CAPflash
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Incentive Compensation Arrangements Among Covered Financial Institutions: Section 956 of the Dodd-Frank Act

By **Rose Marie Orens, Eric Hosken** and **Kelly Malafis**

On April 21, 2016, the National Credit Union Administration (NCUA) issued joint proposed rules governing incentive compensation arrangements for the following agencies: Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corp. (FDIC), Federal Housing Finance Agency (FHFA), NCUA, and the U.S. Securities and Exchange Commission (SEC). The joint proposed rule is a revision to the proposed rule the agencies released five years ago on April 14, 2011 and is intended to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The new proposed rules are 279 pages long and have moved from the principles based guidance of the 2011 proposed rules to a more prescriptive approach that lays out specific incentive compensation practices that covered institutions are expected to comply with and explicitly prohibits certain practices. The agencies are soliciting comments between now and July 22, 2016. Covered financial companies are expected to comply with the proposed rule in the first calendar quarter that begins 540 days (18 months) after the final rule is published in the Federal Register. It will not apply to any incentive-based compensation plan with a performance period that begins before the compliance date.

Given the length of the proposal document, we will focus on summarizing the key provisions and provide some initial thoughts on its implications. It should be noted that much of what is in the new proposal builds on practices that many banks have already adopted as they have responded to regulatory input over the past five years. We will provide more comprehensive feedback as we develop a comment letter on the proposed rule.

> Proposed rules are more prescriptive and focus on larger and longer deferrals, downward adjustments, forfeitures, and clawbacks and also explicitly prohibit certain practices.

REQUIREMENTS AND PROHIBITIONS APPLICABLE TO ALL COVERED INSTITUTIONS

The new proposed rule is similar to the 2011 proposed rule in that it maintains the restrictions against establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk taking and by providing covered persons with excessive compensation, fees or benefits that could lead to material financial loss to the covered institution. A covered institution is one with at least $1 billion in assets.

The following provisions are consistent with the 2011 proposed rule:

- **Excessive Compensation:** Compensation, fees and benefits will be viewed as excessive when amounts paid are unreasonable or disproportionate to the

services provided by a covered person, considering all factors, including:

  - Combined value of all compensation, fees and benefits to a 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 at comparable institutions (specific criteria described in the proposal);
  - For post-employment benefits, the potential cost and benefit to the covered institution;
  - 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.

- **Risk Balancing:** An incentive-based compensation arrangement will be considered to encourage inappropriate risks that could lead to material financial loss to the covered institution, unless the arrangement:
  - Appropriately balances risk and reward;
  - Is compatible with effective risk management and controls; and
  - Is supported by effective governance.

Key Addition: What is new in the proposed rule is that an incentive-based compensation arrangement would not be considered to appropriately balance risk and reward unless it:

- Includes financial and non-financial measures of performance;
- Is designed to let non-financial measures of performance override financial measures of performance, when appropriate; and
- Is subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.

Board Oversight: Also, similar to the 2011 proposed rule, the new proposed rule requires that the Board of Directors:

- Conduct oversight of the covered institution's incentive –based compensation program;
- Approve incentive-based compensation arrangements for senior executive officers, including amounts of awards, and at the time of vesting, payouts under such arrangements; and
- Approve material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

COVERED INSTITUTION CATEGORIES

The proposed rules segment covered institutions into three main categories:

- **Level 1:** Greater than $250 billion assets
- **Level 2:** Greater than $50 billion assets, less than $250 billion assets
- **Level 3:** Greater than $1 billion assets less than $50 billion assets

The requirements of the proposed rule vary by type of institution with the more prescriptive aspects of the rule having the most impact on Level 1 and Level 2 covered institutions which due to their size and complexity are viewed as the most likely organizations to contribute to systemic risk. It should be noted that the Agencies have reserved the authority to require certain Level 3 institutions with assets between $10 billion and $50 billion to comply with the more rigorous requirements applicable to Level 1 and Level 2 organizations if they find that the complexity of operations or compensation practices are comparable to those of a Level 1 or Level 2 covered institution.

