts to be awarded to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and non-financial performance.

The Agencies recognize that although quantitative measures of risk outcomes are useful, they will not necessarily be sufficient to fully measure a covered person's risk-taking. Therefore, qualitative measures, such as risk management, as well as compliance with risk and control standards, should form a part of the performance assessment process. Further, financial institutions will likely find it necessary to exercise discretion in determining whether or not to adjust incentive-based compensation amounts that might otherwise be paid. While the Agencies underscore the important role that the exercise of discretion can play in implementing the 2016 Proposal's principles, they are also concerned that the exercise of discretion could serve to undermine the goals of risk mitigation. As a result, Level 1 and Level 2 covered institutions will be required to describe in their policies and procedures the manner in which discretion in this and other related areas will be exercised.

In addition to these general guidelines on performance measures in incentive-based compensation arrangements, there are specific prohibitions for Level 1 and Level 2 covered institutions:

- Level 1 and Level 2 covered institutions may not award incentive-based compensation for the attainment of performance measures that exceed target measures (1) in excess of 125% of the target amount for senior executive officers and (2) in excess of 150% for significant risk-takers.
- Level 1 and Level 2 covered institutions may not use incentive-based compensation performance measures that are based solely on industry peer group comparisons.
- Level 1 and Level 2 covered institutions may not provide incentive-based compensation to a covered person that is based solely on transaction revenue or volume without regard to transaction quality or compliance by the covered person with risk management.
- Level 1 and Level 2 covered institutions may not purchase a hedging or similar instrument on behalf of a covered person to hedge or offset any decrease in the value of incentive-based compensation.

These rules reflect many of the current practices generally followed by major banking institutions. Discretion to reduce amounts that might otherwise be paid under an incentive program is a common design element in programs of many financial services firms, although policies describing the guidelines used in exercising discretion may not be as prevalent. Similarly, caps on amounts paid for attainment of maximum goals for incentive-based compensation are not an uncommon design feature, and the federal regulators have been overseeing firms' goal setting and the appropriateness of the maximum payments given the risk profile of a firm. It is notable that performance measures based solely on comparisons to industry peers, such as relative total shareholder return, are prohibited by the rule as the Agencies feel that these metrics, by themselves, can encourage inappropriate risk-taking as a means to perform better than peers, and can reward employees even if performance is poor on an absolute level.

Downward Adjustments, Deferral, Forfeiture and Clawbacks

Because the consequences of imprudent risk-taking are often discovered only with the benefit of hindsight, the 2016 Proposal requires each Level 1 and Level 2 covered institution: (1) to retain the discretion to make downward adjustments during the performance period in the amount of incentive-based compensation payments that may be awarded for that performance period,[16] (2) to defer the vesting[17] of a significant portion of a senior executive officer's or significant risk-taker's incentive-based compensation and to subject all of their incentive-based compensation to the possibility of forfeiture for a stated period following the end of the performance period (the "deferral period") and (3) to retain the ability to clawback incentive-based compensation for a seven-year period following vesting, regardless of whether vesting occurred at the end of the performance period or a deferral period (the "clawback period"). As a result, the 2016 Proposal seeks to ensure that incentive-based compensation can be reduced at every stage, from its determination through and after vesting, in order to provide for the accountability of senior executive officers and significant risk-takers for the effect of events that may only be discovered in the long-term.

Downward Adjustment

All incentive-based compensation at Level 1 and Level 2 covered institutions must be at risk of downward adjustment. A "downward adjustment" is the reduction of the amount of incentive-based compensation not yet awarded for a performance period still in progress.[18] To the extent an event is discovered that warrants a downward adjustment of incentive-based compensation, the covered institution would be required to consider all available incentive-based compensation, even if the incentive-based compensation does not specifically relate to the performance in the period in which the relevant event occurred. Events that might trigger a downward adjustment, and the process under which the covered institution determines whether to apply a downward adjustment, are discussed below, under "Downward Adjustment and Forfeiture Reviews."

Deferral

The deferral period, as well as the amount of incentive-based compensation that must be deferred, depends on the Level of the covered institution, whether the individual is a senior executive officer or significant risk-taker and whether the incentive-based compensation is "qualifying incentive-based compensation" or is compensation that was granted under a long-term compensation plan.[19] The following chart describes the differences:

16 The performance period is the period during which the performance of a covered person is assessed for purposes of determining incentive-based compensation.

