Client Alert

April 25, 2016

New Executive Compensation Rule At-A-Glance

On April 21, 2016, the National Credit Union Administration approved a proposed rule on incentive compensation under Section 956 of the Dodd-Frank Act. The other appropriate Federal regulators, as defined in Section 956, are expected to follow suit shortly. Following is a chart of the key provisions of the proposal. Comments are due July 22, 2016. This chart summarizes the proposed rules required under Dodd-Frank regarding incentive compensation at certain "covered financial institutions" (Level 1, Level 2 and Level 3):

	Level 1	**Level 2**	**Level 3**
"Covered financial institutions"	Include (1) banks and bank holding companies, (2) broker-dealers, (3) investment advisers and (4) credit unions, each with $1 billion or more in assets.		
Average total consolidated assets held	Greater than or equal to $250 billion.	Greater than or equal to $50 billion and less than $250 billion.	Greater than or equal to $1 billion and less than $50 billion.
"Senior executive officer"	A covered person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions at a credit union for any period of time in the relevant performance period: 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-taker"	Non-senior executive officer whose compensation for the last calendar year was at least one-third incentive-based compensation and: (1) had the highest 5% in annual base salary and incentive-based compensation among all covered persons (excluding senior executive officers); or	Non-senior executive officer whose compensation for the last calendar year was at least one-third incentive-based compensation and: (1) had the highest 2% in annual base salary and incentive-based compensation among all covered persons (excluding senior executive officers); or	N/A

	(2) who may commit or expose 0.5% or more of the net worth or total capital of the institution.	(2) who may commit or expose 0.5% or more of the net worth or total capital of the institution.	
General requirement	Cannot have incentive-based compensation plans that encourage inappropriate risks by providing a covered person[1] with excessive compensation, fees, or benefits, or that could lead to material financial loss for the institution. An incentive-based compensation arrangement encourages inappropriate risks that could lead to material financial loss for the institution unless the arrangement (1) appropriately balances risk and reward; (2) is compatible with effective risk management and controls; and (3) is supported by effective governance. "Excessive" means amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into consideration all relevant factors such as: 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; the financial condition of the institution; etc.		
Performance measures	Must appropriately balance risk and reward.		
Risk management and controls	The Board of Directors must conduct oversight, approve incentive-based compensation arrangements for senior executive officers and approve material exceptions or adjustments to incentive-based compensation for senior executive officers.		
Deferral requirement for qualifying incentive-based compensation awards:	Yes	Yes	No
Minimum deferral amount	<u>Senior executive officers</u>: at least 60% <u>Significant risk takers</u>: at least 50%	<u>Senior executive officers</u>: at least 50% <u>Significant risk takers</u>: at least 40%	N/A
Minimum deferral period	At least 4 years (or at least 2 years for incentive-based compensation awarded under a long-term incentive plan[2])	At least 3 years (or at least 1 year for incentive-based compensation awarded under a long-term incentive plan)	N/A

[1] Covered person means any executive officer, employee, or director who receives incentive-based compensation.
[2] "Long-term incentive plan" is defined as a plan that is based on a performance period of at least 3 years.

Vesting during deferral period	<u>Pro rata</u>: 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 which the amounts were awarded. <u>Acceleration</u>: no acceleration of vesting except in the case of (1) death or disability of the covered person; or (2) the payment of income taxes that become due on deferred amounts before the covered person is vested in the deferred amount. Any accelerated vesting must be deducted from the scheduled deferred amounts proportionally to the deferral schedule.		N/A
Adjustments of deferred qualifying incentive-based compensation and deferred long-term incentive plan compensation amounts	Not allowed.	Not allowed.	N/A
Forfeiture requirements?	Yes, must place at risk of forfeiture all unvested deferred incentive-based compensation of any senior executive officer or significant risk-taker, including unvested deferred amounts awarded under long-term incentive plans.		No
Downward adjustment requirements?	Yes, must place at risk of downward adjustment all of a senior executive officer's or significant risk-taker's incentive-based compensation amounts not yet awarded for the current performance period, including amounts payable under long-term incentive plans.		No
Forfeiture and downward adjustment triggering event:	Must consider forfeiture and downward adjustment due to any of the following adverse outcomes at the institution: (i) poor financial performance attributable to a significant deviation from the institution's policy risk parameters; (ii) inappropriate risk taking, regardless of financial performance; (iii) material risk management or control failures; (iv) non-compliance with statutory, regulatory, or supervisory standards that results in enforcement or legal action by a federal or state regulator or agency or a requirement that the institution report a restatement of a financial statement to correct a material error; and (v) other aspects of conduct or poor performance.		N/A

