LATHAM&WATKINS

Client Alert
Commentary

Latham & Watkins Financial Institutions Industry Group

May 4, 2016 | Number 1963

Revised Rules on Dodd-Frank Incentive Compensation Requirements for Financial Institutions Proposed

If adopted, the Proposed Rule would have a significant impact on compensation practices at covered institutions.

On April 21, 2016, the National Credit Union Administration (the NCUA) issued a proposed rule regarding incentive-based compensation paid by certain financial institutions (the Proposed Rule) to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Section 956).[1] Section 956 requires various Federal agencies to issue regulations that limit certain incentive compensation practices at financial institutions. The Office of the Comptroller of the Currency (the OCC), the Federal Deposit Insurance Corporation (the FDIC) and the Federal Housing Finance Agency (the FHFA) released their respective versions of the proposed rule on April 26, 2016, and the Board of Governors of the Federal Reserve System (the Federal Reserve) released its version of the proposed rule on May 2, 2016. The Securities and Exchange Commission (the SEC) (collectively, with the NCUA, the OCC, the FDIC, the FHFA and the Federal Reserve, the Agencies) is expected to release its own substantially similar version of the Proposed Rule. The Proposed Rule significantly revises the proposed rule the Agencies jointly published in the Federal Register on April 14, 2011 (the 2011 Proposed Rule), described in our prior Client Alert, and would require major changes to incentive-based compensation programs at covered institutions (as defined below).

While much of the media reports relating to the Proposed Rule indicate that it will not severely impact compensation practices in the industry (as many believe similar practices have been widely adopted), the Proposed Rule would nonetheless have a very significant impact. The Proposed Rule mandates an entirely new compliance and recordkeeping structure, which will likely be costly and complex to manage. This complexity could lead to a talent drain at some institutions, as impacted individuals seek employment where they are not subject to the most rigorous applications of the Proposed Rule.

The Proposed Rule has three main components that would apply to *all* covered institutions:

- Prohibitions:
  - Incentive-based compensation arrangements that encourage inappropriate risks by the covered institution by providing a covered person with “excessive” compensation are prohibited.
  - Incentive-based compensation arrangements that encourage inappropriate risks that could lead to material financial loss to the covered institution are prohibited.
- Board of Directors:
  - The board of directors of a covered institution (or a committee thereof) are required to oversee the covered institution’s incentive-based compensation program.
- Disclosure and Recordkeeping Requirements:

- Covered institutions are required to create and retain annual records that document the structure of all of the institution's incentive-based compensation arrangements and demonstrate compliance with the Proposed Rule, and to disclose these records to the appropriate Agency upon request.

In addition, as detailed below, larger covered institutions are subject to more extensive requirements, including, for instance:

- Requirements to disclose the identity of senior executive officers and "significant risk takers" and provide details of the incentive-based compensation arrangements for such individuals.

- In certain instances, requirements to defer the vesting of specified portions of the incentive-based compensation awarded to senior executive officers and significant risk-takers for specified periods of time.

- Requirements to subject all incentive-based compensation of senior executive officers and significant risk-takers that is not yet awarded to downward adjustment, and to subject all such individuals' incentive-based compensation that is awarded and deferred to forfeiture until vesting, and to subject all vested incentive-based compensation to potential clawback for seven years following vesting.

- Enhanced risk management controls and governance and internal policy and procedure requirements.

Section 956 and the Proposed Rule significantly expand the regulatory grasp of the Agencies. If adopted, the Proposed Rule would represent the first time the Agencies have established specific proscriptions on pay other than for institutions receiving financial assistance from the government. The Proposed Rule would also for the first time subject investment advisers and broker-dealers to Federal compensation standards. Because many provisions of the Proposed Rule are unprecedented, how the Proposed Rule will be enforced and, in particular, whether or not each of the six Agencies will interpret, administer and enforce the rules in a uniform manner remain unclear.

