US Regulators Propose Joint Rule on Incentive-Based Compensation

The federal financial services regulatory agencies (the "regulators"),[1] have proposed a joint rule (the "2016 Proposal") to regulate incentive-based compensation paid by, *inter alia*, banks, investment advisers, broker-dealers and credit unions with over $1 billion in assets. The compliance date for the 2016 Proposal would be the first day of the first calendar quarter beginning at least 540 days after a final rule is published in the Federal Register. The proposed rule would not apply to incentive-based compensation plans that have performance periods that begin before the compliance date. **Comments on the 2016 Proposal are due on July 22, 2016.**

This legal update describes some of the more significant aspects of the 2016 Proposal and provides reference charts summarizing the key requirements.

Overview

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires enhanced disclosure and reporting of compensation arrangements for financial institutions that meet the definition of "Covered Institutions" and prohibits incentive-based compensation arrangements that (1) encourage Covered Institutions to take inappropriate risks through the provision of excessive compensation or benefits or (2) could lead to material financial loss to the Covered Institution.[2]

The agencies issued a proposed rule in 2011 (the "2011 Proposal") to implement these requirements, but that proposal was never finalized. Although most of the 2011 Proposal's provisions are retained in the 2016 Proposal, the 2016 Proposal adds new concepts and requirements (e.g., a new category of Covered Institutions (those with average total consolidated assets of $250 billion or more) that would be subject to the most stringent requirements, a new category of employees that would be subject to more rigorous restrictions and prohibitions, including a clawback requirement).

Covered Institutions and Asset Levels

Covered Institutions. The 2016 Proposal clarifies and expands the categories of financial institutions that would be treated as Covered Institutions.[3] Covered Institutions that offer incentive-based compensation and have at least $1 billion in average total consolidated assets ("consolidated assets") are generally subject to the rule, but the extent to which specific requirements or prohibitions apply to a Covered Institution is a function of whether that institution is categorized as a Level 1, 2 or 3 Covered Institution.

Level 3 Covered Institutions are those with consolidated assets in excess of $1 billion but less than $50 billion; Level 2 Covered Institutions are those with consolidated assets between $50 billion and $250 billion; and Level 1 Covered

Institutions are those with consolidated assets of $250 billion or more.[4] The most stringent measures are imposed on Level 1 Covered Institutions, with some reduction in stringency at each subsequent asset level.[5] However, a Level 3 Covered Institution with at least $10 billion in consolidated assets may be subject to the additional requirements and prohibitions applicable to Level 1 or 2 Covered Institutions if its regulator determines that its operations are sufficiently complex.[6]

Asset Level Calculation. In general, whether a Covered Institution is placed in Level 1, 2 or 3 will depend on that institution's consolidated assets as reported to the relevant regulator during the four most recent consecutive quarters.[7] In most cases, placement in one of the three levels will depend on the cumulative assets attributed to the top-tier holding company. [8] In the case of a foreign banking organization ("FBO"), the determination will be made by reference to the assets of its US operations (different treatment applies to federal branches and agencies, see below).

Subsidiaries

In general, a Covered Institution that is a depository institution subsidiary (e.g., a bank) of another Covered Institution (e.g., a bank holding company) would be subject to the same requirements and prohibitions as its parent because its placement in one of the three levels will be based on the asset level of the parent organization.[9] The 2016 Proposal allows such a Covered Institution subsidiary to comply with any part of the rule through its parent that is a Covered Institution. (However, if a financial institution subsidiary does not have $1 billion in consolidated assets, it would not be a Covered Institution and therefore not subject to the rule, regardless of the amount of consolidated assets held by affiliated Covered Institutions.)

