Client Update

Compensation Practices at Financial Institutions Targeted: Proposed Incentive Compensation Rules Aim to Curb Excessive Risk-Taking

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Last week, the National Credit Union Administration ("NCUA") released revised proposed rules to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Section 956 of the Dodd-Frank Act required the NCUA, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and other U.S. federal financial regulators to issue regulations that restrict certain incentive compensation practices at banks, broker-dealers, investment advisers and other covered financial institutions ("CFIs"). The new rules aim to prohibit CFIs from providing incentive compensation arrangements that encourage "inappropriate" risk-taking (1) by providing "excessive" compensation or (2) that could lead to material financial loss.

The NCUA's proposed rules provide a preview of the rules that other federal financial regulators are expected to propose in the coming weeks for the institutions they regulate. The proposed rules differ significantly from the prior proposal issued in 2011.

If adopted as proposed, the rules would require a significant overhaul of both the design and implementation of bonus and long-term incentive compensation programs at CFIs. Perhaps in recognition of these implementation issues, the proposal contemplates a fairly lengthy transition period and a significant "grandfathering" provision. Final rules will become effective on the first day of the first calendar quarter that begins at least 540 days after a final rule is published, and plans with a performance period that begin prior to effectiveness will not be covered.

HIGHLIGHTS OF THE PROPOSED RULES

Highlights of the proposed rules include, as discussed in greater detail below:

- a new tiered framework that tailors prohibitions to the size of a CFI (using $1 billion, $50 billion and $250 billion consolidated asset thresholds), with more stringent requirements applying to the largest CFIs;
- for CFIs with $50 billion or more in assets (*i.e.*, Level 1 and Level 2 CFIs, as discussed below):
  - broadened applicability of incentive compensation restrictions to a larger group of senior officers and "significant risk-takers" at a CFI, with the categorization of a person as a risk-taker based on whether the person is among the firm's most highly compensated nonexecutive employees or the percentage of the firm's capital the person can commit or expose to risk;
  - requirements to defer payment of 40-60% both short and long-term incentive compensation for 3-4 years *after* the end of the relevant incentive performance period (or 1-2 years for compensation with performance periods of 3 years or more), and to subject that pay to possible forfeiture;
  - prohibitions on accelerated vesting of deferred awards;
  - a new seven-year post-vesting clawback on incentive compensation; and
  - a host of other new provisions, including minimum performance vesting requirements, caps on incentive compensation performance payouts, limitations on the use of certain performance measures and prohibitions on hedging;
- a new requirement to take into account both financial and nonfinancial risk-based measures in determining incentive-based compensation for all employees;
- new recordkeeping and disclosure requirements, as well as corporate governance procedures; and
- reduced reporting obligations as compared to the 2011 proposal.

A WIDE RANGE OF FINANCIAL INSTITUTIONS ARE COVERED

The proposed rules regulate incentive compensation practices at a wide array of CFIs that have average total consolidated assets greater than or equal to $1 billion. CFIs under the Dodd-Frank Act and the proposed rules include

depository institutions, depository institution holding companies, broker-dealers, credit unions and investment advisers.

The proposed rules expand the Dodd-Frank Act definition of CFIs to include state-licensed uninsured branches and agencies of non-U.S. banks, Edge and Agreement Corporations, other U.S. operations of non-U.S. banking organizations that are treated as bank holding companies, such as intermediate holding companies and their subsidiaries, and state-chartered non-depository member trust companies. The proposed rules also update the definition of CFIs in the 2011 proposal to specifically add subsidiaries of national banks, federal savings associations, and federal branches or agencies of foreign banks. Insurance companies would not be affected by the new rules, although their regulated subsidiaries would be subject to the rules.

The proposed rules apply to covered investment advisers, whether or not they are registered under the Investment Advisers Act of 1940 (the "Advisers Act"), and as a result will apply to "exempt reporting advisers" and other international firms (including those based outside of the United States) operating under Advisers Act various exemptions.

The proposal includes an anti-evasion provision that limits the ability of a CFI to dual-hat an employee at a CFI and an affiliated or unaffiliated non-CFI for purposes of paying incentive compensation outside the CFI and outside the reach of the rule.

INCENTIVE COMPENSATION IS BROADLY DEFINED

The proposed rules define "incentive compensation" as any variable compensation, fees or benefits that serve as an incentive or reward for performance. Incentive compensation includes compensation earned under an incentive plan, annual bonuses and discretionary awards. Payments exclusively for reasons other than to induce performance (such as salary and retention awards) are intended to be excluded from the rules. Dividends and appreciation on owned (*i.e.*, vested) equity interests are also excluded.