17 Vesting is defined as the transfer of ownership of the incentive-based compensation to the covered person, such that the covered person's right to the incentive-based compensation is no longer contingent on the occurrence of an event.

18 A reduction in the value of equity-like instruments due to market fluctuations would not be considered a reduction.

19 Incentive-based compensation is granted under a long-term incentive plan if it is based on a performance period of at least 3 years. All other incentive-based compensation is "qualifying incentive-based compensation."

Deferral Requirements

	Level 1 Covered Institutions				Level 2 Covered Institutions			
	Senior Executive Officers		Significant Risk-Takers		Senior Executive Officers		Significant Risk-Takers	
	Deferral Amount	Deferral Period	Deferral Amount	Deferral Period	Deferral Amount	Deferral Period	Deferral Amount	Deferral Period
Qualifying Incentive-Based Compensation (performance period of less than 3 years)	60%	4 Years	50%	4 Years	50%	3 Years	40%	3 Years
Long-Term Incentive-Based Compensation (performance period of at least 3 years)	60%	2 Years	50%	2 Years	50%	1 Year	40%	1 Year

The percentage of incentive-based compensation to be deferred is based on the present value of the incentive-based compensation awarded at the end of the performance period, determined as of the end of the performance period.[20] With respect to qualifying incentive-based compensation, the covered institution would aggregate all incentive-based compensation payable under any incentive-based compensation plan that is not a long-term incentive plan. The minimum deferral amount of compensation payable under long-term incentive plans, however, is computed on a plan by plan basis.

The 2016 Proposal also sets forth specific requirements for the composition of the deferred amounts. To the extent a covered institution issues equity in its incentive-based compensation arrangements or has an affiliate that issues equity, the deferred incentive-based compensation must include substantial portions of both deferred cash and equity-like instruments.[21] In addition, to the extent options are used to satisfy the minimum deferral requirements, the total amount of options utilized may not be more than 15% of the total incentive-based compensation awarded for that performance period. For this purpose, long-term incentive-based compensation and qualifying incentive-based compensation are aggregated.

The fact that the 2016 Proposal mandates that the deferral percentage requirements be met by qualifying incentive-based compensation in the aggregate and, separately, by long-term based compensation on a plan-by-plan basis,

[20] In order to value awards, the 2016 Proposal states that Level 1 and Level 2 covered institutions should use reasonable valuation methods consistent with methods used in other contexts. Examples include Topic 718 of the FASB Accounting Standards Codification and, for purposes of valuing options, the Black-Scholes method.

[21] An equity-like instrument is any form of payment in which the final value is linked to the price of the institution's equity, even if the compensation settles in cash. The concept of "substantial portion" is not defined in the 2016 Proposal.

may require many banks to analyze the deferred proportion of their incentive-based compensation differently than they have in the past. The fact that incentive-based awards that vest solely on the basis of continued employment would not be included in the determination of the deferred percentage at all under the 2016 Proposal may also affect the analysis.

In addition, the following additional requirements apply to deferred incentive-based compensation:

- Pro Rata Vesting. All deferred incentive-based compensation may not vest faster than on a pro rata annual basis beginning no earlier than the first anniversary of the end of the performance period. For example, if a Level 1 covered institution decides to vest qualified incentive-based compensation in even amounts over 4 years, the first 25% would only be required to be deferred for one year, while only the final 25% would be deferred for four years.
- Acceleration of Vesting. The rule prohibits the acceleration of incentive-based compensation required to be deferred, other than in the event of death or disability.[22]
- Adjustments. Deferred incentive-based compensation may not be increased during the deferral period. An increase in value attributable to a change in share value, a change in interest rates or the payment of interest pursuant to the terms of the award will not be considered an increase in incentive-based compensation.

A noteworthy effect of the 2016 Proposal will be its impact on employees' separations from service at Level 1 and Level 2 covered institutions. Although Level 1 and Level 2 covered institutions may waive continued service requirements upon a termination of employment, the full vesting and immediate payment of all incentive-based compensation awards will no longer be a tool in exit negotiations, as the required deferral period may not be shortened. Importantly, a retiring employee who vests because he or she meets a "full service" requirement or accepts government employment will still have a portion of his or her incentive-based compensation subject to a risk of forfeiture if that portion is required to be deferred under the 2016 Proposal.[23]

Forfeitures

All incentive-based compensation at Level 1 and Level 2 covered institutions must be at risk of forfeiture. "Forfeiture" is the reduction of unvested deferred compensation. To the extent an event is discovered that warrants a forfeiture of incentive-based compensation, the covered institution would be required to consider all available incentive-based compensation, even if the incentive-based compensation does not specifically relate to the performance in the period in which the relevant event occurred. Events that might trigger forfeiture, and the discretion afforded the covered institution as to whether to require forfeiture are discussed below, under "Downward Adjustment and Forfeiture Reviews."

