Incentive-Based Compensation Arrangements

Interagency re-proposed rule

April 2016
Executive summary

On April 21, 2016, the National Credit Union Administration (NCUA) became the first agency to re-propose a Dodd-Frank-mandated rule on incentive-based compensation arrangements for certain financial institutions. The Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Federal Housing Finance Agency (FHFA) adopted substantively identical versions of the proposal on April 26, 2016. Two other agencies—the Federal Reserve Board (FRB) and Securities and Exchange Commission (SEC)—are expected to adopt the proposal shortly.

Key takeaways

- Regulators propose increasingly rigorous requirements for larger institutions, especially those above the $250 billion asset threshold.
- Proposal appears to be more stringent than the agencies' original 2011 proposal, as it covers a wider range of employees—including a new category for "significant risk-takers"—and increases the percentage of deferred compensation for senior executive officers.
- Unlike the 2011 proposal, would require Level 1 and Level 2 institutions to include clawback provisions in incentive-based compensation arrangements that would allow them to recover vested compensation for seven years.
- Unlike international rules, does not propose a limit on the absolute size of potential target amounts; however Level 1 and Level 2 institutions would be prohibited from awarding incentive-based compensation to a senior executive officer in excess of 125 percent of the target amount for that compensation (the prohibition for a significant risk taker would be 150 percent of the target amount).
- While the 2011 proposal would have established an annual reporting requirement, the new proposal would require institutions to create annually and maintain for at least seven years records that document compliance.
- Level 1 and Level 2 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.

Comments on the proposed rule are due by July 22, 2016.

Source: [https://www.ncua.gov/About/Documents/Agenda%20Items/AG20160421Item2b.pdf](https://www.ncua.gov/About/Documents/Agenda%20Items/AG20160421Item2b.pdf)
Background

Section 956 of Dodd-Frank requires the agencies to issue regulations to prohibit any types of incentive-based compensation arrangements they determine encourage inappropriate risks by covered institutions.

### Background

- The agencies published their original proposal in April 2011, but decided to re-propose the rule in light of the (1) the **evolution of incentive-based compensation** in the financial services industry, (2) the **supervisory insights they have gained** through applying guidance on the issue, and (3) the **comments received** on the original proposal.

- In June 2010, the FRB, FDIC, and OCC issued **guidance taking a principles-based approach to incentive-based compensation programs**, which applies to all banking organizations regardless of size.

- Prior to issuing the 2010 guidance, the FRB launched a **horizontal review of incentive-based compensation** at 25 large domestic and foreign banking organizations, which is ongoing.
  - The agencies found that **institutions subject to this review have made progress** in developing practices that would incorporate the guidance into their risk management systems.
  - The FRB issued a paper setting forth its **initial findings** from the horizontal review in October 2011.

- Other jurisdictions, including the European Union, have **adopted new compensation regulations** since the agencies’ 2011 proposed rule.

- In June 2015, the UK Prudential Regulation Authority and Financial Conduct Authority issued **compensation rules**, which included clawbacks.

- Financial Stability Board (FSB) published **four progress reports** on implementing the **FSB Principles for Sound Compensation Practices**, in addition to a November 2015 progress report on measures to reduce misconduct risk, which commits to **further examining the use of compensation tools such as malus and clawbacks**.

### Regulatory milestones

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- **June 2010**: FRB, FDIC, OCC issue guidance on sound compensation policies.
- **April 2011**: Agencies propose incentive compensation rule under Section 956 of Dodd-Frank.
- **October 2011**: FRB releases initial findings from horizontal review at large institutions.
- **June 2013**: European Union adopts Capital Requirements Directive (CRD) establishing requirements for compensation structures, policies, and practices.
- **June 2015**: UK Prudential Regulation Authority and Financial Conduct Authority issue policy statement on new remuneration rules.
- **April 2016**: NCUA re-proposes incentive compensation rule under Section 956 of Dodd-Frank.
- **July 22 2016**: Comment period on re-proposed rule ends.