The proposed rules contemplate a life cycle for incentive compensation awards that does not neatly align with typical compensation practices of many industries covered by the rules. For all incentive-based compensation, the rules envision a performance period prior to the making of an award, which for the large institutions subject to the rules, would then be followed by a deferral period prior to vesting and payout. It is not entirely clear how the new requirements

would apply to certain types of awards that do not fit this incentive compensation paradigm, such as carried interest arrangements of a private fund.

CFIS ARE REGULATED BASED ON THEIR TOTAL CONSOLIDATED ASSETS

The proposed rules categorize CFIs into three groups, based on the total consolidated assets of the CFI, with more exacting standards applicable only to the larger institutions. The three tiers are as follows: *Level 1*, CFIs with total consolidated assets greater than or equal to $250 billion; *Level 2*, CFIs with total consolidated assets greater than or equal to $50 billion and less than $250 billion; *Level 3*, CFIs with total consolidated assets of greater than or equal to $1 billion and less than $50 billion. The proposed rules would not apply to institutions with less than $1 billion in assets (even if part of a larger consolidated group). The asset level tier of a subsidiary of a depository institution holding company would be based on the average total consolidated assets of the top-tier depository institution holding company, but whether the subsidiary had at least $1 billion is based on the subsidiary's average total consolidated assets (it is not clear from the proposal whether the U.S. branches of foreign banks would be considered "subsidiaries" of their holding companies for these purposes). The SEC's regulatory regime for broker-dealers and investment advisors would generally apply the rules on an entity-by-entity basis. The Level 1 and Level 2 asset tiers are in line with comparable tiers in other rules that apply to financial institutions such as the Volcker Rule, Liquidity Coverage Ratio and Supplemental Leverage Ratio and Single Counterparty Credit Limits. However, Level 3 is a much lower asset tier than the corresponding $10 billion threshold used in other contexts.

Notwithstanding the above, the proposed rules permit an agency to treat a CFI with at least $10 billion in total consolidated assets as a higher level institution with respect to some or all of the applicable rules if the CFI's complexity of operations or compensation practices are consistent with those of a Level 1 or 2 entity.

DETERMINATION OF TOTAL CONSOLIDATED ASSETS

Under the proposed rules, average total consolidated assets would be the average of the total consolidated assets reported on the CFI's regulatory reports for the four most recent consecutive quarters.

For investment advisers, however, the proposed rules clarify that non-proprietary assets (such as client assets under management) are not included in this determination. This means that private fund assets and other assets under management will not be counted in determining the investment adviser's

average total consolidated assets, even if they otherwise are consolidated into the investment adviser's balance sheet.

DEFERRAL, CLAWBACK AND OTHER RESTRICTIONS ON LEVEL 1 AND LEVEL 2 CFIS

The new rules introduce longer deferral periods, as well as a bevy of new exacting requirements for Level 1 and Level 2 CFIs to allow firms to downwardly adjust compensation should failings in risk management or financial problems emerge over time.

- *Deferral Requirements*. A Level 1 CFI must defer at least 60% of a senior executive officer's and 50% of a significant risk-taker's incentive compensation awarded for each performance period for at least *four* years for shorter-term incentive compensation or *two* years for long-term incentive plan amounts. (A long-term incentive plan must be based on a performance period of at least three years.) A Level 2 CFI must defer at least 50% of a senior executive officer's and 40% of a significant risk-taker's incentive compensation awarded for each performance period for at least *three* years or one year for long-term incentive plan amounts. As was the case in the 2011 proposed rules, deferred qualifying incentive compensation may not vest faster than on a pro rata annual basis, with a minimum vesting period of one year.
- *Mechanism for Deferral*. "Substantial" portions of deferred incentive-based compensation must be paid in the form of both equity-like instruments (unless the institution does not have equity-based compensation) and deferred cash. Substantial is not defined in the proposed rules and is left to CFI discretion. The returns on the deferral are meant to be modest, tied only to normal interest rates or return on the CFI's equity. The proposed rule also limits the amount of options that can be counted in meeting the minimum deferral requirements following a performance period to a maximum of *15%* of the aggregate amount of incentive compensation awarded for that performance period, but does not limit the use of options.
- *Downward Adjustments and Forfeiture*. All incentive compensation amounts not yet awarded to senior executive officers and significant risk-takers for a performance period must be at risk of *downward adjustment*, and all deferred incentive compensation must be subject to *forfeiture* prior to payout, in each case, upon certain triggering events. These events include: (1) poor financial performance attributable to a significant deviation from the risk parameters set forth in policies and procedures; (2) inappropriate risk-taking, regardless of financial impact; (3) material risk management or control failures; and

(4) noncompliance with statutory, regulatory or supervisory standards that results in enforcement or legal action by a Federal or state regulator or agency or a requirement to report a restatement of a financial statement to correct a material error. The proposed rules also set forth factors for identifying which senior executive officers and significant risk-takers would be subject to forfeiture and downward adjustment as a result of the triggering events listed above.

