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Federal Agencies Release Joint Proposed Rule on Financial Institution Incentive-Based Compensation

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Last month, consistent with their obligation under the Dodd-Frank Act, several federal agencies released for comment a joint proposed rule that would prohibit any incentive compensation that encourages inappropriate risk taking by a covered financial institution: (a) by providing an executive officer, employee, director or principal shareholder with excessive compensation; or (b) that could lead to material financial loss to the institution. Companies that are not covered by this proposed rule should also be aware of the proposed rule because it could signal the future of incentive compensation rules for other industries. While the full text and commentary of the proposed rule (all 700 pages of them) can be found here, this blog post is intended to highlight its contours and some of its key points.

Covered Financial Institutions.

The proposed rule applies to "covered financial institutions" that have over $1 billion in average total consolidated assets. Each applicable federal agency has its own definition of a covered institution, but generally they include depository institutions, broker-dealers, credit unions, and investment advisors. There will also be “levels” of financial institutions based on asset size with more rigorous requirements for the larger institutions.

- **Level 1** – Greater than or equal to $250 billion in average total consolidated assets
- **Level 2** – Greater than or equal to $50 billion and less than $250 billion in average total consolidated assets
- **Level 3** – Greater than or equal to $1 billion and less than $5- billion in average total consolidated assets.

Prohibition on Inappropriate Risk.

The proposed rule prohibits covered institutions from establishing or maintaining incentive compensation arrangements that encourage inappropriate risk. Inappropriate risk is encouraged where (a) a covered individual is provided with excessive compensation or (b) the arrangement could lead to material financial loss to the covered institution.

- **Excessive Compensation.** Compensation is excessive when amounts paid are unreasonable or disproportionate to the value of services performance, taking into consideration all relevant factors. Relevant factors include the: (a) value of all compensation paid to the covered individual; (b) compensation history of the covered individual and comparable individuals; (c) financial condition of the institution; (d) compensation practices of comparable institutions; (e) for post-employment benefits, the projected total cost and benefit to the institution; and (f) any connection between the covered individual and any fraudulent act, breach of trust/duty or insider abuse.
- **Material Financial Loss.** Incentive compensation is considered to encourage inappropriate risk that could lead to material financial loss to the covered institution, unless such arrangement: (a) appropriately balances risk and reward; (b) is compatible with effective risk management and controls; and (c) is supported by effective governance.
    - <u>Balance Risk and Reward</u>. The proposed rules provide several levels of requirements in attempt to balance risk and reward. Level 1 and 2 institutions are subject to much stricter requirements.
        - *Performance*. Incentive compensation does not appropriately balance risk and reward unless it: (a) includes financial and non-financial measures of performance; (b) is designed to allow non-financial measures of performance to override financial measures (when appropriate); and (c) is subject to adjustment to reflect actual loss, risks, compliance deficiencies or other measures/aspects of performance. There are several more stringent requirements for Level 1 and Level 2 institutions. For example, Level 1 and Level 2

institutions may not award performance based compensation that exceed target measures in excess of 125% for senior executives.

    - *Deferrals*. Level 1 and Level 2 institutions are subject to mandatory deferral requirements. The amount and deferral period depends on the individual covered as well as the type of compensation. For example, a Level 1 institution would be required to defer at least 60% of a senior executive's qualifying incentive based compensation (i.e., annual bonuses) for at least 4 years.

    - *Forfeiture*. Level 1 and Level 2 institutions must make subject to forfeiture all unvested deferred incentive based compensation for certain covered individuals, including senior executives.

    - *Downward Adjustments*. Level 1 and Level 2 institutions must make subject to subject to downward adjustment all incentive based compensation awarded to certain covered individuals (including senior executives) that has not yet been awarded for the current performance period.

    - *Clawback*. Level 1 and Level 2 institutions are required to include clawback provisions in their incentive based compensation arrangements for covered individuals, including senior executives. The clawback provision would allow recovery of vested incentive compensation if certain events occur (i.e., engaging in misconduct that results in significant harm to the institution).

  - <u>Risk Management and Controls</u>. Level 1 and Level 2 institutions must (a) have a risk management framework for incentive compensation (i.e., provide for monitoring and internal controls), (b) grant appropriate authority to individuals engaged in control functions, and (c) provide independent monitoring of incentive plans, compliance with the proposed rules, and compliance with institutional policies and procedures.

  - <u>Effective Governance</u>. The board of directors of each covered institution would be required to: (a) conduct oversight of incentive compensation programs; (b) approve incentive compensation for senior executives; and (c) approve material exceptions or adjustments to incentive compensation for senior executives. Additionally, Level 1 and Level 2 institutions would be subject to additional requirements, namely, such institutions must establish compensation committees composed of directors who are not senior executives.

<u>Recordkeeping</u>.

Each covered institution must create annually and maintain for at least 7 years records that document the institution's incentive compensation arrangements and demonstrate compliance with the proposed rules. Level 1 and Level 2 institutions would need to maintain additional records with additional information.

<u>Effective Date</u>.

Comments to the proposed rules must be received by July 22, 2016. Thereafter, the compliance date for the final rule would be no later than the beginning of the first calendar quarter that begins at least 540 days after the final rule is published. The proposed rule would not apply to any incentive compensation plan that has a performance period that begins after the above compliance date.