Pearl Meyer

CLIENT ALERT

Dodd-Frank Section 956 Redux: Incentive Compensation at Financial Institutions Subject to Yet Another Set of Proposed Rules

Five years and more than 10,000 comments after the initial proposal in 2011, Federal agencies have issued another round of proposed rules for regulating the use of incentive-based compensation arrangements (ICAs) at certain financial institutions with consolidated assets of at least $1 billion (covered institutions). In some respects the most recent proposal reiterates concepts from the initial proposal, but there are significant modifications as well.

Themes Retained from the 2011 Proposal

- **Prohibition of ICAs that encourage inappropriate risk by**
  - Providing excessive compensation; or
  - Creating a potential for material financial loss.
- **Special rules for institutions with assets greater than $50 billion**
  - Mandatory deferral of a substantial portion of ICAs to certain employees;
  - Enhanced internal review and approval of ICAs; and
  - Rigorous policies and procedures required for ICAs.
- **Alignment with principals in the interagency "Guidance on Sound Incentive Compensation Policies" issued by banking agencies in 2010 ("SICP Guidance").**[1]

[1] See https://www.gpo.gov/fdsys/pkg/FR-2010-06-25/pdf/2010-15435.pdf

Key Changes from the 2011 Proposal

- **Introduction of performance measure and payout adjustment requirements for all covered institutions**
  - Must be a mix of financial and non-financial measures (i.e., cannot be 100% financial);
  - Requirement that non-financial measures emphasize risk-related aspects and have the ability to override financial measures; and
  - ICAs must be subject to downward adjustment under certain circumstances.

- **Shift from required annual reporting to documentation and recordkeeping**
  - Documentation demonstrating compliance with the rule must be developed annually and retained for at least seven years, available for inspection upon request of the appropriate agency.

- **More prescriptive and rigorous rules for institutions with assets greater than $50 billion**
  - Caps on maximum ICA payouts as a percentage of target opportunity;
  - Required "downward adjustment" and "forfeiture" provisions during performance period or deferral period;
  - Seven-year clawback requirement post-vesting;
  - Prohibition of ICAs based solely on either relative performance comparisons, or transaction revenue, or volume that disregards transaction quality or compliance with risk management;
  - Prohibition of hedging arrangements to protect executives from decreases in the value of their ICAs; and
  - Increased governance, controls, and recordkeeping requirements.

- **Further distinction between institutions with $50-$250 billion in assets and those over $250 billion**
  - Definition of "significant risk-taker"; and
  - Level and length of mandatory deferrals.

Overview

Section 956 of the Dodd-Frank Act requires specified Federal financial regulatory agencies to act jointly to prohibit certain ICAs in covered financial institutions with $1 billion or more in assets. The agencies must determine which ICAs encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. An initial set of proposed rules was issued in 2011, but that proposal is replaced with the recent proposal. As of the date of this publication, five of the six specified separate agencies have voted to approve the new proposed rules.[2] The U.S. Securities and Exchange Commission (SEC) is expected to follow suit in the near future. This overview summarizes the Federal Deposit Insurance Corporation's (FDIC) proposal, but each agency may propose rules that are not identical.

Effective date

Importantly, the effective date is far from immediate. The compliance period is set to begin on the first day of the first calendar quarter beginning at least 18 months after publication of a final rule. The proposed rules only apply to ICAs with performance periods beginning after that date. For example, if the final rule was published on December 31, 2016, the compliance period would begin with respect to ICAs with performance periods beginning on or after July 1, 2018 (i.e., for calendar year plans, the earliest year affected would be 2019). ICAs with performance periods already in progress on that date would be grandfathered.

> ***Pearl Meyer Observation:*** While 2019 is likely to be the first year for which the proposed rules will be in effect for most institutions, we anticipate that most covered institutions will begin to take inventory of ICA design, administration, and governance-related procedures in the imminent future, particularly those that have not already been under scrutiny.