- *Prohibition on Acceleration*. The proposed rules generally prohibit the accelerated vesting of deferred incentive compensation except in cases of death or disability. Level 1 and Level 2 CFIs will no longer be permitted to accelerate vesting on customary triggering events, such as involuntary terminations or upon a change in control, even where the CFI no longer exists following the transaction.

- *Seven-Year Clawback*. The proposed rules require a Level 1 or Level 2 CFI to implement clawback provisions that allow for the recovery of incentive compensation from a current or former senior executive officer or significant risk-taker for *seven* years following the date on which the compensation vests if a determination is made that the individual engaged in (1) misconduct that resulted in significant financial or reputational harm to the institution, (2) fraud, or (3) intentional misrepresentation of information used to determine their incentive compensation.

- *Performance Adjustment Caps*. The rules do not cap incentive compensation or target compensation. Incentive compensation cannot, however, be awarded to a senior executive officer in excess of *125% of target*, or to a significant risk-taker in excess of *150% of target*. The rule does not allow for the Level 1 or Level 2 CFI or its board or compensation committee to exercise discretion to increase an award above these caps, even in cases of extraordinary performance.

- *Restrictions on Performance Measures*. Performance measures based solely on industry peer performance comparisons (*e.g.*, relative Total Shareholder Return) are prohibited. Further, the proposed rules do not allow incentive compensation to be based solely on transaction revenue or volume without regard to transaction quality or compliance with sound risk management. These prohibitions apply to all covered persons, and not just senior executive officers or significant risk-takers.

- *Prohibition on Hedging*. CFIs are prohibited from purchasing a hedging instrument or similar instrument on behalf of *any* covered person to hedge or offset any decrease in the value of the covered person's incentive compensation.

PROHIBITIONS APPLICABLE TO ALL CFIS

The proposed rules prohibit incentive compensation arrangements at all CFIs that encourage inappropriate risks (1) by providing covered persons with excessive compensation or (2) that could lead to material financial loss. The general framework for determining when incentive compensation is "excessive," and when incentive compensation arrangements encourage "inappropriate" risks that could lead to material financial loss, remain largely unchanged from the 2011 proposed rules.

- *Prohibition on Excessive Compensation*. For all CFIs, compensation is considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by the covered person, taking into account all relevant factors. The proposed factors in this determination are virtually identical to those set forth in the 2011 proposed rules, which include: (1) the combined value of all compensation, fees or benefits provided; (2) the compensation history of the covered person and other individuals with comparable expertise at the CFI; (3) the financial condition of the CFI: (4) compensation practices at comparable institutions (based on factors like asset size, location and complexity of operations/assets); (5) for postemployment benefits, the projected total cost and benefit to the CFI; and (6) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the CFI. The new rules clarify that this list is not meant to be exclusive and other relevant factors may be taken into account.
- *Prohibition on Compensation That Could Lead to Material Financial Loss*. Incentive compensation at all CFIs must (1) appropriately balance risk and reward; (2) be compatible with effective risk management and controls; and (3) be supported by effective governance. For all covered persons (*i.e.*, all employees, not just senior executives or significant risk-takers) of all CFIs, an incentive compensation arrangement is only considered to appropriately balance risk and reward if the following newly proposed criteria are met:
  - <u>The arrangement must include both financial and nonfinancial measures of performance</u>. In order to comply with the proposed rules, financial measures alone cannot be the basis for determining incentive compensation; nonfinancial measures of risk-taking activity must be taken into account. Nonfinancial measures include considerations of risk-taking that are relevant to a covered person's role and to the CFI's business and can include assessments of a covered person's risk-taking or compliance with limits.

- The arrangement must be designed to allow nonfinancial measures to override financial measures when appropriate in determining incentive compensation. Any violation of risk performance measures means that the covered person should not be eligible to receive the full target amount of incentive compensation under the proposed rules.
- Any amounts to be awarded would be subject to downward adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and nonfinancial performance. A reduction in the value of equity is not considered a downward adjustment. The number of shares awarded would have to be reduced.

Level 1 and Level 2 CFIs are also required to comply with the deferral, clawback, forfeiture and other limitations set forth above in order to appropriately balance risk and reward under the rules.