### Key

- ▲ Proposed Rule
- ★☆ Final Rule/ Guidance
- ● Other

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Summary elements of the proposed rule (1 of 5)

Below are the key components of the proposed rule

<table>
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<th>Elements</th>
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<td><strong>Applicability</strong></td>
<td><strong>Covered institutions as defined by Section 956 of Dodd-Frank</strong>&lt;br&gt;• National banks, state member banks, federal savings associations&lt;br&gt;• Bank holding companies (BHCs), savings and loan holding companies (SLHCs)&lt;br&gt;• SEC-registered broker-dealers&lt;br&gt;• Credit unions&lt;br&gt;• Investment advisers (registered and unregistered)&lt;br&gt;• Fannie Mae, Freddie Mac&lt;br&gt;&lt;br&gt;<strong>Institutions that the agencies jointly propose should be treated as covered institutions</strong>&lt;br&gt;• US operations of foreign banking organizations (FBOs) that are treated as BHCs&lt;br&gt;• Edge and Agreement corporations&lt;br&gt;• State-licensed and uninsured branches and agencies of FBOs&lt;br&gt;• State-chartered non-depository trust companies that are members of the Federal Reserve System&lt;br&gt;• Federal Home Loan Banks</td>
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<td><strong>Exemptions</strong></td>
<td>• Not applicable to institutions with less than $1 billion in assets</td>
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<td><strong>Compliance date</strong></td>
<td>• 18 months after a final rule is published in the <em>Federal Register</em>&lt;br&gt;• Would grandfather any incentive-based plan with a performance period that begins before this date</td>
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<td><strong>Key definitions</strong></td>
<td>• <strong>Covered person</strong> – any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution&lt;br&gt;&lt;br&gt;• <strong>Senior executive officer</strong> – a covered person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions at a covered institution:&lt;br&gt;  o 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&lt;br&gt;&lt;br&gt;• <strong>Significant risk taker</strong> – any covered person at a Level 1 or Level 2 institution who received at least one-third of total compensation as incentive-based compensation, and who meets either of the following tests:&lt;br&gt;  o The “relative compensation test” (i.e., among the top 5 percent of highest compensated persons in the entire consolidated organization, including affiliated covered institutions, for Level 1 institutions, and among the top 2 percent of highest compensated persons in the entire consolidated organization, including affiliated covered institutions, for Level 2 institutions), or&lt;br&gt;  o The “exposure test” (i.e., having authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution)</td>
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<th>Key definitions (continued)</th>
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<th>Forfeiture and downward adjustment</th>
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<td><strong>Elements</strong></td>
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<td>• Level 1 and Level 2 institutions would be required to make subject to forfeiture all unvested incentive-based compensation of a senior executive officer or significant risk-taker and make subject to downward adjustment all incentive-based compensation not yet awarded if the following adverse outcomes occur:</td>
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<td>• Poor financial performance attributable to a significant deviation from the institution’s risk parameters set forth in the policies and procedures, inappropriate risk taking, regardless of the impact on financial performance, material risk management or control failures, non-compliance with regulatory standards resulting in an enforcement action or a requirement that the institution correct a material error to a financial statement</td>
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| Deferral | **Level 1**
- 60 percent of a senior executive officer’s qualifying incentive-based compensation for at least four years
- 50 percent of a significant risk-taker’s qualifying incentive-based compensation for at least four years
- 60 percent of a senior executive officer’s incentive-based compensation awarded under a long-term incentive plan for at least two years after the end of the related performance period
- 50 percent of a significant risk-taker’s incentive-based compensation awarded under a long-term incentive plan for at least two years after the end of the related performance period
- Deferred compensation may vest no faster than on a pro rata annual basis
  - For covered institutions that issue equity or are subsidiaries of covered institutions that issue equity, the deferred amount would be required to consist of “substantial amounts of both deferred cash and equity-like instruments”
- The amount of options used to meet the minimum required deferred compensation may not exceed 15 percent of the amount of total incentive-based compensation awarded for that performance period

