Client Alert | Employment, Compensation & Benefits

New Proposed Rules on Curbing Wall Street Incentive Compensation

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Introduction

Six federal agencies (the "Agencies") consisting of: the Federal Deposit Insurance Corporation ("FDIC"), National Credit Union Administration ("NCUA"), Federal Housing Finance Agency ("FHFA"), Office of the Comptroller of the Currency ("OCC"), Securities and Exchange Commission ("SEC") and the Board of Governors of the Federal Reserve (the "Federal Reserve") have recently issued proposed rules governing incentive compensation at financial institutions. The Agencies have issued these proposed rules in accordance with Section 956 of Dodd Frank which generally requires the Agencies to jointly issue regulations or guidelines (1) prohibiting incentive-based payment arrangements that the Agencies determine encourage inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss; and (2) requiring those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate federal regulator. The proposed rules aim to limit inappropriate risk-taking at larger financial institutions by creating requirements to, among other things, require substantial deferrals of such larger institutions executives' incentive compensation and providing for seven year clawbacks after vesting of incentive compensation. Additionally, the proposed rules would require all covered financial institutions, regardless of size, to implement additional record keeping and compliance procedures to help stop excessive compensation that could result in inappropriate risk taking. These proposed rules go a step further than the 2011 proposed rules which the Agencies issued to implement the Dodd-Frank Section 956 requirements.

Selected Noteworthy Provisions

- *Three Tiers*: Covered financial institutions under each proposed rule are broken down into three tiers based on asset size, which generally would be determined using regulatory reports for the four most recent consecutive quarters, *e.g.*, call reports (details discussed in "Covered Institutions" below). The proposed rules establish the following three tiers of covered financial institutions based on asset size:
  - *Level 1*: greater than or equal to $250 billion
  - *Level 2*: greater than or equal to $50 billion and less than $250 billion
  - *Level 3*: greater than or equal to $1 billion and less than $50 billion
- *Covered Persons*: Generally, covered persons under the proposed rules consist of any executive officer, employee, director, or principal shareholder who receives incentive compensation at a "covered institution." Certain of the most noteworthy requirements apply only to "senior executive officers" or "significant risk-takers." Senior executives include, among others, the CEO, CFO and COO. Significant risk-takers generally include individuals who are not "senior executive officers" but may still expose a Level 1 or Level 2 institution to material financial loss. To qualify as a covered person, a significant risk-taker must receive at least 1/3 of his/her total compensation as incentive based compensation and meet either the "relative-compensation test" or "exposure test." The "relative-compensation test" covers those employees in the top 5% of the highest compensated employees for Level 1 institutions and the top 2%

for Level 2 institutions. The exposure test covers any person who may commit or expose 0.5% or more of the capital of the covered financial institution.

- *Minimum Deferral*:

  - *Level 1*: For senior executive officers, at least 60% of incentive based compensation (50% for significant risk-takers) must be deferred for at least four years and at least 60% (50% for significant risk-takers) of compensation awarded under a long term incentive plan ("LTIP") must be deferred at least two years, in each case beyond the end of the performance period.

  - *Level 2*: For senior executive officers, at least 50% of incentive based compensation (40% for significant risk takers) must be deferred for at least three years and at least 50% (40% for significant risk-takers) of compensation awarded under an LTIP must be deferred at least one year, in each case beyond the end of the performance period.

  - *Level 3*: Level 3 institutions (e.g., certain community banks) are not subject to the same minimum required deferral as Level 1 and Level 2 institutions.

- *Clawback*: Clawback is a feature whereby an institution can recover vested incentive compensation after it has vested. For both Level 1 and Level 2 covered institutions, all incentive based compensation awarded to senior executive officers and significant risk-takers must be subject to clawback for at least seven years from the vesting date. Level 3 institutions are not subject to the newly proposed clawback rules. Clawback may be exercised in a range of instances such as fraud and certain misconduct resulting in significant financial or reputational harm to the covered institution. The proposed clawbacks for financial institutions are much longer and would cover more employees than the existing clawback provisions required under Section 304 of Sarbanes Oxley to be implemented in accordance with Section 954 of Dodd-Frank.

- *Downward Adjustment and Forfeiture*: Downward adjustment and forfeiture refer to a reduction in the amount of incentive compensation. Downward adjustment refers to a reduction for a performance period that is still occurring, and forfeiture refers to reduction for a performance period that has ended but vesting has not yet occurred. Level 1 and Level 2 covered institutions must consider both downward adjustment and forfeiture should certain triggering events occur. These triggering events include, but are not limited to inappropriate risk-taking and certain poor financial performance

Covered Institutions

The proposed rules will apply (if implemented) to many institutions beyond Wall Street, though; each must have average total consolidated assets of $1 billion or more to be covered:

1) *NCUA Rule*: certain credit unions

2) *FDIC Rule*: certain state non-member banks, state savings associations, and state insured branches of foreign banks as well as certain of their subsidiaries if the subsidiary is not a broker, dealer, person providing insurance, investment company, or investment advisor

3) *OCC Rule*: certain national banks, federal savings associations, or federal branches or agencies of a foreign bank, as well as certain subsidiaries, if the subsidiary is not a broker, dealer, person providing insurance, investment company, or investment advisor

4) *Federal Reserve Rule*: a "regulated institution" which includes among others, certain state member banks, bank holding companies, savings and loan holding companies, Edge and Agreement Corporations, state-licensed branch or agencies of a foreign bank, and the US operations of a foreign banking organization (and a US subsidiary of such foreign banking organization that is not a depository institution, broker-dealer, or investment advisor.)

5) *SEC Rule*: certain broker-dealers and investment advisers

6) *FHFA Rule*: Fannie Mae, Freddie Mac, and federal home loan banks

Other Provisions

The proposed rules contain a broad range of other suggested provisions, including, among others, governance, risk management, and recordkeeping requirements. Certain of these requirements, such as the requirement for covered institutions to maintain, for at least seven years, records that evidence the structure of the entire covered institution's incentive compensation arrangements (which must demonstrate compliance with law) apply to all covered institutions, regardless of tier. Additionally, the basic requirements applicable to all tiers include a general prohibition on incentive compensation that encourages inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss. These requirements, while not as stringent as some of the provisions directed at Level 1 and Level 2 tiers (e.g., minimum deferral), will undoubtedly place additional administrative expense on companies to ensure compliance.

Implications

These new rules, if approved, will force financial institutions to adopt certain practices potentially affecting substantially large numbers of their employees. Any employer that may be considered a "covered institution" should prepare for these potentially costly adjustments to their pay practices. The proposed rules, if finalized, won't be effective until the first day of the calendar quarter 540 days after publication of the final rule in the federal register (thus they will likely not affect most employers before the 2019 compensation year). With the proposal of these rules, the United States is taking steps towards the notoriously stringent European Union rules on remuneration and their treatment of incentive compensation for financial institutions.

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