Background

According to the preamble to the Proposed Rule (the Preamble), the Agencies believe that flawed incentive-based compensation practices in the financial industry, which did not comprehensively encompass the interests of the full range of stakeholders and the larger economy, were one of the many factors contributing to the financial crisis that began in 2007. The Agencies stated that they believe supervision and regulation of incentive-based compensation can play an important role in helping ensure that incentive-based compensation practices at covered institutions help address the negative externalities affecting the broader economy or other institutions. Such externalities may arise from inappropriate risk-taking by large financial institutions and do not threaten their safety and soundness. The Agencies modified the 2011 Proposed Rule based on a consideration of the comments provided on the 2011 Proposed Rule as well as practices adopted by financial institutions and foreign regulators in recent years.

Important Definitions

Covered Institution

The Proposed Rule would apply to a "covered institution," which is defined in the Preamble separately by each Agency to include only financial institutions regulated by such Agency. The Proposed Rule would cover the following types of institutions, with respect to the agency indicated, that have $1 billion or more in consolidated assets:

- **The OCC**: a national bank, Federal savings association or Federal branch or agency of a foreign bank (both insured and uninsured), with average total consolidated assets greater than or equal to $1 billion; and a subsidiary of any such national bank, Federal savings association or Federal branch or agency of a foreign bank that is (i) not a broker, dealer, person providing insurance, investment company or investment adviser and (ii) has average total consolidated assets greater than or equal to $1 billion.
- **The Federal Reserve**: a state member bank; bank holding company that is not a foreign banking organization and a subsidiary of such bank holding company that is not a depository institution, broker-dealer or investment adviser; a savings and loan holding company and a subsidiary of such savings and loan holding company that is not a depository institution, broker-dealer or investment adviser; an Edge and Agreement Corporation; a state-licensed uninsured branch or agency of a foreign bank; and the US operations of a foreign banking organization that is treated as a bank holding company pursuant to Section 8(a) of the International Banking Act of 1978 and a subsidiary of such foreign banking organization that is not a depository institution, broker-dealer or investment adviser.
- **The FDIC**: a state non-member bank, state savings association and a state insured branch of a foreign bank, with average total consolidated assets greater than or equal to $1 billion; and a subsidiary of a state non-member bank, state savings association or state insured branch of a foreign bank that (i) is not a broker, dealer, person providing insurance, investment company or investment adviser and (ii) has average total consolidated assets greater than or equal to $1 billion.
- **The FHFA**: Fannie Mae and any of its affiliates and Freddie Mac and any of its affiliates, with total consolidated assets greater than or equal to $1 billion, and a Federal Home Loan Bank.
- **The NCUA**: an insured credit union or a credit unit eligible to apply to become an insured credit union.
- **The 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 (including both registered and unregistered investment advisers).

Notably, this definition of “covered institution” is broader than those financial institutions specifically identified in the definition of “covered financial institution” in Section 956, in that the Proposed Rule would also apply to Federal Home Loan Banks, state-licensed uninsured branches and agencies of a foreign bank, Edge and Agreement Corporations, other US operations of foreign banking organizations that are treated as bank holding companies pursuant to Section 8(a) of the International Banking Act of 1978 and state-chartered non-depository trust companies that are members of the Federal Reserve. The expansion of the list of financial institutions under the Proposed Rule is intended to achieve equal treatment across similar entities that are under the same regulatory regime or that have different charters, and to ensure parity of treatment between US banking organizations and foreign banking organizations operating in the US.

Level 1, Level 2 and Level 3 Covered Institutions

The requirements of the Proposed Rule are tailored based on the size and complexity of covered institutions, which the Proposed Rule generally categorizes into the following three levels:

- Level 1 (greater than or equal to $250 billion in consolidated assets)
- Level 2 (greater than or equal to $50 billion and less than $250 billion in consolidated assets)
- Level 3 (greater than or equal to $1 billion and less than $50 billion in consolidated assets)

The Proposed Rule would apply more rigorous requirements to Level 1 and Level 2 covered institutions, as such institutions tend to be significantly more complex and implicate greater risks for the financial system and the overall economy. Most of the requirements, other than those related to deferral, would apply to Level 1 and Level 2 covered institutions in a similar manner.

