New Incentive-Based Compensation: Proposed Rules for Financial Institutions

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A group of financial regulators has released for comment rules (the Proposed Rules) under Section 956 of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), providing for regulations and guidelines with respect to incentive-based compensation practices at financial institutions (Covered Institutions) with $1 billion or more in assets. These regulators include the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the National Credit Union Administration, and the Federal Housing Finance Agency (collectively the Agencies).

Covered Institutions – the following financial institutions with average total consolidated assets of $1 Billion or more:	
Depository institutions or depository institution holding companies (as defined in Section 3 of the Federal Deposit Insurance Act)	Investment advisers (as defined in Section 202(a)(11) of the Investment Advisers Act of 1940)
Credit unions (as described in Section 19(b)(1)(A)(iv) of the Federal Reserve Act)	Broker-Dealers (registered under Section 15 of the Exchange Act of 1934)
Federal National Mortgage Association (Fannie Mae)	Federal Home Loan Mortgage Corporation (Freddie Mac)

The Proposed Rules replace proposed rules previously issued by the agencies in 2011. The Proposed Rules require institutions to comply as of the first calendar quarter beginning at least 18 months after the publication of the final rules in the *Federal Register*. Additionally, only compensation plans with performance periods beginning on or after the effective date of the finalized rules would be subject to compliance. Based on this information, these new rules will likely not be effective until at least January 2019, if not later. All the Agencies have approved the Proposed Rules for public comment. While each Agency will act independently, it is expected that the text of the rules proposed by each Agency will be substantially similar, and that each version will share a single, common preamble.

The Proposed Rules ***prohibit*** Covered Institutions from providing incentive-based compensation arrangements that encourage inappropriate risk-taking by providing a Covered Person, as defined below, with excessive compensation, fees, or benefits; or that could lead to material financial loss to a Covered Institution. A compensation arrangement would be considered ***excessive*** if amounts paid are unreasonable or disproportionate to the value of services performed when taking into account all relevant factors, such as, a Covered Person's compensation history compared to individuals with comparable expertise and the financial condition of the Covered Institution. An incentive compensation arrangement would be considered to encourage inappropriate risks that could lead to material financial loss *unless the arrangement*

"appropriately balances risk and reward;" is compatible with "effective risk management and controls;" and is supported by "effective governance."

Unlike previously issued proposed rules and guidance, the Proposed Rules now specifically state that an incentive compensation arrangement will **not** be considered to appropriately balance risk and reward unless:

- the arrangement includes financial and nonfinancial measures of performance, including considerations of risk-taking;
- the arrangement is designed to allow nonfinancial measures of performance to override financial measures of performance, when appropriate; and
- amounts to be awarded are subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and nonfinancial performance.

Covered Institutions

As previously mentioned, the Covered Institutions subject to the Proposed Rules include depository institutions, credit unions, Fannie Mae, Freddie Mac, investment advisers, and broker-dealers, with average total assets of $1 billion or more. Under the Proposed Rules these financial institutions are divided into three new categories of Covered Institutions based on average total consolidated assets. These categories may be subject to different rules relating to permissible incentive-based compensation arrangements. The different categories of Covered Institutions are:

Level 1 Covered Institutions	Level 2 Covered Institutions	Level 3 Covered Institutions
Average total consolidated assets greater than $250 billon	Average total consolidated assets between $50 billion and $250 billion	Average total consolidated assets between $1 billion and $50 billion

Level 3 institutions are primarily subject to the provisions of the Proposed Rules related to risk management and controls, governance requirements, and record keeping and disclosure mandates. However, the stricter limitations and requirements under the Proposed Rules in connection with mandatory deferral periods, mandatory forfeiture and downward adjustment provisions, and mandated clawback periods only apply to Level 1 and Level 2 Covered Institutions.

Covered Persons

The Proposed Rules would apply to incentive-based compensation arrangements with respect to "Covered Persons." Such persons consist of executive officers, employees, directors, and principal shareholders who receive incentive compensation from the Covered Institution. Notably, the Proposed Rules introduce a new class of Covered Person applicable to Level 1 and Level 2 Covered Institutions—the "significant risk-taker."

A significant risk-taker is any Covered Person, other than a senior executive officer, with annual compensation made up of at least one third of incentive-based compensation, and who passes a "relative compensation test" or an "exposure test."

- **Relative Compensation Test**: The person's annual base salary and incentive compensation is among the highest 5 percent (for Level 1 institutions) or 2 percent (for Level 2 institutions) of all Covered Persons (other than senior executive officers) of the institution; or
- **Exposure Test**: The person may commit or expose 0.5 percent or more of a specified measure of capital of the Covered Institution.

Risk Management and Controls

The Proposed Rules require Covered Institutions to provide "effective risk management and controls" in connection with their incentive-based compensation arrangements. Moreover, Level 1 and Level 2 Covered Institutions would be specifically required to establish and maintain a risk management framework independent of any lines of business. This would include an independent compliance program that provides for internal controls, testing, and monitoring and training commensurate with the institution's size and complexity of operations.

In addition to establishing a robust risk management framework, all Covered Institutions must maintain records that document their incentive compensation requirements and demonstrate compliance with the rules for at least seven years. At a minimum, such records and documents must include copies of all incentive-based compensation plans, a record of who is subject to each plan, and a description of how the incentive-based compensation program is compatible with effective risk management and controls. Although there will not be an annual reporting requirement, such documents must be available upon request of an applicable Agency. Level 1 and Level 2 Covered Institutions would be subject to additional record-keeping requirements to document and monitor compliance with the additional rules they are subject to in connection with certain plan design features for incentive-based compensation arrangements.