Determining forfeiture or downward adjustment amounts:	At a minimum, must consider the following factors: (i) intent of the senior executive officer or significant risk-taker to operate outside the risk governance framework approved by the Board of Directors or to depart from the institution's policies and procedures; (ii) the senior executive officer's or significant risk-taker's level of participation in, awareness of, and responsibility for, the events triggering the forfeiture and downward adjustment review; (iii) any actions the senior executive officer or significant risk-taker took or could have taken to prevent the events triggering the forfeiture and downward adjustment review; (iv) the financial and reputational impact of the events triggering the forfeiture and downward adjustment review including the magnitude of any financial loss and the cost of known or potential subsequent fines, settlements, and litigation; (v) the causes of the events triggering the forfeiture and downward adjustment review including any decision-making by other individuals; and (vi) any other relevant information, including past behavior and past risk outcomes attributable to the senior executive officer or significant risk-taker.	N/A
Clawback requirements?	Yes, must include clawback provisions in incentive-based compensation arrangements for senior executive officers and significant risk-takers that, at a minimum, allow the institution to recover incentive-based compensation from a current or former senior executive officer or significant risk-taker for seven years following the date on which such compensation vests, if the institution determines that the senior executive officer or significant risk-taker engaged in: (i) misconduct that resulted in significant financial or reputational harm to the institution; (ii) fraud; or (iii) intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation.	No
Hedging prohibitions?	Yes, must not purchase a hedging instrument or similar instrument on behalf of a covered person to hedge or offset any decrease in the value of the covered person's incentive-based compensation.	No

Maximum incentive-based compensation requirement?	Yes, must not award a senior executive officer in excess of 125% of the target amount for that incentive-based compensation; or a significant risk-taker in excess of 150% of the target amount for that incentive-based compensation.	No
Performance measure requirements?	Yes, incentive-based compensation cannot be based (1) solely on industry peer performance comparisons; or (2) solely on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management.	No
Risk management control requirements?	Yes, must employ a risk framework for incentive-based compensation that: (1) is independent of any lines of business; (2) includes an independent compliance program that provides for internal controls, testing, monitoring, and training with written policies and procedures; and (3) is commensurate with the size and complexity of the institution's operations.	Risk management control requirements?
Policy and procedure requirements?	Yes, must develop and implement policies and procedures that: (1) are consistent with the requirements of this rule; (2) specify the substantive and procedural criteria for the application of forfeiture and clawback, including the process for determining the amount of incentive-based compensation to be clawed back; (3) require that the institution maintain documentation of final forfeiture, downward adjustment, and clawback decisions; (4) specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person; (5) identify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions, including when discretion is authorized; (6) describe how discretion is expected to be exercised to appropriately balance risk and reward; (7) require that the institution maintain documentation of the establishment, implementation, modification, and monitoring of incentive-based compensation arrangements, sufficient to support the institution's decisions; (8) describe how incentive-based compensation arrangements will be monitored; (9) specify the substantive and procedural requirements of the independent compliance program; and (10) ensure appropriate roles for risk management, risk oversight, and other control.	No

	function personnel in the institution's processes for designing incentive-based compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback and vesting, and assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.	
Governance requirements?	Yes, must establish a compensation committee composed solely of directors who are not senior executive officers to assist the Board of Directors in carrying out its responsibilities. The compensation committee must obtain: (1) input from the risk and audit committees of the Board of Directors, or groups performing similar functions, and risk management function on the effectiveness of risk measures and adjustments used to balance risk and reward in incentive-based compensation arrangements; (2) a written assessment of the effectiveness of the institution's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the risk profile of the institution, submitted on an annual or more frequent basis by management and developed with input from the risk and audit committees of its Board of Directors, or groups performing similar functions, and from the institution's risk management and audit functions; and (3) an independent written assessment of the effectiveness of the institution's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the institution's risk profile, submitted on an annual or more frequent basis by the internal audit or risk management function of the institution, developed independently of management.	No
General recordkeeping	Must create annually and maintain for a period of at least seven years records that document the structure of all its incentive-based compensation arrangements.	
Additional disclosure and record keeping	Annually create and maintain documentation for seven years: - List of senior executive officers and significant risk-takers by job function, organizational hierarchy and line of business;	None. However, the applicable federal regulator may require a Level 3 with average total consolidated assets greater than or equal to $10 billion and less than $50 billion to comply with some or all of the Level 1 and Level 2 record-keeping provisions if it is determined that 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; - Any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and - Any material changes to incentive-based compensation arrangements and policies.	Level 3's complexity of operations or compensation practices are consistent with those of a Level 1 or Level 2. Factors considered in making this determination include the activities, complexity of operations, risk profile, and compensation practices of the Level 3, in addition to any other relevant factors.
Compliance date	Within 540 days after the date that the institution qualifies as a Level 1. Will continue to be a Level 1 until average total assets drops below $250 billion for four consecutive quarters.	

The deadline for submitting comments is July 22, 2016.

Authors

Oliver Ireland
(202) 778-1614
oireland@mofo.com

Anna Pinedo
(212) 468-8179
apinedo@mofo.com

Ze'-ev Eiger
(212) 468-8222
zeiger@mofo.com

Alexandra Perry
(212) 336-4261
aperry@mofo.com