Institutions covered

The proposed rule covers institutions with total consolidated assets of $1 billion or more that fall under the jurisdiction of one of the following agencies:

- **Federal Reserve Bank (FRB):** State member banks, bank holding companies, savings and loan holding companies, Edge and Agreement corporations, state-licensed uninsured branches, and agencies of foreign banks, as well as the U.S. operations of foreign banks

- **Federal Deposit Insurance Corporation (FDIC):** State non-member banks, state savings associations, and state insured U.S. branches of foreign banks

- **Federal Housing Finance Agency (FHFA):** Fannie Mae, Freddie Mac, and the Federal Home Loan Banks

- **National Credit Union Administration (NCUA)**: Insured credit unions and credit unions eligible to apply to become an insured credit union

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[2] See FRB Proposal at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160502a2.pdf; FDIC Proposal at https://www.fdic.gov/news/board/2016/2016-04-26_notice_dis_a_fr.pdf; NCUA Proposal at https://www.ncua.gov/About/Documents/Agenda%20Items/AG20160421Item2b.pdf; FHFA Proposal at https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/Incentive-Based%20Compensation%20NPR_4-26-16.pdf; and OCC Proposal at http://www.occ.gov/news-issuances/news-releases/2016/nr-occ-2016-49a.pdf

- **Office of the Comptroller of the Currency (OCC):** National banks, federal savings associations, and federal branches or agencies of foreign banks
- **Securities and Exchange Commission (SEC):** Registered broker-dealers and all investment advisers

Tiers of institutions and individuals with special rules

The proposed rule would establish a three-tiered system for covered financial institutions:

Level 1: $250 billion or greater in average total consolidated assets
Level 2: $50 billion up to $250 billion in average total consolidated assets
Level 3: $1 billion up to $50 billion in average total consolidated assets

For the purpose of determining the tier of a covered institution, subsidiaries would be subject to the requirements applicable to the top-tier holding company. "Average total consolidated assets" means the average of total consolidated assets, as reported on the top-tier company's regulatory reports, for the four most recent consecutive quarters (or assets as of the most recent reported quarter if four consecutive quarters are not available).

It is important to note that despite the clear definition of each level, each respective agency reserves the authority to treat a Level 3 institution with assets greater than or equal to $10 billion as though it is a Level 1 or Level 2 institution for some or all of the proposed rules if it believes the complexity of operations or compensation practices of the Level 3 institution are consistent with a Level 1 or Level 2 institution.

> ***Pearl Meyer Observation:*** The discretionary authority retained by each agency to apply the more stringent rules to smaller institutions is likely to result in "regulatory creep" whereby these institutions are held to higher standards. More generally, we also anticipate that the bar will be raised for all banking institutions. In our experience, regulators have expected banks, including those not covered, to adopt administrative and governance practices that address the spirit of the rulemaking commensurate with the institution's size.

There are also different standards for different types of individuals:

- **Covered person:** any executive officer, employee, director, or principal shareholder who receives ICA at a covered institution.
- **Senior executive officer (SEO):** 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 (SRT):** any covered person at a Level 1 or Level 2 covered institution who
  - Receives at least one-third of total compensation in incentive-based compensation and is (1) in the highest five percent (Level 1 covered institutions) or two percent (Level 2 covered institutions) of all covered persons (calculated based on salary and incentive-based compensation and excluding SEOs), or (2) may commit or expose 0.5 percent or more of the common equity tier 1 capital (or other definition of capital, depending on type of covered institution) of the institution; or
  - Is specifically designated as a "significant risk-taker" by the relevant agency.