**Level 2**
- 50 percent of a senior executive officer’s qualifying incentive-based compensation for at least four years
- 40 percent of a significant risk-taker’s qualifying incentive-based compensation for at least four years.
- 50 percent of a senior executive officer’s incentive-based compensation awarded under a long-term incentive plan for at least one year after the end of the related performance period
- 50 percent of a significant risk-taker’s incentive-based compensation awarded under a long-term incentive plan for at least one year after the end of the related performance period
- Deferred compensation may vest no faster than on a pro rata annual basis
  - For covered institutions that issue equity or are subsidiaries of covered institutions that issue equity, the deferred amount would be required to consist of “substantial amounts of both deferred cash and equity-like instruments”
- The amount of options used to meet the minimum required deferred compensation may not exceed 15 percent of the amount of total incentive-based compensation awarded for that performance period

| Clawback | Level 1 and Level 2 institutions would be required to include clawback provisions in the incentive-based compensation arrangements for senior executive officers and material risk-takers if the institution determines that these current or former employees engaged in misconduct that resulted in “significant financial or reputational harm to the covered institution, fraud, or intentional misrepresentation of information” |
### Summary elements of the proposed rule (4 of 5)

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| **Maximum incentive-based compensation** | • Level 1 and Level 2 institutions would be required to limit the amount by which the actual incentive-based compensation awarded to a senior executive officer or significant risk taker could exceed the target amounts for performance measure goals established at the beginning of the performance period  
  o Senior executive officers would be prohibited from receiving incentive-based compensation in excess of 125 percent of the target amount for that incentive-based compensation  
  o Significant risk takers would be prohibited from receiving incentive-based compensation in excess of 150 percent of the target amount for that incentive-based compensation  
  o The agencies do not propose a limit on the absolute size of potential target amounts |
| **Disclosure and recordkeeping requirements** | **All institutions**  
  • Create annually and maintain for at least seven years records that document the structure of incentive-based compensation arrangements and that demonstrate compliance with the rule  
  • Include copies of all incentive-based compensation plans, a list of who is subject to each plan, and a description of how the compensation program is compatible with effective risk management and controls  
  **Additional requirements for Level 1 and Level 2 institutions**  
  • Maintain a list of all senior executive officers and significant risk-takers and their incentive-based compensation arrangements, any forfeiture and downward adjustment or clawback reviews and decisions, and any material changes to incentive-based compensation arrangements and policies  
  • Maintain records in a manner that would allow for an independent audit of incentive-based compensation arrangements, policies, and procedures |
| **Risk management framework and controls** | • Level 1 and Level 2 institutions would be required to have a risk management framework for their incentive-based compensation programs that is independent of any lines of business, 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 its operations |
| **Governance** | • Level 1 and Level 2 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  
  • Management would be required to submit an annual written assessment to the compensation committee on the effectiveness of the incentive-based compensation program and related compliance and control processes  
  • Compensation committee would be required to obtain an independent written assessment from the internal audit or risk management function of the program’s effectiveness |

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Summary elements of the proposed rule (5 of 5)

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| Requirements for boards of directors | • Conduct oversight of the 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  
• Approve material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers                                                                                                                                                                                                                                                                                                                                                           |
| Policies and procedures   | • Level 1 and Level 2 institutions would be required to have policies and procedures that, among other things:  
  o Specify the criteria for forfeiture and clawback  
  o Document final forfeiture, downward adjustment, and clawback decisions  
  o Specify the criteria for the acceleration of payments of deferred incentive-based compensation  
  o Identify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions  
  o Describe how incentive-based compensation arrangements will be monitored  
  o Specify the requirements of the independent compliance program  
  o Ensure appropriate roles for risk management, risk oversight, and other control personnel in the processes for designing incentive-based compensation arrangements |
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