Downward Adjustment and Forfeiture Reviews

A Level 1 or Level 2 covered institution that discovers one of the triggering events listed below must undertake a downward adjustment and forfeiture review to determine whether a downward adjustment or forfeiture is warranted,

[22] Acceleration is also permitted for covered persons of credit unions if the person is subject to an income tax liability on the deferred amount.

[23] The Agencies also determined not to permit acceleration when a covered employee accepts government employment.

and in what amount. In the preamble to the 2016 Proposal, the Agencies state that the best practice would be to tie the downward adjustment and forfeiture review to broader risk reviews, and require all Level 1 and Level 2 covered institution to describe their processes in their policies and procedures, and to document any actual reviews and decisions as part of their recordkeeping and disclosure responsibilities (as discussed below). Further, covered institutions should provide their independent compensation committee with a report of any decisions related to downward adjustments, forfeitures or clawbacks as part of the annual reports the committee receives from management and the institution's risk management function.[24]

The following is the rule's non-inclusive list of events that will trigger a downward adjustment or forfeiture review:

- Poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered institution's policies and procedures;
- Inappropriate risk-taking, regardless of the impact on financial performance;
- Material risk management or control failures;
- Non-compliance with standards that results in legal action or enforcement by a federal or state regulator or agency or a restatement of financial statements to correct a material error; and
- Any other aspects of conduct or poor performance defined by the covered institution.

Further, in the case of a senior executive officer or significant risk-taker who was not directly responsible for a triggering event, but whose failure or poor performance with respect to his responsibilities contributed to, or failed to prevent, the event, that individual's incentive-based compensation must also be subject to a review.

Upon deciding that this downward adjustment or forfeiture review should be undertaken, the rule provides that the Level 1 or Level 2 covered institution must consider, at a minimum, the following factors in determining whether to adjust amounts and to what extent:

- The intent of the individual to operate outside the risk framework or to depart from the covered institution's policies and procedures;
- The individual's level of participation in, awareness of and responsibility for, the events triggering the forfeiture and downward adjustment review;
- Any action the individual took, or could have taken, to prevent the events triggering the review;
- The financial and reputational impact of the events triggering the forfeiture and downward adjustment review (including the costs of any actual or potential fines, settlements or litigation);
- The causes of the events triggering the review, including any decision-making by other individuals; and

[24] As discussed below under "Effective Governance," the independent compensation committee is also responsible for approving, or assisting the board of directors in approving, the actual payments to senior executive officers (which is a broader group of officers than those whose compensation is commonly approved by most boards of directors and compensation committees).

- Any other relevant information, including past behavior and past risk outcomes attributable to the individual.

In evaluating the possible implementation of downward adjustments or forfeitures, the rule relies upon the documented judgment of the board, the compensation committee or management, as the case may be, in evaluating the facts involved and their relative materiality.

Clawbacks

Unlike the 2011 Proposal, the 2016 Proposal requires Level 1 and Level 2 covered institutions to include clawback provisions in incentive-based compensation arrangements for senior executive officers and significant risk-takers that would allow for recovery of up to 100% of vested incentive-based compensation for seven years following the date of vesting.[25] Unlike the clawback in Section 951 of Dodd-Frank,[26] and the clawback in Section 304 of the Sarbanes-Oxley Act of 2002, both of which focus on material financial restatements, the rule's clawback provision can be triggered due to the following acts by a senior executive officer or a significant risk-taker, regardless of whether the act or acts took place during the clawback period:

- Misconduct that resulted in significant financial or reputational harm to the covered institution;
- Fraud; or
- Intentional misrepresentation of information used to determine the individual's incentive-based compensation.

The 2016 Proposal does not require that Level 1 or Level 2 covered institutions exercise their clawback provisions, allowing firms to use discretion in its implementation, or that they adhere to any specific process to recover vested incentive-based compensation. Each covered institution is required to review the facts and circumstances to determine whether to exercise its discretion to clawback incentive-based compensation and to document the process and its result.

Notably, the rule's seven-year post-vesting clawback period is a longer period than any imposed under current federal law or regulations.