General requirements for all covered institutions

Rules that are applicable to all covered institutions regardless of tier resemble those set forth in the SICP Guidance. In general, institutions must:

- Prohibit ICAs that encourage inappropriate risks by providing "excessive compensation";

- Prohibit ICAs that encourage inappropriate risks that could lead to a "material financial loss";

- Establish requirements for performance measures to appropriately balance risk and reward;

- Create and retain records for all new ICAs, demonstrating compliance with the rules, for a minimum of **seven** years (note this is a change from the original proposed rules, which would have required annual reports to be submitted to the applicable agency), including but not limited to:
  - Copies of all incentive-based compensation plans,
  - Record of who is subject to each plan,
  - Description of how the overall incentive-based program is compatible with effective risk management and controls;

- Disclose the records to the appropriate agency upon request; and

- Have their boards or committees conduct oversight of the overall incentive-based compensation program, review and approve all ICAs for SEOs, and approve any material exceptions or adjustments to ICAs or related policies for SEOs.

Pearl Meyer Observation: Financial institutions with the least rigorous demands under the proposed rule may also be the least equipped for its implications. For example, Level 1 and Level 2 banking organizations have generally been adapting to these requirements informally over the past several years as their primary regulators have increased scrutiny and advocated reforms to their ICAs. However, smaller Level 3 banking organizations and those institutions not previously subject to the SICP Guidance (e.g., credit unions) generally have not been under the same level of scrutiny. These institutions may require substantial changes to their governance and administrative practices to fully comply with the proposed rule.

Definitions of "excessive compensation" and "lead to a material financial loss"

Compensation, fees, and benefits are considered **"excessive"** when 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:

- 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 financial condition of the covered institution;
- Compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the covered institution's operations and assets;
- For post-employment benefits, the projected total cost and benefit to the covered institution; and
- 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 covered institution.

An incentive-based compensation arrangement at a covered institution is deemed to encourage inappropriate risks that could **"lead to a 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.

Performance measure requirements for all covered institutions

ICAs at all covered institutions must (1) include both financial and non-financial measures of performance weighted to reflect risk-taking, (2) allow non-financial measures of performance to override financial measures if appropriate, and (3) be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.

Additional requirements for Level 1 and Level 2 institutions

- **Performance measures:** Performance measures for ICAs at Level 1 and Level 2 institutions cannot solely be based on either relative performance comparisons, or transaction revenue or volume that disregards transaction quality or compliance with risk management.

- **Maximum permitted payout leverage:** Maximum ICA payout opportunity as a percentage of target would be subject to the following caps for Level 1 and Level 2 institutions (although there is no absolute limit on the size of the target).

	Level 1	Level 2	Level 3
Maximum Award	125% of target for SEO 150% of target for SRT	125% of target for SEO 150% of target for SRT	N/A

- **Hedging prohibition:** Level 1 and Level 2 institutions would be prohibited from purchasing hedging instruments on behalf of covered executives to protect them from decreases in the value of their ICAs.

- **Deferral requirements following the end of a performance period:** Deferrals of a certain percentage of total ICA for short-term incentives (STI), defined as less than a three-year performance period, and long-term incentives (LTI), defined as at least a three-year performance period, would be required at Level 1 and Level 2 institutions.

	Level 1	Level 2	Level 3
Minimum Amount	60% for SEO 50% for SRT	50% for SEO 40% for SRT	N/A
Minimum Time Following Performance Period	4 years for STI 2 years for LTI	3 years for STI 1 year for LTI	N/A

During the deferral period, ICAs would not be allowed to vest faster than pro-rata beginning on the first anniversary of the end of the performance period (other than for death and disability or where needed for payment of income taxes). Increases in the value of the deferral may only occur as a result of the change in share value, a change in interest rates, or the payment of interest according to terms set out at the time of the award.

For SEOs and SRTs at Level 1 or Level 2 institutions that issue equity, deferred amounts must include “substantial” portions of both cash and equity-like instruments throughout the deferral period. Additionally, if the SEO or SRT receives ICA payouts in the form of options, no more than 15 percent of the minimum deferral amount requirements can be satisfied by deferral of options for the respective performance period.

