

Client Alert

New Proposed Rules for Financial Institutions' Incentive Compensation

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Management Advisors

On April 21, 2016, the National Credit Union Administration (NCUA) issued new proposed rules governing incentive compensation arrangements for financial institutions.¹ The U.S. Securities and Exchange Commission (SEC) issued its version of these proposed rules on May 6, 2016 (Proposed Rule).² The Office of the Comptroller of the Currency, Treasury (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and the Federal Housing Finance Agency (FHFA) are all expected to issue similar rules shortly. These proposed rules are designed to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These proposed rules are revisions of the proposed rules released by all of the above agencies in 2011.

The NCUA requested comments by July 22, 2016 (92 days after the new proposed rules were announced). We expect the other agencies will provide a similar comment period.

Summary of the Proposed Rule

The Proposed Rule requires financial institutions to prohibit incentive arrangements that encourage inappropriate risks, establish performance measure requirements that appropriately balance risk and reward, require director oversight of incentive arrangements, and keep appropriate records concerning the activities covered by the Proposed Rule regarding incentive arrangements.

Furthermore, for certain larger covered financial institutions (based on average total consolidated net assets), the re-proposed rules mandate a **clawback period of up to 7 years** as well as hold-backs (**mandatory deferrals**) of **up to 60%** of incentive-based compensation for **up to 4 years**. These provisions may eventually be viewed as appropriate for non-financial companies, as was done with TARP companies' vote on pay that ended up forming the basis for Dodd-Frank's "say-on-pay vote."

¹ The proposed rules are available at:
<https://www.ncua.gov/About/Documents/Agenda%20Items/AG20160421Item2b.pdf>.

² The SEC's version of the proposed rules is available at:
<https://www.sec.gov/rules/proposed/2016/34-77776.pdf>.

Financial Institutions Covered by the Proposed Rule

The Proposed Rule will apply to all financial institutions with total consolidated assets of \$1 billion or more and covered by the rules of the:

- Federal Reserve;
- FDIC;
- FHFA;
- NCUA;
- OCC; or
- SEC.

Graduated Requirements Under the Proposed Rule

The requirements under the Proposed Rule will vary based on the level of consolidated assets held by the financial institution:

- Level 1—average total consolidated net assets greater than or equal to \$250 billion.
- Level 2—average total consolidated net assets greater than or equal to \$50 billion and less than \$250 billion.
- Level 3—average total consolidated net assets greater than or equal to \$1 billion and less than \$50 billion.

Persons Covered by the Proposed Rule

The restrictions on incentive compensation arrangements for financial institutions covered by the Proposed Rule will apply to “covered persons,” i.e., any executive officer, employee, director, or principal shareholder who receives incentive-based compensation.

The Proposed Rule specifically defines several terms used in figuring out how the covered person requirement applies at the covered financial institutions:

- **Director** is a member of the board of directors of the covered financial institution.
- **Principal shareholder** is a natural person who, directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of the covered financial institution.

Note: The NCUA’s proposal does not include this provision since credit unions are not-for-profit financial cooperatives with member owners.

- **Senior executive officer** is defined to include a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of 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 officer, or head of a major business line or control function.

- **Significant risk-taker** is an individual who is not a senior executive officer but is in a position to put a Level 1 or Level 2 covered financial institution at risk of material financial loss. In making this determination, the Proposed Rule introduces two tests: (1) the **relative compensation test**—based on the amounts of annual base salary and incentive-based compensation of a covered person relative to other covered persons working for the covered financial institution or affiliate, which looks to see whether the individual is among the top 5 percent (for Level 1 covered financial institutions) or top 2 percent (for Level 2 covered financial institutions) of highest compensated covered persons in the entire consolidated organization, including affiliates, and (2) the **exposure test**—based on whether the individual has authority to commit or expose 0.5 percent or more of the capital of the covered financial institution or an affiliate that is itself a covered financial institution.