Consolidation

Generally, the Agencies propose that covered institutions that are subsidiaries of other covered institutions would be subject to the same requirements, and defined to be the same level, as the parent covered institution. According to the Agencies, this approach of assessing risks at the level of the holding company for a consolidated organization recognizes that financial stress or the improper management of risk in one part of an organization has the potential to spread rapidly to other parts of the organization.

The Proposed Rule contains specific guidelines for determining how to calculate consolidated assets in order to determine Level 1, Level 2 or Level 3 classification, generally based on a rolling four-quarter average of assets as reported in the financial institution's four most recent regulatory reports.

Notably, the SEC is not proposing to require a covered institution under its proposed rule that is a subsidiary of another covered institution under that proposed rule to be subject to the same requirements, and defined to be the same levels, as the parent covered institution. This is because broker-dealers and investments advisers' operations, services and products are not typically effected through subsidiaries, and their incentive-based compensation arrangements are typically derived from the activities of the broker-dealers and investment advisers themselves. Nevertheless, broker-dealers and investment advisers that are subsidiaries of depository institution holding companies would be consolidated on the basis of such depository institution holding companies generally. As an example, a global investment bank that has a bank holding company as its parent, with subsidiaries that are registered as broker-dealers and/or investment advisers, would be consolidated on the basis of such bank holding company, and those subsidiaries would be subject to the same requirements, and defined to be the same level, as the bank holding company parent. According to the Preamble, this is because there is often a greater integration of products and operations, public interest, and assessment and management of risk (including those related to incentive-based compensation) across the depository holding companies and their subsidiaries.

In addition, the thresholds for investment advisers are based on the total assets reported on their most recent fiscal year-end balance sheet, excluding non-proprietary assets such as client assets under management. As a practical matter, this will result in most investment advisers not being covered institutions at all, and very few falling within Level 1 or Level 2. Indeed, the SEC estimates in the Preamble that of the approximately 669 investment advisers the agency believes would fall within the definition of covered institution, only approximately 18 will be Level 1 covered institutions, approximately 21 will be Level 2 covered institutions and approximately 630 will be Level 3 covered institutions.

Upon an increase in average total consolidated assets, a 540-day transition period applies before a covered institution would be required to comply with any requirements under the Proposed Rule that previously did not apply to the institution. Upon a decrease in total consolidated assets, a covered institution would remain subject to the provisions of the Proposed Rule that applied to it before the decrease until the total consolidated assets fell below $250 billion, $50 billion or $1 billion, as applicable, for four consecutive regulatory reports.

Lastly, the proposed rule of the Federal Reserve, the OCC and the FDIC (collectively, the Federal Banking Agencies) includes a provision that provides that a covered institution that is (i) subject to the Federal Banking Agencies' proposed rule and (ii) a subsidiary of another covered institution, may meet any requirement of the Federal Banking Agencies' proposed rule if the parent covered institution complies with such requirement in a way that causes the relevant portion of the subsidiary covered institution's incentive-based compensation program to comply with the requirement. For example, a subsidiary covered institution that is subject to the Federal Banking Agencies' proposed rule could rely on this provision to comply with the Proposed Rule's corporate governance or policies and procedures requirements (discussed below). The Federal Banking Agencies have included this provision in order to reduce the compliance burden on subsidiaries that would be subject to the Federal Banking Agencies' proposed rule, and in recognition of the fact that holding companies, national banks, Federal savings associations, state non-member banks and state savings associations may perform certain functions on behalf of such subsidiaries.

Incentive-Based Compensation

The Proposed Rule defines "incentive-based compensation" as any variable compensation, fees or benefits that serve as an incentive or reward for performance. The form of payment, whether cash, an equity-like instrument or any other thing of value, does not affect whether compensation, fees or benefits meet this definition. The Preamble provides that compensation provided solely for continued employment, such as salary, would not be considered incentive-based compensation. The Proposed Rule also notes that the proposed definition does not include dividends paid or appreciation realized on equity instruments that a covered person owns outright. However, such equity instruments would not be considered owned outright while subject to any vesting or deferral arrangement.