Preventing Material Financial Loss: Risk Management and Controls

The 2016 Proposal considers any incentive-based compensation arrangement that is not compatible with effective risk management and control to be an arrangement that encourages inappropriate risks that could lead to a material financial loss. Therefore, each covered institution would be required to have appropriate controls governing the design, implementation and monitoring of incentive-based compensation. The extent and formalities of these

[25] The seven-year period starts after the vesting date of each pro rata portion of incentive-based compensation subject to deferral. By way of example, if qualifying incentive-based compensation were awarded to a senior executive officer or significant risk-taker at a Level 1 covered institution subject to a four-year pro-rated vesting schedule, the last tranche which vests on the fourth anniversary of the end of the performance period would not be free of potential recoupment until 11 years after the end of the performance period.

[26] For a discussion of the clawback requirements of Section 951 of Dodd-Frank, please see our client memo "SEC Proposed Highly Anticipated Clawback Rules," available at: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2015/07/SEC-Proposes-Highly-Anticipated-Clawback-Rules-ECEB-070915.pdf.

controls will vary depending on the size and complexity of the covered institution but must be capable of ensuring risk is managed in a manner that properly balances it with reward.

A Level 1 or Level 2 covered institution, however, must meet specific requirements in order to be in compliance with the 2016 Proposal. These requirements are as follows:

- Risk Management Framework. Incentive-based compensation programs must be designed within a risk management framework that (1) is independent of any lines of business and (2) includes an independent compliance program providing for internal controls, testing, monitoring and training with written policies and procedures. The Agencies state that these frameworks would include processes and systems for identifying and reporting deficiencies and establishing managerial responsibility. The framework should also be provided with sufficient stature within the institution, authority, resources and access to the board of directors.
- Appropriate Authority. Individuals engaged in control functions must have the authority to influence the risk-taking of the business areas they monitor and must be compensated in accordance with the achievement of performance objectives linked to their control functions (independent of the performance of the business area).
- Independent Monitoring. Level 1 and Level 2 covered institutions must provide for independent monitoring of (1) all incentive-based compensation plans in order to ensure the incentives do not encourage imprudent risk-taking, (2) events related to downward adjustment and forfeiture reviews and (3) compliance with the institution's policies and procedures. The frequency of these reviews will vary depending on the institution.

These rules reflect many of the principles already contained in the 2010 Guidance and the Board's final rule implementing Section 165 of Dodd-Frank[27] emphasizing the independence of the risk management function and its obligations to report to a firm's board of directors or a committee of the board. Unlike Section 165, however, the 2016 Proposal makes explicit that control functions include not only compliance, risk management and internal audit, but also legal, human resources, accounting, financial reporting and finance roles responsible for identifying, measuring, monitoring or controlling risk-taking. The 2016 Proposal specifies that the heads of control functions should also be considered senior executive officers but, like the rule implementing Section 165 of Dodd-Frank, the 2016 Proposal does not prescribe ways in which incentive-based compensation of persons in risk management and control functions should differ in design from that of other senior executive officers, other than to say that their incentives should not be tied to the financial performance of the business they monitor.

Preventing Material Financial Loss: Effective Governance

Although management retains the responsibility for designing and monitoring a covered institution's incentive-based compensation program, the 2016 Proposal charges the board of directors (or a committee thereof)[28] with the responsibility to conduct oversight of the program. This oversight will require communicating the overall goals and

[27] 12 CFR Part 252. This rule provides for enhanced prudential standards for certain bank holding companies and US operations of foreign banking organizations.

[28] For a foreign banking organization, "board of directors" refers to the relevant oversight body for the firm's US branch, agency or operations, consistent with the foreign banking organization's overall corporate and management structure.

purposes of the program to senior management with enough detail so that the senior managers can create a program with objectives, plans and arrangements for each line of business. The board or committee will be expected to actively engage with senior management, to challenge the managers' recommendations and assessments and to hold management accountable for executing the incentive-based compensation program.

In addition, as a means of holding senior management responsible for the covered institution's risk posture, the board or committee must approve all incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, the actual payout. Further, the board or committee must approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

In addition, Level 1 and Level 2 covered institutions must establish a compensation committee composed solely of directors who are not senior executive officers to assist the board in carrying out its responsibilities.[29] This committee must receive the following input from various parties that will enable it to assess whether the institution's risk measures and adjustments are adequately balancing risk and reward:

- Input from the risk and audit committee or groups performing similar functions, and the covered institution's risk management function, on the effectiveness of the risk measures and adjustments being utilized;
- A written assessment from management, at least annually, of the effectiveness of the incentive-based compensation program and related compliance and control processes in properly balancing risk with reward; and
- A written assessment from the internal audit or risk management function of the institution, at least annually, of the effectiveness of the incentive-based compensation program and related compliance and control processes in properly balancing risk with reward.