Note that the SEC's version of the rule does not follow this consolidated approach for subsidiaries of Covered Institution broker-dealers and investment advisers. Such subsidiaries are not subject to the same asset level requirements as their SEC-regulated parents.[10] However, a broker-dealer that is a Covered Institution subsidiary within a bank holding company that is itself a Covered Institution would still be subject to the top-tier parent's requirements.[11]

FBOs

FBO Asset Level. The treatment of FBOs, in terms of ranking in one of the three asset levels, generally mirrors that for US bank holding companies. Unlike other Dodd-Frank regulations (e.g., some cases under Section 165) that base the size of an FBO on global asset levels, under the 2016 Proposal, the asset level of US regulated institutions within an FBO would be determined by the total consolidated US assets of the FBO, "including the assets of any US branches or agencies ... any US subsidiaries ... and any US operations held pursuant to section 2(h)(2) of the Bank Holding Company Act."[12] Because asset level is determined by reported assets to the appropriate regulator, the 2016 Proposal contemplates an amendment of the FR Y-7Q form.[13]

Federal Branches and Agencies

The asset level of a foreign bank's federal branch would be determined by the assets of that federal branch, *not* the combined US assets of the branch's affiliates.[14] Accordingly, it is possible that a small federal branch of a foreign bank would not be treated as a Covered Institution despite the overall asset level of its US FBO affiliates, including other affiliated Covered Institutions. This approach is consistent with that of national banks or federal saving associations that are not subsidiaries of holding companies.[15]

Covered Persons

A Covered Person is *any* employee, executive officer, director or principal shareholder who receives incentive-based compensation at a Covered Institution.[16] However, the most stringent provisions contemplated by the 2016 Proposal would be limited to two categories of employees—"Senior Executive Officers" and employees defined as "Significant Risk-Takers."[17]

Senior Executive Officers. Senior Executive Officers are defined as Covered Persons at Covered Institutions who hold the title or otherwise perform the functions of 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 or chief accounting officer. In addition, those who head a major business line or control function would also be treated as Senior Executive Officers, regardless of their title.[18]

Significant Risk-Takers. Significant Risk-Takers are employees, other than Senior Executive Officers, who have the ability to create a risk of material financial loss to a Covered Institution. As shown in Chart 2, under the rule, an individual is a Significant Risk-Taker if:

1. The individual meets either the "Relative Compensation Test" or the "Exposure Test"; and
2. The individual's incentive-based compensation is at least one-third of his/her total annual base salary and incentive-based compensation combined (the "Threshold Test").

Under the Relative Compensation Test, an individual qualifies if he or she is among the top five percent most highly compensated Covered Persons (excluding Senior Executive Officers) in the entire consolidated organization (including affiliated Covered Institutions), based on annual salary and incentive compensation paid during the calendar year ending 180 days prior to the beginning of the performance period for which the Significant Risk-Takers are being identified.[19] In the case of Level 2 Covered Institutions, the individual must be among the highest two percent.[20] Alternatively, an individual can also qualify as a Significant Risk-Taker if she or he satisfies the Exposure Test,[21] meaning possessing the authority to commit or expose to risk at least 0.5 percent of the common equity tier 1 capital of the Covered Institution or an affiliate that is also a Covered Institution.

General Requirements and Prohibitions for All Covered Institutions

The provisions applicable to all Covered Institutions are essentially principles-based and include generally the concepts below.[22]

Excessive Compensation. The 2016 Proposal provides that compensation is excessive if it is unreasonable or disproportionate to the value of the services provided by the Covered Person, taking into account all relevant factors, such as, *inter alia*, the combined value of all compensation or benefits provided to the Covered Person, the compensation history of the Covered Person and other individuals with comparable expertise at the Covered Institution and the financial condition of the Covered Institution and comparable institutions, among others.

Material Financial Loss. In order to satisfy the requirement that an incentive-based compensation arrangement not encourage inappropriate risk that could lead to "material financial loss," the arrangement must (1) appropriately balance risk and reward, (2) be compatible with effective risk management and controls and (3) be supported by effective governance.

Balance Risk and Reward. Incentive-based compensation arrangements must balance risk and reward by:

- Taking account of financial and non-financial measures of performance;[23]

- Allowing non-financial measures of performance to override financial measures of performance; and
- Being subject to adjustment to reflect actual losses, instances of inappropriate risk, compliance deficiencies or other aspects of performance that expose the Covered Institution to unacceptable risk.

