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Agencies Propose Incentive Compensation Rules for Financial Institutions

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The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the U.S. Securities and Exchange Commission recently proposed new restrictions on incentive-based compensation for financial institutions pursuant to the Dodd-Frank Act of 2010. These new rules would apply to "covered-persons," including executive officers, employees, directors and principal shareholders who receive incentive-based compensation at a "covered institution." Most of the new proposed rules, apply primarily to senior executive officers and "significant risk takers."

A "covered institution" includes any of the following with $1 billion or more in assets:

1. a depository institution or depository institution holding company;
2. a broker-dealer registered under Section 15 of the Securities Exchange Act of 1934;
3. a credit union; and
4. an investment adviser.

The proposed rules provide general qualitative requirements for all covered institutions, with additional requirements for those institutions with total consolidated assets of at least $50 billion and even stronger requirements for institutions with total consolidated assets greater than $250 billion.

Proposed Rules Applicable to All Covered Institutions

The proposed rules applicable to all covered institutions include:

No Excessive Compensation. The proposed rules would prohibit compensation, fees and benefits that are unreasonable or disproportionate to the value of the services performed by a covered person. Factors include:

- 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 covered institutions, based on factors like asset size, geographic location and the complexity of the covered institutions assets and operations;
- the projected total cost and benefit of post-employment benefits 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.

Board of Directors Approval. A covered institution's board of directors, or a committee, would be required to oversee the covered institution's incentive-based compensation program, approve incentive compensation arrangements and approve any material exceptions.

Effective Controls. A covered institution would be required to implement controls over the design, implementation and monitoring of incentive compensation appropriate to the institution's size and complexity.

Disclosure and Recordkeeping. A covered institution would be required to annually create, and maintain for at least seven years, records documenting the structure of all of the institution's incentive compensation. At a minimum, a covered institution's records must include copies of all incentive-based compensation plans, a list of who is subject to each plan, and a description of how the covered institution's incentive-based compensation program is compatible with effective risk management and controls.

Performance Measures. A covered institution's incentive compensation arrangements must appropriately balance risk and reward, be compatible with effective risk management and controls, and be supported by effective governance. An incentive compensation arrangement would have to include relevant financial and non-financial measures of performance, be designed to allow non-financial measure of performance to override financial measures when appropriate and any amounts would be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and non-financial performance.

Proposed Rules Applicable to Level 1 and Level 2 Covered Institutions

Certain additional rules would apply to “Level 1” and “Level 2” covered institutions (those with greater than $250 billion in total consolidated assets and those with between $50 and $250 billion in total consolidated assets). These include:

Incentive Limits

Leverage. The maximum incentive-based compensation opportunity could not exceed 125% of the target amount for senior executive officers and 150% of the target amount for “significant risk-takers.” Notably, changes in share value, interest rates or the payment of reasonable interest or a reasonable rate of return would not be counted as increases in the target amount.

Performance Measures. The proposed rules would not allow performance measures to be based solely on relative performance comparisons (compared to peer companies or an industry average) or transaction revenue or volume without regard to transaction quality or risk management compliance. An institution would be permitted to use relative performance measures in combination with absolute performance measures.

Required Deferrals

Level 1 and 2 covered institutions which distinguish between incentive-based compensation under a “long-term incentive plan” (a performance period of at least three years) and “qualifying incentive-based compensation” (compensation awarded for a particular performance period other than under a long-term incentive plan).

For Level 1 institutions, at least 60% of qualifying incentive-based compensation of senior executives would need to be deferred for at least four years and at least 60% of long-term incentive-based compensation would need to be deferred for at least two years. For significant risk takers, the percentage of relevant incentive compensation would be 50%.

For Level 2 institutions, at least 50% of qualifying incentive-based compensation of senior executives would need to be deferred for at least three years and at least 50% of long-term incentive-based compensation would need to be deferred for at least one year. For significant risk takers, the percentage of relevant incentive compensation would be 40%.

During the deferral period, incentive-based compensation could not vest faster than on a pro-rata annual basis, beginning no earlier than the first anniversary of the end of the performance period. Accelerated vesting would be prohibited except in the case of death or disability. For covered institutions issuing equity, the deferred amount would need to consist of “substantial portions” of both deferred cash and equity-like instruments for the deferral period.

Downward Adjustments, Forfeiture and Clawbacks

Downward Adjustment and Forfeiture. The proposed rules would require all incentive-based compensation for senior executives and significant risk takers at Level 1 and Level 2 institutions to be subject to possible downward adjustment and forfeiture. Forfeiture or downward adjustments would be triggered by the occurrence of one or more of the following events:

- poor financial performance attributable to a significant deviation from the covered institution’s risk parameters;
- inappropriate risk taking, regardless of the impact on financial performance;
- non-compliance with statutory, regulatory or supervisory standards resulting in enforcement or legal action against the covered institution by a federal or state regulator or agency, or a requirement that the covered institution restate a financial statement to correct a material error;
- material risk management or control failures; and
- any additional triggers based on conduct or poor performance defined by the covered institution.

Clawbacks. The proposed rules would require Level 1 and 2 institutions to include clawback provisions in incentive compensation agreements for senior executive officers and significant risk-takers. These provisions would require that the covered institution would be able to recover all vested incentive compensation awarded to current or former senior executive officers or significant risk takers for at least seven years after the vesting date. Triggering events would include a determination that the individual engaged in (1) misconduct that resulted in significant financial or reputational harm to the covered institution, (2) fraud or (3) intentional misrepresentation of information used to determine the individual’s compensation.

Governance Requirements

Level 1 and 2 institutions would also be required to adopt compliance and control processes and frameworks to monitor risk and establish managerial responsibility. The risk management framework generally will be required to be independent of any lines of business, include an independent compliance program that provides for internal controls, testing, monitoring and training, and be appropriate for the size and complexity of the covered institution. Level 1 and 2 institutions would also be required to establish a compensation committee composed solely of directors who are not senior executive officers.

Disclosure and Recordkeeping Requirements

The proposed rules would also impose additional and more detailed recordkeeping requirements on Level 1 and 2 institutions for at least seven years. These include records of:

- senior executive officers and significant risk takers listed by legal entity, job function, organizational hierarchy and line of business;
- incentive compensation arrangements for senior executive officers and significant risk takers, including information on the percentage of incentive compensation deferred and the form of award;
- any forfeiture, downward adjustment or clawback reviews and decisions for senior executive officers and significant risk takers; and
- material changes, if any, to the covered institution's incentive compensation arrangements and policies.

These records would be required to be kept in a manner to allow for an independent audit.

The public has until July 22 to comment on the proposed rules and the compliance date would be no later than the beginning of the first calendar quarter following at least 540 days after a final rule is published.

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