The 2016 Proposal does not appear to task the board of directors or a committee of the board with direct responsibilities for approving incentive-based compensation arrangements or awards for significant-risk takers, apart from its obligation to review the aforementioned reports and assessments of the effectiveness of programs in balancing risk with reward.

Disclosure and Recordkeeping

All covered institutions must create annually, and maintain for a period of at least 7 years, records that document the structure of all of its incentive-based compensation arrangements and demonstrate compliance with the 2016 Proposal.[30] These records must be disclosed to the relevant Agency upon request. The records must include (at a minimum), (1) copies of all incentive-based compensation plans, (2) a record of who is subject to each plan and (3)

[29] Many compensation committees will already satisfy this independence requirement as a result of the listing standards of the various stock exchanges of which they are members.

[30] This requirement replaces the provision in the 2011 Proposal that required each covered institution to submit an annual narrative report to its respective Agency.

a description of how the incentive-based compensation program is compatible with effective risk management and controls. Covered institutions will not, however, be required to report the actual amount of compensation of any covered person.

In addition, the 2016 Proposal prescribes additional recordkeeping requirements for Level 1 and Level 2 covered institutions. These records must document: (1) the covered institution's senior executive officers and significant risk-takers, listed by legal entity, job function, organizational hierarchy and line of business; (2) the incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on percentage of incentive-based compensation deferred and form of award; (3) any downward adjustment, forfeiture or clawback reviews and decisions for senior executive offices and significant risk-takers; and (4) any material changes to the covered institution's incentive-based compensation arrangements and policies. Further, all records of Level 1 and Level 2 covered institutions, including their policies and procedures (the requirements of which are described on Appendix B), must be maintained for seven years and in a manner that allows for independent audit of incentive-based compensation arrangements.

Enforcement

Section 956 of Dodd-Frank provides that it will be enforced under Section 505 of the Gramm-Leach-Bliley Act (the "GLB Act"), with a violation of Section 956 being treated as a violation of the privacy protection provisions of the GLB Act (Title V, Subtitle A).

Under Section 505 of the GLB Act, the OCC, the FDIC, the Board, the NCUA and the SEC will enforce the provisions of the GLB Act with respect to the covered institutions subject to their respective jurisdictions. For the FHFA, the final rule would be enforced under subtitle C of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. Consequences of enforcement by the Agencies include the issuance of civil monetary penalties, injunctions and cease and desist orders, removal or suspension of individual officers or directors from office, temporary or permanent termination of depository insurance or registration status, as applicable, and potential criminal penalties against the financial institution and other persons.

Applicability and Effective Date

A covered institution will be required to meet the requirements of the rule no later than the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register. As a result, the 2016 Proposal provides covered institutions with a relatively long period before its implementation, and initial compliance will not be until 2018, at the earliest (although federal regulators have been, and will likely continue to, apply similar rules and principles to financial firms through their supervisory authority). Whether a covered institution is a Level 1, Level 2 or Level 3 covered institution on the compliance date would be determined based on the average total consolidated assets as of the beginning of the first calendar quarter that begins after a final rule is published in the Federal Register.

The above timeline is consistent with the 2016 Proposal's requirement that a covered institution that moves to a higher level (i.e., Level 2 to Level 1) due to an increase in average total consolidated assets does not have to begin complying with the requirements applicable to that level for another 18 months. There is no transition period, however, when a covered institution moves to a lower level. A covered institution moves to a lower level when the total consolidated assets of the covered institution falls below the relevant threshold for each of four consecutive quarters.

The 2016 Proposal provides for the grandfathering of incentive-based compensation plans with performance periods that began before the covered institution became a Level 1, 2 or 3 covered institution. Covered institutions would only be required to comply with the rule's requirements that applied to the covered institution at the beginning of the performance period.