Board of Directors. Covered Institutions' boards of directors must (i) conduct oversight of the institution's incentive-based compensation program; (ii) approve incentive-based compensation arrangements for Senior Executive Officers, including amounts of all awards and, at the time of vesting, payouts under such arrangements; and (iii) approve any material exceptions or adjustments to incentive-based compensation arrangements for Senior Executive Officers.

Recordkeeping Requirement. Under the 2016 Proposal, all Covered Institutions would be required to create annual records documenting incentive-based compensation arrangements and demonstrating compliance with the 2016 Proposal. (This annual recordkeeping requirement replaces a more onerous annual reporting requirement in the 2011 Proposal.) A Covered Institution would be required to maintain such records for seven years.

Additional Requirements and Prohibitions for Levels 1 and 2[24]

Level 1 and Level 2 Covered Institutions would be required to include additional provisions in their incentive-based compensation arrangements, including deferral, forfeiture, downward adjustment and clawback provisions as a condition of such arrangements being treated as appropriately balancing risk and reward. (Please refer to Chart 3.)

Deferral

The 2016 Proposal requires that Level 1 and Level 2 Covered Institutions defer specified percentages of incentive-based compensation of Senior Executive Officers and Significant Risk-Takers and prescribes the required duration of such deferrals.[25] The specific percentage required to be deferred and the required duration of such deferral depend on the size of the Covered Institution, the status of the individual and the duration of the incentive-based compensation (i.e., short-term or long-term; for the schedule of the percentages and durations, please refer to Chart 4). Deferred amounts must vest no more rapidly than on a pro rata annual basis beginning no earlier than the first anniversary of the end of the performance period for which the amounts were awarded. The acceleration of unvested deferred amounts is only permitted in the limited case of death or disability.[26]

For those Level 1 or Level 2 Covered Institutions that issue equity as part of compensation, deferred amounts must consist of substantial amounts of cash and equity-like instruments (i.e., any form of payment where the final value is linked to the price of the Covered Institution's equity, even if such compensation settles in the form of cash).[27] In addition, the amount of options used to satisfy the deferral requirements, with respect to a Senior Executive Officer or a Significant Risk-Taker, cannot exceed 15 percent of the total incentive-based compensation awarded to the individual for that performance period.[28]

Forfeiture and Downward Adjustment

Level 1 and Level 2 Covered Institutions would be required (i) to place at risk of downward adjustment all of a Senior Executive Officer's or Significant Risk-Taker's incentive-based compensation amounts not yet awarded for the current performance period and (ii) to place at risk of forfeiture all unvested, deferred incentive-based compensation of any Senior Executive Officer or Significant Risk-Taker.[29] Such unvested, deferred incentive-based compensation subject to downward adjustment and forfeiture would include long-term incentive plans. The forfeiture provisions would apply even to unvested deferred amounts in excess of that which is required to be deferred under the 2016 Proposal.[30]

Events and factors that would require a Level 1 or Level 2 Covered Institution to consider forfeiture or downward adjustment of the incentive-based compensation of a Senior Executive Officer or Significant Risk-Taker include:[31]

1. Poor financial performance due to a significant deviation from the Covered Institution's risk parameters, as set forth in its policies and procedures;
2. Inappropriate risk-taking (even if it resulted in a positive financial result for the institution);
3. Material failures of risk management or controls;
4. Enforcement or legal action brought by a federal or state regulator or agency; or
5. A required restatement of a financial statement to correct a material error.

Consideration of forfeiture or downward adjustment would be required not only for the Senior Executive Officers and Significant Risk-Takers directly responsible for the trigger event but also for those Senior Executive Officers and Significant Risk-Takers with responsibility due to their role or position in the Covered Institution's organizational structure for the event.[32]

Reviews or consideration of forfeiture or downward adjustment must be part of the incentive-based compensation arrangements for Senior Executive Officers and Significant Risk-Takers.