Governance

The Proposed Rules also require that all incentive-based compensation arrangements be supported by "effective governance." This includes a requirement that all Covered Institutions have its board of directors or a designated committee:

- conduct oversight of the Covered Institutions incentive-based compensation program;

- approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and

- approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

Level 1 and Level 2 Covered Institutions would face additional governance requirements such as:

- establishing a board-level compensation committee composed solely of directors who are not senior executive officers;
- mandating that the compensation committee obtain input from the board's risk and audit committees and risk management function on the effectiveness of the institution's risk measures and adjustments used to balance risk and reward in incentive-compensation arrangements; and
- mandating that the compensation committee prepare and submit an annual written assessment of the effectiveness of the institution's incentive-compensation program and related processes in providing risk-taking incentives. The internal audit or risk management function would also be required to prepare and submit to the compensation committee an annual independent written assessment that is developed independently of the institution's management.

Incentive-Based Compensation: Mandatory Provisions

The Proposed Rules provide specific requirements for incentive-based compensation arrangements in order for such arrangements to be considered appropriately balanced for risk and reward.

Mandatory Deferral Rules

In order to be considered appropriately balanced for risk and reward, mandatory deferral rates must be applied to incentive-based compensation. Mandatory deferral rates include the following:

	Senior Executive Officer		Significant Risk-Taker	
	Level 1	Level 2	Level 1	Level 2
Long-Term Incentive Compensation	60 percent for 2 years	50 percent for 1 year	50 percent for 2 years	40 percent for 1 year
Other Incentive-Based Compensation	60 percent for 4 years	50 percent for 3 years	50 percent for 4 years	40 percent for 3 years

- **Deferral Period.** The deferral period would begin at the end of the incentive compensation's performance period.
- **Vesting.** Vesting can occur no faster than on a pro-rata annual basis beginning on the first anniversary of the end of the performance period.

- **Restrictions on Accelerated Vesting.** Accelerated vesting would not be permitted except for the death or disability of a Covered Person. This means that payments may not be accelerated for retirement, termination of employment, or a change-in-control.

Mandatory Forfeiture and Adjustment Powers

The Proposed Rules require Level 1 and Level 2 Covered Institutions to consider forfeiture and downward adjustments to a Covered Person's amount of incentive-based compensation upon the occurrence of a "Triggering Event." Additionally, the Proposed Rules identify certain factors that must be considered when determining how much incentive-based compensation will be forfeited or adjusted down.

Triggering Events
Poor financial performance attributable to a significant deviation from the risk parameters set forth in the 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 enforcement or legal action against the institution or a financial restatement
Factors Used To Determine Amounts To Be Forfeited or Adjusted Downward
The individual's intent to deviate from the institution's policies and procedures or risk governance framework
The individual's level of participation in, awareness of, and responsibility for the events triggering the review
Any actions the individual took or could have taken to prevent the events triggering the review
The financial and reputational impact of the events triggering the review
The causes of the events triggering the review
Any other relevant information, including past behavior and risk outcomes attributable to the individual

Mandatory Clawbacks

The Proposed Rules require incentive-based compensation plans to include "clawback" provisions that permit recovery of compensation for at least seven years, post vesting, when a current or former Covered Person has engaged in:

- misconduct that resulted in significant financial or reputational harm to the institution;
- fraud; or
- intentional misrepresentation of information used to determine the individual's incentive compensation.

Note, this clawback requirement was not in the 2011 proposed rules, and reaches beyond the clawback requirement under Section 954 of the Dodd-Frank Act. The Section 954 clawback is only triggered when an issuer is required to prepare a financial restatement to correct a material non-compliance issue with securities laws and would only apply to the three-year period subject to the restatement.

Maximum Incentive Compensation Opportunity

The Proposed Rules limit the actual amounts of awardable incentive-based compensation to a senior executive officer and a significant risk-taker. These limits are based on multiples of established target amounts for measured performance goals. Specifically, senior executive officers will be limited to awards with a maximum payout equal to 125 percent of an established target amount. Significant risk-takers will be limited to awards with a maximum payout equal to 150 percent of an established target amount.

Next Steps?

Companies should consider various next steps as a result of the Proposed Rules. First, determine whether your company is a Covered Institution. If your company is a Covered Institution, then you must determine whether your company is a Level 1, Level 2, or Level 3 Covered Institution. All Covered Institutions should begin identifying those individuals considered "Covered Individuals" to determine who will be impacted by the Proposed Rules. Next a company should consider the impact of the Proposed Rules. We recommend revisiting incentive compensation arrangements and deferred compensation plans as they relate to the Proposed Rules to determine if any proactive changes may be warranted. Additionally, Covered Institutions should begin to evaluate existing governance and risk management functions to determine if they would be compliant with the Proposed Rules as if the Proposed Rules were effective today. This evaluation will inform a Covered Institution on changes that may be needed to their governance and risk management structures.

Interested in Commenting?

All Agencies that have released the Proposed Rules are requesting comments on the rules. Should you wish to comment, we can be of assistance in drafting or reviewing comments. The comment period ends July 22, 2016.

Please join us for a webinar about these recently re-proposed rules at 12 PM ET on July 18, 2016. Click here to register. We will explore key new concepts and discuss:

- New restrictions that will be imposed on executive compensation practices
- The rules and impact on a financial institution’s risk management and control systems, and
- The impact on decision makers such as directors and compensation committees.

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