MORE PERSONS RECEIVING INCENTIVE COMPENSATION ARE COVERED

A "covered person" under the proposed rules continues to mean any of the CFI's executive officers, employees, directors or principal shareholders (*i.e.*, 10% owners). However, the newly proposed rules expand the pool of employees at Level 1 and Level 2 institutions to whom the more stringent requirements apply.

- *Senior Executive Officers*. The list of senior executive officer positions covered by the rules is broader than that in the 2011 proposed rules and now includes heads of compliance, audit and other control functions. A "senior executive officer" now means a covered person who holds the title or performs the functions of president, CEO, executive chairman, the chief operating, financial, investment, legal, lending, risk, compliance, audit, credit and accounting officers, and any head of a major business line or control function.
- *Significant Risk-Takers*. "Significant risk-takers" at Level 1 and Level 2 firms are subject to the more stringent rules governing incentive compensation. In revisiting the somewhat unclear "material risk-taker" provision in the 2011 proposed rule, the current proposal expands the definition to apply to a larger cross-section of employees. A significant risk-taker at a Level 1 or 2 firm is identified through either one of two tests: The so-called "compensation test" considers whether the employee is among the top 5% (for Level 1 CFIs) or top 2% (for Level 2 CFIs) of the highest compensated covered persons in the consolidated organization, including affiliated CFIs. The alternative "exposure test" looks to whether an employee has the authority to commit or expose 0.5% or more of the capital of the CFIs or an affiliate that is itself a CFI, even if the employee is employed by an affiliate of

the CFI that is not itself a CFI. A covered employee is a significant risk-taker only if he or she received annual base salary and incentive compensation of which at least one-third is incentive compensation, as calculated for the relevant period.

DISCLOSURE AND RECORDKEEPING REQUIREMENTS

The proposed rules thankfully omit the annual reporting requirements of the 2011 proposal but do impose certain disclosure and significant documentation and recordkeeping requirements for all CFIs. Among other items, the proposed rules require the annual creation of records that document the structure of incentive compensation arrangements and their compliance with the proposed rules. These records must be disclosed to the applicable regulator upon request. However, there is no requirement to report the actual amount of individuals' compensation, fees or benefits.

CORPORATE GOVERNANCE REQUIREMENTS

The proposal includes a requirement that the board of directors or a committee of the board of *all* CFIs (1) conduct oversight of the incentive programs; (2) approve incentive arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and (3) approve any material exceptions or adjustments to incentive compensation policies or arrangements for senior executive officers. Although many boards and compensation committees already perform these duties, the proposed rules may require more touchpoints with the compensation committee during the life cycle of an award, for example, at a meeting at the time of vesting to assess forfeitures and approve payouts, and may require smaller, private CFIs to set up a board-level oversight function.

Compensation committees of Level 1 and 2 CFIs must be comprised solely of directors who are not senior executive officers. Further, these committees must be provided at least annually with additional information and reports regarding the effectiveness of risk measures and adjustments, including a written risk assessment from management and separate reports from the internal audit or risk management functions.

POLICIES AND PROCEDURES

The proposed rules require Level 1 and Level 2 CFIs to develop and implement a minimum level of policies and procedures that govern incentive compensation practices. Level 3 CFIs are not held to this requirement. Many of the prohibitions discussed above would need to be operationalized through policies

and procedures, a process that would require a great deal of detailed analysis, planning and thought, particularly as it relates to determination of significant risk-takers, vesting and the application of forfeiture and clawbacks. Level 1 and Level 2 CFI policies and procedures would also be required to memorialize each step of the process. Criteria for bonuses would become increasingly important and would need to be spelled out for each senior executive and significant risk-taker. Given the limitations on volume-driven performance measures, feedback programs such as 360 reviews would perhaps become more prevalent as a way of providing a crowd-sourced procedure for performance decisions. Policies and procedures would also need to be put in place to define the role of risk management personnel in the CFI's incentive compensation design processes and in assessing the effectiveness of restraints on inappropriate risk-taking.

As was the case in the 2011 proposed rules, the current proposed rules prohibit CFIs from evading restrictions by doing anything indirectly that they would be prohibited from doing directly.

WHAT'S NEXT?

The proposed rules were approved by the NCUA at its meeting on April 21, 2016, but must be approved by each of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the Office of Thrift Supervision, the Federal Housing Finance Agency and the SEC before the proposed rule is published in the Federal Register. Each of the Agencies is expected to vote on the rules in the coming weeks. The comment period ends July 22, 2016.

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Please do not hesitate to contact us with any questions.