RISK MANAGEMENT AND CONTROLS

The risk management and controls required under the proposed rules are more extensive than prior guidance. Level 1 and Level 2 institutions would be required to have a risk management framework in place for their incentive based compensation programs that is independent of any lines of business and includes an independent compliance program to provide controls, testing, monitoring and training of the institution's policies and procedures. In addition it would require covered institutions to:

- Provide individuals in control functions with appropriate authority to influence the risk-taking business areas they monitor and ensure that covered persons in control functions would be compensated independently from the areas they monitor; and

- Provide for independent monitoring of whether plans are appropriately risk balanced, events that relate to forfeiture or downward adjustments and compliance with the institution's policies and procedures

While not as explicit in the 2011 rules this is another area where most large institutions have developed well defined risk management functions that independently oversee/monitor incentive compensation programs and participate in evaluating individual and plan compliance.

GOVERNANCE

The proposed rule formally requires Level 1 and Level 2 institutions to establish an independent compensation committee (comprised of directors who are not members of management) to assist the Board of Directors in carrying out its responsibilities. It would be expected to obtain input from the institution's audit and risk committees related to the effectiveness of the institution's overall program and related processes. Management will be required to submit a written assessment of the effectiveness of the program, compliance and processes that are consistent with the risk profile of the covered institution. Separately, the compensation committee would also be required to annually obtain a similar written assessment from the audit or risk management function.

Level 1 and Level 2 institutions have generally integrated their processes for reviewing compensation programs and individual decision making with the risk (and audit) committee at least annually. Additionally compensation committees receive reports on a periodic basis from internal risk management. The rules provide a more detailed set of processes and documentation for these activities.

DISCLOSURE AND RECORD KEEPING REQUIREMENTS

The proposed rule requires all Level 1 and Level 2 covered institutions to create annually, and retain for seven years, documents that cover the following:

1. Senior executives and significant risk-takers (listed by legal entity, job function, organizational hierarchy and line of business)

2. Incentive-based compensation arrangements for senior executives and significant risk-takers, including percentage of incentive-based compensation deferred and the form of award

3. Any forfeiture, downward adjustments or clawback reviews and decisions for senior executives and significant risk-takers

4. Any material changes to the covered institution's incentive-based compensation arrangements or policies

This record keeping requirement replaces an annual reporting requirement in the 2011 proposal. Based on our experience, in their interactions with regulators, most covered institutions have been required to develop and maintain extensive record keeping around their incentive compensation arrangements so the main new requirements are the specific content of the record keeping and the seven year retention period.

COVERED PERSONS

The proposed rule describes specific employees that will be subject to the proposed rule labeled as senior executive officers and significant risk-takers. These categories are roughly equivalent to Category 1 and Category 2 employees under the 2011 proposed rules; however they have been expanded somewhat and the rules for defining significant risk-takers are somewhat more prescriptive.

- **Senior Executive Officers:**

  - 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 Executive, or head of a major business line or control function

  - Anyone performing the equivalent function to the above titles

- **Significant Risk-Taker:** There are two main tests to determine whether someone is a significant risk taker. If either test is met, the employee is a significant risk-taker

  - **Relative Compensation Test:** For a Level 1 institution, are they among the 5 percent highest compensated covered persons; for a Level 2 institution are they among the 2 percent highest compensated covered persons

  - **Exposure Test:** Does the covered person have the authority to commit more than 0.5% of the capital of the covered institution

  - **One-Third Threshold:** A covered person will only be considered a significant risk-taker if 1/3 or more of their total compensation is incentive-based compensation

We suspect that many covered institutions will find that their current list of Category 2 employees has significant overlap with who will ultimately be considered significant risk-takers. However, organizations that have spent the past few years developing rigorous criteria for identifying Category 2 employees may find it frustrating to have to comply with a new set of criteria, particularly since the new criteria appear to be more sweeping and less tailored to the nature of specific institutions' lines of business.