Compensation Covered by the Proposed Rule

The Proposed Rule will apply to incentive-based compensation, which is any variable compensation, fees, or benefits that serve as an incentive or reward for performance. The form of payment does not matter.

The Proposed Rule indicates that certain types of compensation will **not** be treated as **incentive-based compensation**:

- Compensation, fees, or benefits that are awarded **solely for**, and the payment of which is solely tied to, **continued employment**, e.g., salary or a retention award that is conditioned solely on continued employment.
- Compensation arrangements that provide payment **solely for** achieving or maintaining a **professional certification or level of educational achievement**.
- Compensation arrangements that are determined **solely on** the covered **person's level of fixed compensation** and that **do not vary based on one or more performance measures**, e.g., employer contributions to a 401(k) retirement savings plan computed based on a fixed percentage of an employee's salary.
- **Dividends paid** and **appreciation realized** on **stock** or other equity-like instruments that are **owned** outright by a covered person; but note that while stock or other equity-like instruments are subject to vesting or any deferral (including mandatory deferral) arrangement, it will not be treated as owned outright.

Requirements With Respect to Covered Compensation

All covered financial institutions are prohibited from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk by providing covered persons with excessive compensation, fees, or benefits that could lead to material financial loss to the covered financial institution.

According to the Proposed Rule, compensation, fees, or benefits **will be considered excessive** when **amounts paid are unreasonable or disproportionate** to the value of the services performed by a covered person, taking into account all the relevant factors, including:

- The combined value of all compensation, fees, or benefits provided to a covered person;
- The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;

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

An incentive-based compensation arrangement will be considered to encourage inappropriate risks that could lead to material financial loss to the covered financial institution, unless the arrangement:

- Appropriately balances risk and reward;
- Is compatible with effective risk management and controls; and
- Is supported by effective governance.

The Proposed Rule specifically provides that an incentive-based compensation arrangement will not be considered to appropriately balance risk and reward unless it:

- Includes financial and non-financial measures of performance;
- Is designed to allow non-financial measures of performance to 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.

The board of directors of a covered financial institution would be required to:

- Conduct oversight of the covered financial 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.

Finally, the Proposed Rule prohibits covered financial institutions from doing indirectly, or through or by any other person, anything that would be unlawful for the covered financial institution to do directly under the Proposed Rule.

Additional Requirements for Level 1 and Level 2 Covered Financial Institutions

The Proposed Rule imposes additional requirements on Level 1 and Level 2 covered financial institutions, the key provisions of which are set forth in the chart below.

Requirement	Level 1 Institution	Level 2 Institution
Recordkeeping	<p>Create annually and maintain for at least 7 years records that document:</p> <ul style="list-style-type: none"> • The covered financial institution's senior executive officers and significant risk-takers, listed by legal entity, job function, organizational hierarchy, and line of business; • The incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on the 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 the covered financial institution's incentive-based compensation arrangements and policies. 	
Deferral	<p>The Proposed Rule requires that incentive-based compensation arrangements for senior executive officers and significant risk-takers include deferral of payments, risk of downward adjustment and forfeiture, and clawback to appropriately balance risk and reward.</p> <p>Deferred compensation may vest no faster than on a pro rata annual basis, and for public companies would be required to consist of substantial amounts of both deferred cash and equity-like instruments throughout the deferral period.</p> <p>Options for a performance period used to meet the minimum required deferred compensation requirement may not exceed 15% of the total incentive-based compensation awarded for that performance period.</p> <p>The Proposed Rule would prohibit acceleration of the payment of a covered person's deferred incentive-based compensation, except for death or disability.</p> <p>Qualifying incentive-based compensation is defined as incentive-based compensation awarded to a covered person for a particular performance period, excluding amounts awarded under a long-term incentive plan.</p> <p>Long-term incentive plan compensation is defined as incentive-based compensation based on a performance period of at least 3 years. Incentive-based compensation awarded to a covered person for a performance period of less than 3 years would not be awarded under a long-term incentive plan, but instead would be treated as qualifying incentive compensation (and therefore subject to a longer deferral period).</p>	
Level-Specific Deferral Requirements	<ul style="list-style-type: none"> • Defer a specified percentage of qualifying incentive-based compensation for at least 4 years: <ul style="list-style-type: none"> — Senior executive officers: 60% — Significant risk-takers: 50% • Also must defer a specified percentage of incentive-based compensation awarded under a long-term incentive plan for at least 2 years: <ul style="list-style-type: none"> — Senior executive officers: 60% — Significant risk-takers: 50% 	<ul style="list-style-type: none"> • Defer a specified percentage of qualifying incentive-based compensation for at least 3 years: <ul style="list-style-type: none"> — Senior executive officers: 50% — Significant risk-takers: 40% • Also must defer a specified percentage of incentive-based compensation awarded under a long-term incentive plan for at least 1 year: <ul style="list-style-type: none"> — Senior executive officers: 50% — Significant risk-takers: 40%