"Qualifying incentive-based compensation" is incentive-based compensation that is not awarded under a long-term incentive plan. A "long-term incentive plan" is a plan to provide incentive-based compensation based on a performance period of at least three years.

Covered Persons

"Covered persons" consist generally of executive officers, employees, directors,[2] principal shareholders (generally, individuals who control 10 percent or more of any class of voting securities of the institution) and significant risk-takers (as defined below).[3] An "executive officer" would include individuals who are senior executive officers (as defined below), as well as other individuals the covered institution designates as executive officers. Notably, it is not the case that the entire Proposed Rule would apply to all covered persons. As described below, certain parts of the Proposed Rule would apply to only senior executive officers and significant risk-takers.

Senior Executive Officers

"Senior executive officer" is defined generally as a person who holds the title — or, without regard to title, salary or compensation, performs the function — of one or more of the following positions: 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

A covered person is considered a "significant risk-taker" (applicable only to Level 1 and Level 2 covered institutions) if the covered person received an annual base salary and incentive-based compensation of which at least one-third was incentive-based compensation during the last calendar year that ended at least 180 days before the beginning of the performance period for which significant risk-takers are being identified, and the covered person either

- Is among the top five percent (for Level 1 covered institutions) or top two percent (for Level 2 covered institutions) of highest compensated covered persons in the entire consolidated organization
- Has authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution

Even if neither test is met, the Agencies may designate additional individuals as significant risk-takers, including because of their ability to expose a covered institution to risks that could lead to material financial loss in relation to the institution's size, capital or overall risk tolerance. The requirements of the Proposed Rule relating to senior executive officers would also generally apply to significant risk-takers to some degree, as described below.

In addition, the Proposed Rule provides the Agencies with the flexibility to adjust the number of persons designated as significant risk-takers with respect to a Level 1 covered institution. Specifically, the Proposed Rule provides that for a Level 1 covered institution whose activities, complexity of operations, risk profile and compensation practices are similar to those of a Level 2 covered institution, an Agency has the discretion, in accordance with procedures the Agency establishes, to apply a two percent threshold to that Level 1 covered institution, instead of the five percent threshold that would otherwise apply.

Components of the Proposed Rule That Apply to All Covered Institutions

Prohibition on Excessive Compensation, Fees or Benefits

The Proposed Rule would prohibit covered institutions from maintaining any incentive-based compensation arrangement that encourages inappropriate risks by the covered institution by providing a covered person with "excessive" compensation. Compensation is considered excessive when the compensation is unreasonable or disproportionate to the amount, nature, quality and scope of services the covered person performs.

The factors the Agencies would consider in deciding whether an incentive-based compensation arrangement provides excessive compensation include, among others:

- The combined value of all compensation, fees or benefits provided to the covered person
- The compensation history of the covered person and other individuals with comparable expertise at the covered institution
- The covered institution's financial condition
- Compensation practices at comparable covered institutions (based on asset size, geographic location and the complexity of the covered institution's operations and assets)
- The projected total cost and benefit to the covered institution of any post-employment benefits
- Any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse regarding the covered institution

Prohibition on Incentive-Based Compensation Policies That Could Lead to Material Financial Loss to the Covered Institution

The Proposed Rule would prohibit covered institutions from maintaining incentive-based compensation arrangements that encourage inappropriate risks by providing incentive-based compensation to covered persons that could lead to material financial loss to the covered institution.

In order to comply with this part of the Proposed Rule, a covered institution's incentive-based compensation arrangements must: (i) balance risks (including credit, market, liquidity, operational, legal, compliance and reputational risks) and financial rewards; (ii) be compatible with effective controls and risk management; and (iii) be supported by strong corporate governance, including active and effective oversight by the covered institution's board of directors or a committee of the board.[4] An incentive-based compensation arrangement will not be considered to appropriately balance risk and reward unless the arrangement (i) 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 the covered person is engaged, and that are appropriately weighted to reflect risk-taking; (ii) is designed to allow non-financial measures of performance to override financial measures when appropriate; and (iii) allows for any amounts that are awarded under the arrangement to be subject to adjustment to reflect annual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and non-financial performance.