DEFERRAL, FORFEITURE, DOWNWARD ADJUSTMENT AND CLAWBACK REQUIREMENTS

Deferral

The 2011 proposed guidance mandated covered institutions with more than $50 billion assets to require executive officers to defer at least 50% of incentive-based compensation for at least three years. The new rule expands the deferral requirement in several ways:

- **Deferral Percentages:** Amounts deferred have been modified to apply to senior executives and significant risk-takers with required deferral percentages by institution and employee designation. The table below summarizes the requirements by type of institution, type of incentive and class of executive:

LEVEL / INCENTIVE TYPE	SENIOR EXECUTIVE	SIGNIFICANT RISK-TAKER
Level 1 – Short-term	60% for at least four years	50% for at least four years
Level 1 – Long-term	60% for at least two years	50% for at least two years
Level 2 – Short-term	50% for at least three years	40% for at least three years
Level 2 – Long-term	50% for at least one year	40% for at least one year

- **Deferral Period:** Deferrals cannot vest any faster than a pro rata basis over the full deferral period (i.e., for a Level 1 Senior Executive, the deferral of a short-term incentive cannot vest any faster that 25% per year over the four anniversaries of the award date; for a long term award deferral commences at the end of the performance period)

- **Form of Deferral:** Under the proposed rules, incentive based compensation will be deferred in cash and equity like instruments. While the rules do not propose specific percentages for each form they expect a degree of balance between the two. The rules are specific as to how much incentive based compensation can be deferred in the form of stock options.

- **Stock Options:** Under the proposed rules, stock options cannot represent more than 15% of the total incentive compensation used to meet the minimum required deferred compensation awarded for that period

- **Acceleration of Deferrals:** Level 1 and Level 2 covered institutions are prohibited from accelerating deferrals in any circumstances other than the death or disability of the covered person (i.e., no ability to accelerate upon other termination scenarios as is common today)

The more challenging aspects of the new requirements will be the mandatory deferral of both cash and equity in proportionate amounts, long-term performance plan payouts and the prohibition of the acceleration of deferrals. Companies may reconsider the amount of deferred compensation delivered in long-term performance plans if the new rules remain in place, as it will potentially diminish the value associated with plans due to the longer vesting period and increase the complexity of compensation programs. Many of these plans among Level 1 institutions have only recently been adopted and are well-received by long term investors. In addition, it is a fairly common practice to accelerate payouts of deferred compensation upon a termination of employment following a change in control or other termination scenarios (e.g., involuntary termination without cause or retirement). We suspect there will be additional commentary on this provision and that many institutions will begin to reexamine their practices as a result of the new rule.

FORFEITURE AND DOWNWARD ADJUSTMENT

Under the new proposed rules, the guidance has defined two new terms for practices that have been developed over the past few years as covered institutions have worked to comply with the 2011 proposed guidance:

- **Forfeiture:** A reduction of the amount of deferred incentive-based compensation that has been awarded but not yet vested.

- **Downward Adjustment:** A reduction of the incentive-based compensation not yet awarded to a covered person for a performance period that has already begun

Under the proposed rules all deferred incentive-based compensation will be subject to forfeiture and all not

yet awarded incentive-based compensation will be subject to downward adjustment under the following circumstances:

- 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 enforcement or legal action brought by a federal or state regulator or agency, or a requirement that the covered institution report a restatement of a financial statement to correct a material error; and
- Other aspects of conduct or poor performance as defined by the covered institution

Under the proposal, the covered institution can exercise discretion in determining how much, if any, of an award will be impacted by the forfeiture or downward adjustment. However, in the proposal, there are specific factors that should be considered in making the determination, including the intent of the covered person, the covered person's responsibility or awareness of the circumstances around the triggering event, actions that could have been taken to prevent the triggering event, the financial and reputational impact of the event, the cause of the events and any other relevant information related to the event, including past behavior of the covered person.

Based on our experiences with covered institutions, we expect this portion of the rule to be straightforward to comply with as most organizations have developed rigorous processes to cover forfeiture and downward adjustments over the past few years.