Clawback

Level 1 and Level 2 Covered Institutions would be required to include clawback provisions in incentive-based compensation arrangements that permit the Covered Institution to recover incentive-based compensation from current and former Senior Executive Officers or Significant Risk-Takers for seven years following the date such compensation vests if the Covered Institution discovers that the individual engaged in (i) misconduct that resulted in significant financial or reputational harm to the Covered Institution, (ii) fraud or (iii) intentional misrepresentation of information used to determine the Senior Executive Officer's or Significant Risk-Taker's compensation award.[33] The clawback period would apply for seven years following the date on which the incentive-based compensation vests.[34]

Additional Prohibitions[35]

- **Specific limits on the maximum performance compensation that can be paid to Senior Executive Officers and Significant Risk-Takers** (please refer to Chart 3). If an incentive-based compensation plan allows a Senior Executive Officer or Significant Risk-Taker at a Level 1 or Level 2 Covered Institution to receive amounts in excess of his or her target amount due to performance that exceeds those targets, such amounts may not exceed 125% of the target amount for a Senior Executive Officer or 150% of the target amount for a Significant Risk-Taker.
- **No hedging for any Covered Persons.** This prohibition applies to all Covered Persons at Level 1 or Level 2 Covered Institutions, not only Senior Executive Officers and Significant Risk-Takers. This prohibition does not limit a Level 1 or Level 2 Covered Institution's ability to hedge its own exposure in deferred compensation obligations, a prudent practice.
- **No *exclusive* use of relative performance measures for incentive-based compensation decisions.** This prohibition applies to all Covered Persons at Level 1 or Level 2 Covered Institutions, not

only Senior Executive Officers and Significant Risk-Takers. A Level 1 or Level 2 Covered Institution may combine relative performance measures with absolute performance measures (e.g., total shareholder return) in making such decisions.

- **No incentive-based compensation decisions based *exclusively* on transaction revenue or volume.** This prohibition applies to all Covered Persons at Level 1 or Level 2 Covered Institutions, not only Senior Executive Officers and Significant Risk-Takers. A Level 1 or Level 2 Covered Institution must consider the transaction quality and the Covered Person's compliance with sound risk management practice.

Additional Requirements

- **More detailed recordkeeping requirements.**[36] Level 1 and Level 2 Covered Institutions must create and maintain for seven years records that document (1) who is a Senior Executive Officer and Significant Risk-Taker, listing them by legal entity, job function, organizational hierarchy and business line; (2) the incentive-based compensation arrangements for such individuals, including information regarding deferral percentages and the form of awards; (3) any forfeiture and downward adjustment or clawback reviews and decisions; and (4) any material changes to the Covered Institution's incentive-based compensation arrangements and policies. Such records must be maintained in a manner that allows for an independent audit.
- **More extensive risk management and controls.**[37] A risk management framework would be required for Level 1 and Level 2 Covered Institutions, which must (1) be independent from the business lines; (2) include an independent compliance program with internal controls, testing, monitoring and training as well as written policies and procedures; and (3) provide that control function personnel have appropriate authority to influence risk-taking of business areas and their compensation be determined independently from the performance of the business area that they monitor. In addition, independent monitoring of compliance with the rule would be required.
- **Governance and internal assessments.**[38] The compensation committees of the boards of directors at Level 1 or Level 2 Covered Institutions could not include Senior Executive Officers and would be required (1) to seek input from the risk and audit committees and risk management function regarding the effectiveness of risk measures and (2) to obtain an independent written assessment from internal audit as well. Additionally, management of a Level 1 or Level 2 Covered Institution, with input from the risk and audit committees, would be required to submit an annual (or more frequent) written assessment to the compensation committee, documenting the effectiveness of the incentive-based compensation program's compliance.
- **Written policies and procedures must comply with the 2016 Proposal.**[39] The 2016 Proposal specifies the minimum requirements for written policies and procedures at a Level 1 or Level 2 Covered Institution (e.g., must specify the criteria for, and provide for the process concerning and documentation of final forfeiture, downward adjustment and clawback decisions), although we anticipate that the regulators will require policies and procedures to be specifically tailored to a Covered Institution's business and risk profile.