Board of Directors

The Proposed Rule would require that the board of directors of a covered institution (or a committee thereof) be required to (i) conduct oversight of the covered institution's incentive-based compensation program; (ii) approve incentive-based compensation arrangements for senior executive officers, including amounts of awards and, at the time of vesting, payouts under such arrangements; and (iii) approve material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

Disclosure and Recordkeeping Requirements

Under the Proposed Rule, each covered institution would be required to create and maintain records that document the structure of all of the institution's incentive-based compensation arrangements and demonstrate compliance with the Proposed Rule, as well as to disclose these records to the appropriate Agency upon request. Such records would need to be created on an annual basis and maintained for at least seven years post-creation, which would generally align with the required clawback period mandated for senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions, as described in more detail below. At a minimum, these records must include copies of all incentive-based compensation plans, a list of who is subject to each plan and a description of how the covered institution's incentive-based compensation program is compatible with effective risk management and controls. A covered institution would not be required to report the actual amount of covered persons' compensation, fees or benefits as part of this requirement. Agencies expect to treat information provided to the Agencies as non-public and to maintain confidentiality of that information; however, covered institutions should nevertheless request confidential treatment by an Agency.[5]

Enhanced Requirements for Level 1 and Level 2 Covered Institutions

In addition to the general requirements applicable to all covered institutions discussed above, Level 1 and Level 2 covered institutions would be required to comply with additional obligations under the Proposed Rule. These requirements must be met in order for these institutions' incentive-based compensation arrangements to be considered to balance risk and financial rewards appropriately. A Level 3 covered institution with consolidated assets of between $10 billion and $50 billion could be required to comply with some or all of these additional obligations based on the institution's complexity of operations or compensation practices (such as involvement in high-risk business lines and having significant levels of off-balance sheet activities) subject to reasonable advance written notice by an Agency — an authority the Proposed Rule anticipates Agencies would invoke infrequently.

Additional Disclosure and Recordkeeping Requirements

In addition to the disclosure and recordkeeping requirements applicable to all covered institutions, Level 1 and Level 2 covered institutions would be required to document (i) their senior executive officers and significant risk-takers listed by legal entity, job function, organizational hierarchy and line of business; (ii) the incentive-based compensation arrangements for senior executive officers and significant risk-takers, including deferral terms and form of award; (iii) any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and (iv) any material changes to the covered institution's incentive-based arrangements and policies. All records the Proposed Rule for Level 1 and Level 2 covered institutions requires must be sufficient to allow for an independent audit. Records may be required to be disclosed to an Agency as frequently as requested, which could be as often as annually depending on the Agency and the type of records to be disclosed.

Deferral of Incentive-Based Compensation

The Proposed Rule's provisions regarding deferral assume that incentive-based compensation is first awarded following a performance period. The Proposed Rule would require that Level 1 and Level 2 covered institutions defer the vesting of a certain portion of all incentive-based compensation awarded (the Deferral Amount) to a senior executive officer or significant risk-taker for at least a specified period of time following the end of the performance period (the Deferral Period). For these purposes, "vesting" means being paid out upon ceasing to be subject to forfeiture based on the risk- and performance-related events and circumstances described under "Forfeiture and Downward Adjustment" below; the Proposed Rule does not require that deferred amounts be subject to typical vesting based on continued employment. How the Proposed Rule would treat incentive-based compensation that is not first awarded following a performance period, such as carried interests, remains unclear.

The Deferral Amount and the Deferral Period would depend on (i) the level classification of the covered institution, (ii) the classification of the covered person as a senior executive officer or significant risk-taker and (iii) whether the incentive-based compensation is awarded under a long-term incentive plan. For a Level 1 covered institution, the Deferral Amount is 60 percent of a senior executive officer's incentive-based compensation and 50 percent of a significant risk-taker's incentive-based compensation, and the Deferral Period is four years for qualifying incentive-based compensation and two years for compensation awarded under a long-term incentive plan. For a Level 2 covered institution, the Deferral Amount is 50 percent of a senior executive officer's incentive-based compensation and 40 percent of a significant risk-taker's incentive-based compensation, and the Deferral Period is three years for qualifying incentive-based compensation and one year for compensation awarded under a long-term incentive plan.