Requirement	Level 1 Institution	Level 2 Institution
<p>Forfeiture and Downward Adjustment</p>	<p>All unvested deferred incentive-based compensation, including unvested deferred amounts awarded under long-term incentive plans, of any senior executive officer or significant risk-taker will be subject to forfeiture. This requirement would apply regardless of whether the deferral was required by the Proposed Rule.</p> <p>All incentive-based compensation amounts (including amounts payable under a long-term incentive plan) not yet awarded to any senior executive officer or significant risk-taker for the current performance period would be subject to downward adjustment.</p> <p>Covered financial institutions will be required to consider forfeiture or downward adjustment of incentive-based compensation if any of the following adverse outcomes occur:</p> <ul style="list-style-type: none"> • Poor financial performance attributable to a significant deviation from the covered financial institution’s risk parameters set forth in the covered financial institution’s policies and procedures; • Inappropriate risk-taking, regardless of the impact on financial performance; • Material risk management or control failures; • Noncompliance 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 financial 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 financial institution. 	
<p>Clawback</p>	<p>The Proposed Rule would require the inclusion of clawback provisions in the incentive-based compensation arrangements for senior executive officers and significant risk-takers. These provisions must permit the clawback of such compensation from current and former senior executive officers and significant risk-takers at a minimum for 7 years following the date on which compensation vests, if the covered financial institution determines that the senior executive officer or significant risk-taker engaged in misconduct that resulted in significant financial or reputational harm to the covered financial institution, fraud, or intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker’s incentive-based compensation.</p>	
<p>Additional Prohibitions</p>	<p>The Proposed Rule contains additional prohibitions for Level 1 and Level 2 covered financial institutions that apply to:</p> <ul style="list-style-type: none"> • Hedging—such financial institutions would be prohibited from purchasing hedging instruments or similar instruments on behalf of covered persons to hedge or offset any decrease in the value of the covered person’s incentive-based compensation. • Maximum incentive-based compensation opportunity (leverage)—such financial institutions would be prohibited from awarding incentive-based compensation that exceeds the target amount for that incentive-based compensation by 125% for senior executive officers and 150% for significant risk-takers. • Relative performance measures—such covered financial institutions would be prohibited from using incentive-based compensation performance measures based solely on industry peer performance comparisons for all covered persons, not just senior executive officers and significant risk-takers (<i>e.g., relative TSR plans would be prohibited</i>). • Volume-driven incentive-based compensation—would prohibit providing incentive-based compensation to a covered person that is based solely on transaction or revenue volume without regard to quality or the compliance of the covered person with sound risk management. 	