2016 Proposed Rule: Incentive-Based Compensation (“IBC”) Summary Reference Charts

1. Covered Institution’s Asset Level (“Level”) determined by average total consolidated assets[40]		
LEVEL 1	**LEVEL 2**	**LEVEL 3**
At least $250 billion	At least $50 billion, but less than $250 billion	At least $1 billion, but less than $50 billion

2. Covered Persons: *Any* executive officer, employee, director or principal shareholder who receives IBC.	
Senior Executive Officers and **Significant Risk-Takers** (discussed in further detail in the text above these charts) are a subset of Covered Persons. A number of additional requirements and prohibitions apply to Senior Executive Officers and Significant Risk-Takers at Level 1 and Level 2 Covered Institutions (see Charts 3 and 4).	
SENIOR EXECUTIVE OFFICER	Includes 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 or chief accounting officer and heads of major business line or control functions, regardless of title.
SIGNIFICANT RISK TAKER	Those other than Senior Executive Officers who meet (1) either the Relative Compensation Test or the Exposure Test and (2) the Threshold Test. ***Relative Compensation Test*** Is the Covered Person among the highest compensated Covered Persons (other than Senior Executive Officers) in the entire consolidated organization (including affiliated Covered Institutions)? • Top 5% of Covered Persons (excluding Senior Executive Officers) at Level 1 Covered Institutions • Top 2% of Covered Persons (excluding Senior Executive Officers) at Level 2 Covered Institutions ***Exposure Test*** Does the Covered Person have authority to commit or expose 0.5% of the common equity tier 1 capital of the Covered Institution or an affiliate that is also a Covered Institution? ***IBC Threshold Test*** Is the Covered Person’s IBC at least one-third of his/her total annual base salary and IBC combined?

3. Required Plan Provisions for Senior Executive Officers and Significant Risk-Takers at Level 1 and Level 2 Covered Institutions	
DEFERRAL	A substantial portion (determined in accordance with the rule) of IBC payable to a Senior Executive Officer or Significant Risk-Taker at a Level 1 or 2 Covered Institution must be deferred and subject to a risk of forfeiture for a specified period. (For required deferral percentages and duration, see Chart 4.)
FORFEITURE AND DOWNWARD ADJUSTMENT	Plans must provide that certain events (e.g., inappropriate risk-taking) trigger mandatory *consideration* by the board of directors for forfeiture or downward adjustment. • **Forfeiture** reduces the amount of a Senior Executive Officer or Significant Risk-Taker's unvested, deferred IBC. • **Downward Adjustment** reduces a Senior Executive Officer or Significant Risk-Taker's IBC amount not yet awarded for any performance period that is underway.
CLAWBACK	Plans must include provisions that all vested IBC of Senior Executive Officers and Significant Risk-Takers is subject to a seven-year clawback in the event of certain occurrences or conduct. Triggered if the Covered Institution determines that a Senior Executive Officer or Significant Risk-Taker engaged in: • Misconduct resulting in significant financial or reputational harm to the Covered Institution; or • Fraud or intentional misrepresentation of information used to determine the IBC award of that individual.
PROHIBITION ON ACCELERATION OF DEFERRED IBC	• Generally, acceleration of deferred IBC is not permitted. • Acceleration of deferred IBC is only allowed in the limited cases of disability or death.
LIMITS ON PERFORMANCE COMPENSATION	If a plan allows a Senior Executive Officer or Significant Risk-Taker to receive amounts in excess of his/her target amount due to performance that exceeds those targets, such amounts may not exceed: • 125% of the target amount for a Senior Executive Officer • 150% of the target amount for a Significant Risk-Taker

4. Deferral Percentages and Duration[41]				
	LEVEL 1		**LEVEL 2**	
	Senior Executive Officers	**Significant Risk-Takers**	**Senior Executive Officers**	**Significant Risk-Takers**
QUALIFYING IBC (SHORT-TERM)	60% deferral for four years	50% deferral for four years	50% deferral for three years	40% deferral For three years
LONG-TERM INCENTIVE PLANS	60% deferral for two years	50% deferral for two years	50% deferral for one year	40% deferral for one year

Descriptions above are abbreviated, and numerous other requirements may apply that are not detailed in these charts. Please refer to the text above the charts.