CLAWBACK

The 2011 proposed guidance did not require clawbacks. Under the new rule, there will be a clawback provision covering any incentive compensation (cash and equity) for seven years from the time that the award vests. This would mean that some forms of deferred compensation could potentially be subject to clawback for more than ten years from the date that they were originally awarded. The clawback will apply to a current or former senior executive officer or significant risk-taker. While the time-frame for the new provision is long in duration, the triggering events for a clawback are described more narrowly than the events that would trigger a review for forfeiture or downward adjustment. Specifically, the triggering events for a clawback are defined as:

1. Misconduct that resulted in significant financial or reputational harm to the covered institution;
2. Fraud;
3. Intentional misrepresentation of information used to determine the senior executive officer's or significant risk-taker's incentive-based compensation.

This is one of the most significant changes included in the new proposal and is likely to result in significant comment. While it will be hard to argue with the triggering events, the time-frame for the clawback provision may create challenges in implementation and may create anxiety among covered employees.

ADDITIONAL PROHIBITIONS

While the bulk of the proposed rule is spent discussing the institutions covered, the individuals subject to the deferral requirements, the form of the deferral, forfeiture, downward adjustment and clawback requirements; there are some additional aspects of the rule that will be of interest to institutions and may have significant impact on compensation design.

HEDGING

The proposed rule will prohibit covered institutions from purchasing hedging instruments on behalf of covered persons. As a practical matter, many financial institutions go further than this as they prohibit executives from engaging in hedging activities on their own behalf.

MAXIMUM INCENTIVE-BASED COMPENSATION OPPORTUNITY (ALSO REFERRED TO AS LEVERAGE)

Over the course of the last five years since the original guidance was provided, regulators have raised concerns with covered institutions over the degree of leverage in short-term and long-term incentive compensation arrangements. While many companies had incentive compensation arrangements with upside leverage of 200% of the target incentive opportunity when the 2011 rules were issued, most now have upside leverage of either 150% of target or 125% of target for their formulaic incentive-based compensation arrangements. The new proposed rule explicitly limits the upside leverage allowed for Level 1 and Level 2 institutions:

- **Senior Executives:** 125% of the target incentive opportunity
- **Significant Risk-Takers:** 150% of the target incentive opportunity

The professed intent is not to create a ceiling on incentive compensation but to constrain a plan feature that may contribute to inappropriate risk taking. However it will likely be viewed by institutions as weakening their ability to align pay with performance on the downside and the upside and as an uncompetitive feature when compared to other non-covered financial service firms or other companies.

RELATIVE PERFORMANCE MEASURES

Similar to the proposal on upside leverage in incentive plans, regulators have raised concerns over the use of relative performance measurement. While the proposed rule is described as a prohibition on relative performance, it is really just a prohibition on using relative performance measurement as the sole performance criteria in an incentive compensation plan. The majority of large financial institutions using relative performance measurement combine measures of absolute and relative performance in their plans. It is not clear what proportion of performance measures can be relative.

We expect that many organizations may continue to use the relative performance measure as a modifier or as some portion of a plan where the primary determinant of performance is based on the institution's absolute performance.

VOLUME-DRIVEN INCENTIVE-BASED COMPENSATION

The proposed rules prohibit incentive compensation for Level 1 and Level 2 senior executive officers and significant risk-takers based on volume based performance measures without regard to the quality of the products sold or compliance with sound risk management. This restriction is more likely to have implications for incentive-compensation plans for significant risk-takers than for senior executive officers. In practice, most institutions have added assessments of compliance with risk management and credit quality to individual evaluations for incentive-based compensation so this may be more of a formality in terms of going forward compliance.

CONCLUSIONS

The new proposed rules are the culmination of five plus years of regulatory review of incentive-based compensation practices and follow a period of considerable interaction with covered institutions. A good portion of what is proposed is a codification of the discussions and exchanges that have occurred between financial institutions and their regulators. Some of the major new pieces of the rules, e.g., potentially larger group of covered individuals, increases to the required deferral percentages and vesting periods, required deferrals of long-term incentive compensation, the prohibition of acceleration of deferrals, and the lengthy and broader clawback requirement were likely not anticipated. We expect that the agencies will receive significant feedback on these points over the comment period. That said, we expect that much of the proposed rule particularly as it relates to governance and risk management, policies and procedures will be retained in the final rules, as they are generally consistent with guidelines that the large institutions have worked to implement over the past five years.

Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.