Requirement	Level 1 Institution	Level 2 Institution
Risk Management and Controls	<p>Level 1 and Level 2 covered financial institutions would be required to have a risk management framework for their incentive-based compensation programs that is independent of any lines of business and includes an independent compliance program that provides for internal controls, testing, monitoring, and training with written policies and procedures and is commensurate with the size and complexity of the covered financial institution's operations.</p> <p>Level 1 and Level 2 covered financial institutions would also have to:</p> <ul style="list-style-type: none"> • Provide individuals in control functions 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; and • Provide for independent monitoring of: <ul style="list-style-type: none"> — Incentive-based compensation plans to identify whether the plans appropriately balance risk and reward; — Events related to forfeiture and downward adjustment and decisions of forfeiture and downward adjustment reviews to determine consistency with the Proposed Rule; and — Compliance of the incentive-based compensation program with the covered financial institution's policies and procedures. 	
Governance	<p>Level 1 and Level 2 covered financial institutions would be required to 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 under the Proposed Rule.</p> <p>The compensation committee would be required to obtain input from the covered financial institution's risk and audit committees, or groups performing similar functions, and risk management function on the effectiveness of risk measures and adjustments used to balance incentive-based compensation arrangements.</p> <p>Management of such institutions would be required to annually submit to the compensation committee a written assessment of the effectiveness of the covered financial 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 covered financial institution.</p> <p>The compensation committee would also be required to obtain a written assessment from the internal audit or risk management function regarding the same matters.</p>	

Requirement	Level 1 Institution	Level 2 Institution
Policies and Procedures	<p>Level 1 and Level 2 covered financial institutions would be required to have policies and procedures that, among other requirements:</p> <ul style="list-style-type: none"> • Are consistent with the requirements and prohibitions of the Proposed Rule; • Specify the substantive and procedural criteria for forfeiture and clawback; • Document final forfeiture, downward adjustment, and clawback decisions; • Specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person; • Identify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions, including when discretion is authorized; • Describe how discretion is exercised to achieve balance; • Require that the covered financial institution maintain documentation of its processes for the establishment, implementation, modification, and monitoring of incentive-based compensation arrangements; • Describe how incentive-based compensation arrangements will be monitored; • Specify the substantive and procedural requirements of the independent compliance program; and • Ensure appropriate roles for risk management, risk oversight, and other control personnel in the covered financial institution's processes for designing incentive-based compensation 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. 	

When Will the Proposed Rule Apply?

The Proposed Rule indicates that it will apply no later than the first calendar quarter that begins at least 540 days after a final rule is published in the *Federal Register* (Compliance Date). Significantly, the Proposed Rule would not apply to any incentive-based compensation plan with a performance period that begins before the Compliance Date.

Implications and Next Steps

If the new requirements set forth in the Proposed Rule as compared to the 2011 proposed rules are included in the final rule that is ultimately adopted by the agencies, then public financial institutions covered by the Proposed Rule will need to significantly change their compensation programs for executives. The mandatory deferral periods and mandatory minimum withholding percentages, the mandatory downward adjustment, the caps on the maximum payout percentage for incentive-based compensation, and the elimination of solely using relative performance measures for all Level 1 and Level 2 covered financial institutions will have far-reaching implications for the design and operation of their executive compensation programs.

Looking at how past legislation aimed at the financial industry was subsequently utilized as a reference for new rules for non-financial institutions, even non-financial institutions should familiarize themselves with the Proposed Rule and consider the implications if they had to comply with some or all of these provisions, most notably the mandatory deferral, cap on maximum payout percentage, and elimination of relative performance as the sole performance measure for an incentive-based plan.

Financial institutions should carefully review their current compensation programs in respect to the Proposed Rule's requirements and undertake to apply these requirements to the past several years' worth of pay decisions to determine their impact and differences.

Companies (both financial and non-financial institutions) should review the Proposed Rule's requirements and determine the impact of applying these requirements to their compensation programs. Additionally, companies should consider whether they should provide a comment letter on the Proposed Rule so that the agencies can be made aware of their point of view on the requirements before adopting the final rule.



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