- **Required downward adjustments and forfeitures during performance or deferral period:** SEOs and SRTs at Level 1 and Level 2 institutions would be subject to downward adjustments and forfeitures. Downward adjustments may be made during the performance period or between the end of the performance period and before the performance is determined (the award date). Forfeitures may happen between the award date and the vesting date during the deferral period.

Downward adjustments and forfeitures occur upon a "triggering event," which may include: (1) poor financial performance attributable to a significant deviation from the institution's established risk parameters, (2) inappropriate risk-taking by a covered person, regardless of the impact on financial performance, (3) material risk management or control failures, (4) 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 restatement of a financial statement to correct a material error, and (5) other aspects of conduct or poor performance as defined by the covered institution. In determining the amount subject to adjustment or forfeiture, the institution must consider the SEO's or SRT's level of participation and responsibility for the triggering event.

- **Clawbacks after vest:** ICAs of SEOs and SRTs at Level 1 and Level 2 institutions would be subject to clawback for seven years following vesting. Clawback events include: (1) misconduct that resulted in significant financial or reputational harm to the covered institution, (2) fraud, and (3) intentional misrepresentation of information used to determine incentive-based compensation.

- **Risk management, controls, governance, and recordkeeping:** The proposed rules have more extensive requirements covering the risk management, governance, and recordkeeping for Level 1 and Level 2 covered institutions, including:
    - Establish a compensation committee composed solely of directors who are not SEOs;
    - Adopt detailed policies and procedures that, among other things, address forfeiture, downward adjustment, and clawback processes;
    - Have a risk management framework for incentive-based compensation programs that is independent of any lines of business and that includes an independent compliance program that provides for internal controls, testing, monitoring, and training;
    - Provide individuals in control functions (e.g., audit and risk management personnel) with appropriate authority to influence the risk-taking of the business areas they monitor and ensure covered persons engaged in control functions are compensated independently of the performance of the business areas they monitor;
    - Provide for independent monitoring of incentive-based compensation plans, events, and decisions related to forfeiture and downward adjustment, and compliance of the incentive-based compensation program with the covered institution's policies and procedures; and
    - Maintain documentation of (1) the covered institution's SEOs and SRTs, listed by legal entity, job function, organizational hierarchy, and line of business; (2) the ICAs for SEOs and SRTs; (3) any forfeiture and downward adjustment or clawback reviews and decisions for SEOs and SRTs; and (4) any material changes to the covered institution's ICAs and related policies.

Conclusions

The current revisions to the original 2011 proposed rules are far more substantial than what we have seen with most proposed rulemaking. Many constituencies weighed in—more than 10,000 comments concerning the 2011 proposal were received—and agencies have had more than five years of hands-on experience enforcing the SICP Guidance. These facts lead us to believe the final rule will closely resemble the current proposal.

Ironically, financial institutions with the least rigorous demands under the proposed rule may also be the least equipped for its implications. Larger banking organizations have generally been adapting to these requirements informally over the past several years as their primary regulators have increased scrutiny and advocated reforms to their current incentive programs. However, smaller Level 3 banking organizations and those institutions not previously subject to the SICP Guidance generally have not been under the same level of scrutiny. These institutions may require substantial changes to their governance and administrative practices to fully comply with the proposed rule. Overall, we anticipate that the bar will be raised for all banking institutions.

While 2019 is likely to be the first year for which the proposed rules will be in effect for most institutions, we believe most covered institutions will begin to take action now. Whether it means a few tweaks or a complete overhaul, taking inventory of ICA plan design, administration, and governance-related procedures is an important first step to successful compliance. Initial steps may include:

- Identifying SEOs and SRTs;
- Implementing or refining the risk review process to ensure that ICAs do not encourage inappropriate risks;
- Reviewing the design of ICAs to ensure compliance with plan payout leverage and performance metrics;
- Implementing or refining deferral procedures to comply with vesting, forfeiture, and downward adjustments;
- Refining governance policies and procedures including oversight and policies such as clawbacks and anti-hedging; and
- Developing recordkeeping practices consistent with the proposed rule.

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