In addition, the Proposed Rule would require that vesting of the Deferral Amount may not occur faster than on a pro rata annual basis beginning on the one-year anniversary of the end of the performance period. For example, if a Level 1 covered institution is required to defer $100,000 of a senior executive officer's incentive-based compensation for four years, the covered institution could choose to make $25,000 available for vesting on each anniversary of the end of the performance period, or instead choose to have the entire $100,000 cliff vest on the fourth anniversary of the end of the performance period. Alternatively, the same covered institution could choose to make eligible to vest $10,000 on the first anniversary, $30,000 on the second anniversary, $30,000 on the third anniversary and $30,000 on the fourth anniversary, as the cumulative vesting on each anniversary of the end of the performance period is not greater than the cumulative total that would have been eligible for vesting had the covered institution made equal amounts eligible for vesting each year.

Additionally, the Proposed Rule would require that (i) unvested Deferred Amounts may not be increased during the Deferral Period;[6] (ii) for covered institutions that issue equity or are subsidiaries of covered institutions that issue equity, substantial portions of deferred incentive-based compensation must be paid in the form of both equity-like instruments and deferred cash;[7] (iii) the total amount of options and stock appreciation rights that may be used to meet the minimum deferral amount requirements may not exceed 15 percent of the amount of total incentive-based compensation awarded for a given performance period; and (iv) accelerated vesting of unvested Deferred Amounts may not occur except in the case of death and disability.[8]

Forfeiture and Downward Adjustment

The Proposed Rule would require that Level 1 and Level 2 covered institutions must subject all of a senior executive officer's or significant risk-taker's deferred and unvested incentive-based compensation awarded under any plan to forfeiture (including any amounts deferred in excess of the amounts required by the Proposed Rule). Furthermore, all of a senior executive officer's or significant risk-taker's incentive-based compensation pending during an ongoing performance period must be subject to downward adjustment before performance is determined. A Level 1 or Level 2 covered institution would be required to consider forfeiture or downward adjustment of incentive-based compensation if any of the following adverse outcomes occur:

- Poor financial performance attributable to a significant deviation from the covered institution's 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 statutory, regulatory or supervisory standards resulting in an enforcement or legal action by a Federal or state regulator or agency, or a requirement that the covered institution restate a financial statement to correct a material error
- Other aspects of conduct or poor performance as defined by the covered institution

Individuals whose compensation is subject to forfeiture and downward adjustment with respect to any event that triggers the forfeiture and downward adjustment review would be senior executive officers or significant risk-takers with direct responsibility, or responsibility due to the senior executive officer's or significant risk-taker's role or position in the covered institution's organizational structure, for the event. A Level 1 or Level 2 covered institution must consider certain specified factors when determining the amount of incentive compensation to be forfeited or adjusted downward, including the senior executive officer's or significant risk-taker's intent to operate outside the risk governance framework the covered institution's board of directors has approved, or to depart from the institution's policies and procedures; the senior executive officer's or significant risk-taker's level of participation in, awareness of and responsibility for, the applicable event; any actions the senior executive officer or significant risk-taker took or could have taken to prevent the event; the event's financial and reputational impact on the institution, the line or sub-line of business and individuals involved; the causes of the event; and any other relevant information.

Clawback Period

The Proposed Rule would require that Level 1 and Level 2 covered institutions include clawback provisions in incentive-based compensation arrangements for senior executive officers and significant risk-takers that, at a minimum, would allow for recovery of 100 percent of any vested incentive-based compensation from a current or former senior executive officer or significant risk-taker for a period of seven years following the respective vesting date. Clawback would be exercised if a senior executive officer or significant risk-taker engages in (i) misconduct that resulted in significant financial or reputational harm to the covered institution; (ii) fraud; or (iii) intentional misrepresentation of information used to determine such individual's incentive-based compensation. The Proposed Rule anticipates that the clawback requirement would go beyond, but not conflict with, the clawback provisions enumerated in Section 304 of the Sarbanes-Oxley Act of 2002 and Section 10D of the Securities Exchange Act.