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Endnotes

[1] The agencies issuing the joint rule are the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC) and the Securities and Exchange Commission (SEC).

[2] 12 U.S.C. § 5641.

[3] *See, e.g.,* 81 FR 37683-85 (Preamble contains a consolidated list of all the Covered Institutions from across the versions of the 2016 Proposal).

[4] *See, e.g.*, 81 FR 37807 (FRB defining Level 1, Level 2 and Level 3 Covered Institutions).

[5] *See, e.g., id.*

[6] *See, e.g.,* 81 FR 37810 (FRB's reservation of authority for Level 3 Covered Institutions).

[7] Investment advisers use a different calculation. Alternative calculations are provided for institutions that do not have four consecutive regulatory reports.

[8] Depository institution holding company is defined in the FDIC, OCC and SEC's version of the 2016 Proposed Rule. *See, e.g.*, 81 FR 37815 (FDIC defining depository institution holding company to be the top-tier depository institution holding company). The definition includes bank holding companies by reference to 12 U.S.C. § 1813.

[9] 81 FR 37685 (called "consolidation" under the rule).

[10] 81 FR 37686

[11] *Id.*

[12] 81 FR 37685, fn 58.

[13] *See, e.g.*, 81 FR 37808 (FRB defining "regulatory report").

[14] 81 FR 37685, fn 58; 81 FR 37800-01 (defining federal branches and agencies as Covered Institutions and defining, for instance, a Level 1 Covered Institution as a Covered Institution with at least $250 billion in assets.)

[15] 81 FR 37685, fn 58.

[16] *See, e.g.,* 81 FR 37800 (OCC defining Covered Person).

[17] *See, e.g.,* 81 FR 37808 (FRB defining Senior Executive Officer and Significant Risk-Taker).

[18] *See, e.g., id.* (definition of Senior Executive Officer).

[19] *See, e.g., id.* (definition of Significant Risk-Taker). *See also*, 81 FR 37692 (preamble's explanation).

[20] *See, e.g., id.*

[21] See, e.g., 81 FR 37808 (Exposure Test).

[22] *See, e.g.,* 81 FR 37809-10 (requirements and prohibitions applicable to all Covered Institutions).

[23] The preamble explains that non-financial measures of performance could include assessments of a Covered Person's risk-taking or his or her compliance with limits on risk-taking. *See*, 81 FR 37711.

[24] *See, e.g.,* 81 FR 37810-12.

[25] *See, e.g.,* 81 FR 37810.

[26] *See, e.g.,* 81 FR 37810-11.

[27] *See, e.g.,* 81 FR 37811.

[28] *See, e.g., id.* Note that the NCUA rule allows acceleration of incentive-based compensation of credit union employees to pay taxes in certain circumstances.

[29] *See, e.g., id.*

[30] *See, e.g.,* 81 FR 37717.

[31] *See, e.g.,* 81 FR 37811.

[32] *See, e.g., id.*

[33] *See, e.g., id.*

[34] *See, e.g., id.*

[35] *See, e.g.,* 81 FR 37812.

[36] *See, e.g.,* 81 FR 37810.

[37] *See, e.g.,* 81 FR 37812.

[38] *Id.*

[39] *See, e.g.,* 81 FR 37812-13.

[40] Please refer to the text above these charts for a discussion of whether a parent company's asset level determines a subsidiary's asset level.

[41] Qualifying IBC is the amount of IBC awarded for a particular performance period, excluding amounts awarded for that particular performance period under any long-term incentive plans.