Conclusion

Because many of the 2016 Proposal's requirements are the result of the banking Agencies' review of the practices already implemented at many financial institutions and the evolution of those practices under the Agencies' supervision since the financial crisis, the rule will not require wholesale changes for senior executive officers at many Level 1 banks. In other respects, however, such as the four-year deferral period for annual bonuses (and the two-year deferral period for long-term incentives), as well as the seven-year post-vesting clawback period, the 2016 Proposal is stricter than the requirements that many banks currently impose. With the addition of significant risk-taker requirements, many institutions may find that adjustments are necessary to the structure of incentive-based arrangements for a large number of employees, which may affect the fixed costs and governance structures of the organization. Further, the delay and additional risk imposed by the rule on the payments of incentives can be expected to negatively affect employees' perception of the value of their incentive-based compensation.

Overall, the 2016 Proposal will continue the emphasis on a culture of accountability at financial services firms through tightening the reins on incentives, and increasing the emphasis on risk control management and the ability to audit and hold a firm responsible for its decisions. The 2016 Proposal's emphasis on a "long-term" approach to the ultimate payment of incentives underscores the Agencies' views of the lessons learned in the wake of the financial crisis. It also marks another step in the evolution of the design of incentive-based compensation programs which may, in some form, influence incentive practices in other industries.

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Appendix A

Covered Institutions

The following chart shows, for each Agency, the specific entities to which that Agency's rule applies. In all cases, the covered institution must have average total consolidated assets of at least $1 billion.

Agency	Covered Institutions
OCC	▪ A national bank, federal savings association, or federal branch or agency of a foreign bank; and ▪ A subsidiary of any of the above, if the subsidiary is not a broker, dealer, person providing insurance, investment company or investment adviser.
Board	▪ A state member bank, as defined in 12 CFR 208.2(g); ▪ A bank holding company, as defined in 12 CFR 225.2(c) that is not a foreign banking organization, as defined in 12 CFR 211.21(o), and a subsidiary of such a bank holding company that is not a depository institution, broker-dealer or investment adviser; ▪ A savings and loan holding company, as defined in 12 CFR 238.2(m), and a subsidiary of a savings and loan holding company that is not a depository institution, broker-dealer or investment adviser; ▪ An organization operating under Sections 25 or 25A of the Federal Reserve Act; ▪ A state-licensed uninsured branch or agency of a foreign bank, as defined in section 3 of the Federal Deposit Insurance Act ("FDIA") (12 USC 1813); and ▪ The US operations of a foreign banking organization, as defined in 12 CFR 211.21(o), and a US subsidiary of such foreign banking organization that is not a depository institution, broker-dealer or investment adviser.
FDIC	▪ State nonmember bank, state savings association and a state insured branch of a foreign bank, as such terms are defined in Section 3 of the FDIA; and ▪ A subsidiary of a state nonmember bank, state savings association or a state insured branch of a foreign bank, as such terms are defined in section 3 of the FDIA that is not a broker, dealer, person providing insurance, investment company or investment adviser.
NCUA	▪ A credit union as described in Section 19(b)(1)(A)(iv) of the Federal Reserve Act.
SEC	▪ A broker or dealer registered under Section 15 of the Securities Exchange Act of 1934; and ▪ An investment adviser, as defined in Section 202(a)(11) of the Investment Advisers Act of 1940 (but not persons excluded from that definition).
FHFA	▪ An "enterprise" as defined in 12 USC 4502(10); and ▪ A Federal Home Loan Bank.

Appendix B

Policies and Procedures

The 2016 Proposal requires each Level 1 and Level 2 covered institution to develop and implement policies and procedures for its incentive compensation program. These policies and procedures must be consistent with the requirements of the rule and must, at a minimum:

1. Specify the substantive and procedural criteria for the application of forfeiture and clawbacks, including the process for determining the amount of incentive-based compensation to be clawed back;
2. Require that the covered institution maintain documentation of final forfeiture, downward adjustment and clawback decisions;
3. Specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person;
4. Identify and describe the role of any employees, committees or groups authorized to make incentive-based compensation decisions, including when discretion is authorized;
5. Describe how discretion is expected to be exercised to appropriately balance risk and reward;
6. Require that the covered institution maintain documentation of the establishment, implementation, modification and monitoring of incentive-based compensation arrangements, sufficient to support the covered institution’s decisions;
7. Describe how incentive-based compensation arrangements will be monitored;
8. Specify the substantive and procedural requirements of the independent compliance program consistent with the 2016 Proposal’s requirements and
9. Ensure appropriate roles for risk management, risk oversight and other control function personnel in the covered institution’s processes for:
    a. Designing incentive-based compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback and vesting and
    b. Assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.