Prohibitions Related to Payment and Measurement of Incentive-Based Compensation

The Proposed Rule would prohibit Level 1 and Level 2 covered institutions from engaging in the following activities with respect to payment and measurement of incentive-based compensation. All of the below, except for the caps on incentive-based compensation described in the second bullet, apply to all covered persons and not just senior executive officers and significant risk-takers:

- Purchasing hedge instruments or similar instruments on behalf of covered persons in order to hedge or offset any decrease in the value of the covered person's incentive-based compensation.
- Awarding incentive-based compensation to a senior executive officer that is more than 125 percent of the respective target amount, or to a significant risk-taker that is more than 150 percent of the respective target amount. The prohibition would apply on a plan-by-plan basis. There is no absolute cap on incentive-based compensation.
- Using incentive-based compensation performance measures based solely on industry peer performance comparisons. The Proposed Rule explicitly permits incorporation of relative performance measures in combination with absolute performance measures.
- Providing incentive-based compensation to a covered person based solely on transaction or revenue volume without regard to transaction quality or the covered person's compliance. The Proposed Rule explicitly permits incorporation of transaction or revenue volume as a factor in combination with other factors designed to cause covered persons to account for the risks of their activities.

Risk Management and Controls

The Proposed Rule would require all Level 1 and Level 2 covered institutions to have a risk management framework for their incentive-based compensation program that is independent of any lines of business, and includes an independent compliance program that provides for internal controls, testing, monitoring and training with written policies and procedures, and is commensurate with the size and complexity of the covered institution's operations. In addition, the Proposed Rule would require Level 1 and Level 2 covered institutions to provide individuals in control functions with appropriate authority to influence the risk-taking of the business areas they monitor, and ensure covered persons engaged in control functions are compensated in accordance with the achievement of performance objectives linked to their control functions and independently of the performance of the business areas they monitor. Such institutions would also have to provide for independent monitoring of (i) all 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 covered institution's policies and procedures.

Governance and Internal Policies and Procedures Requirements

The Proposed Rule would require that Level 1 and Level 2 covered institutions establish an independent compensation committee composed solely of directors who are not senior executive officers, to assist the board of directors in carrying out its responsibilities under the Proposed Rule. The independent compensation committee must obtain input from the risk and audit committees, as well as the risk management function, on the effectiveness of risk measures and adjustments used to balance incentive-based compensation arrangements. Additionally, the independent compensation committee must obtain annually from both management and an internal audit or risk management function of the covered institution, separate written assessments 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 covered institution's risk profile.

The Proposed Rule also sets out requirements for minimum policies and procedures that Level 1 and Level 2 covered institutions should implement. Such policies and procedures should:

- Be consistent with the Proposed Rule's prohibitions and requirements
- Specify the substantive and procedural criteria for the application of forfeiture, downward adjustment and clawback, including any circumstances or triggers
- Require the maintenance of documentation of final forfeiture, downward adjustment and clawback decisions
- Specify the substantive and procedural criteria for acceleration of payments of deferred incentive-based compensation consistent with the Proposed Rule
- Identify and describe the role of any employees, committees or groups authorized to make incentive-based compensation decisions, including when discretion is authorized and expected to be exercised
- Describe how incentive-based compensation arrangements will be monitored
- Require maintenance of documentation regarding incentive-based compensation arrangements sufficient to support the covered institution's decisions
- Specify the substantive and procedural requirements of the independent compliance program
- Address the appropriate roles for risk management, risk oversight and other control function personnel for designing, awarding and assessing the effectiveness of incentive-based compensation arrangements

Timing of the Rules

A three-month comment period on the Proposed Rule will end on July 22, 2016. The SEC must approve the Proposed Rule before it is published in the Federal Register. The Proposed Rule's requirements will not become effective until the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register. Incentive-based compensation arrangements that are in place prior to the effective date will be grandfathered for any performance periods in effect on the effective date.

Conclusion

The Proposed Rule would have a significant impact on covered institutions and covered persons. Firms would be required to invest in complex new compliance programs to ensure compliance with the Proposed Rule, and they may well lose talented executives to lesser regulated institutions.

If the Proposed Rule is adopted, financial institutions should first determine whether they are covered under the Proposed Rule, and if so, identify which compensation arrangements will be subject to the Proposed Rule. Covered institutions should then determine whether any of their incentive-based compensation arrangements either provide "excessive compensation" or could expose the institution to a material financial loss based on the criteria set forth in the Proposed Rule.

All covered institutions should consider establishing written policies and procedures to maintain and ensure compliance with the Proposed Rule. Level 1 and Level 2 covered institutions should consider whether changes to their equity and other incentive-based compensation plans and arrangements will be necessary in order to comply with the required deferral, forfeiture, downward adjustment, clawback and other incentive-based compensation policies for senior executive officers and significant risk-takers. Covered institutions may also wish to consider implementing appropriate procedures to prepare the required records.

Finally, covered institutions should review the responsibilities of their compensation committees and of their risk-management, risk-oversight and internal control personnel to ensure the design, approval, monitoring and review of incentive-based compensation arrangements will comply with all Section 956 requirements. Amending the compensation committee charter to ensure that the committee has the requisite authority to satisfy its obligations under Section 956 may also be appropriate. To ensure complete compliance under the Proposed Rule, consultation with counsel is advised.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Stephen P. Wink
stephen.wink@lw.com
+1.212.906.1229
New York

Alan W. Avery
alan.avery@lw.com
+1.212.906.1301
New York

Lori D. Goodman
lori.goodman@lw.com
+1.212.906.4533
New York

Brett M. Ackerman
brett.ackerman@lw.com
+1.202.637.2109
Washington, D.C.

Pia Naib
pia.naib@lw.com
+1.212.906.1208
New York

Jordan S. Salzman
jordan.salzman@lw.com
+1.212.906.4625
New York

You Might Also Be Interested In

Federal Agencies Propose Rules on Dodd-Frank Incentive Compensation Requirements for Financial Institutions

SEC Approves New Municipal Advisor Fiduciary Duty Rule

FINRA's New Research Rules

Broker-Dealer Regulation: New Developments and Continuing Practical Concerns Regarding Registration Requirements for Business Brokers, "Finders," and Other Financial Intermediaries

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit http://events.lw.com/reaction/subscriptionpage.html to subscribe to the firm's global client mailings program.

Endnotes

1 The Proposed Rule will not be published in the Federal Register until after all of the Agencies have acted. The final version may differ from the version available at https://www.ncua.gov/About/Documents/Agenda%20Items/AG20160421Item2b.pdf.

2 For Federal credit unions, only one director, if any, may be considered a covered person, since, under the Federal Credit Union Act and NCUA's regulations, only one director may be compensated as an officer of the board of directors.

3 The NCUA's version of the Proposed Rule does not include this definition because credit unions are not-for-profit financial cooperatives with member owners.

4 These standards are based upon the three principles for sound incentive-based compensation policies contained in the 2010 Federal Banking Agency Guidance.

5 For example, Exemption 4 of the Freedom of Information Act (FOIA) provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 6 provides an exemption for information about individuals in "personnel and medical files and similar files" when the disclosure of such information "would constitute a clearly unwarranted invasion of personal privacy." 5 U.S.C. 552(b)(6). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

6 Increases due solely to a change in share value, a change in interest rates or the payment of reasonable interest or a reasonable rate of return according to terms set out at the award date would not be considered increases in the amount awarded.

7 The Proposed Rule does not discuss specific percentages and explicitly provides covered institutions with flexibility to meet this general balancing requirement.

8 The NCUA would also allow a limited exception, which would permit acceleration of payment if covered persons were subject to income taxes on the entire amount of an incentive-based compensation award before deferred amounts vest.