Reproposed Regulations on Financial Institution Incentive-Based Compensation Expand Definition of Covered Institutions and Require Significant Changes to Incentive-Based Compensation Arrangements

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Section 956 of the Dodd Frank Act requires six different federal agencies (the "Agencies") to jointly issue rules regulating incentive-based compensation at covered financial institutions by (1) prohibiting incentive-based compensation arrangements that encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss and (2) requiring covered financial institutions to disclose information concerning incentive-based compensation arrangements to the institutions' appropriate federal regulator. In April 2011, the Agencies originally issued proposed regulations to implement these requirements of the Dodd Frank Act. Five years later, the Agencies have jointly issued reproposed regulations (the "2016 Proposal") with significant changes. *Comments on the 2016 Proposal must be received by July 22, 2016.* Covered financial institutions will become subject to the regulations 540 days after the final regulations are published in the Federal Register. However, an incentive-based compensation arrangement with a performance-period that begins prior to the final regulations' effective date would not be subject to the final regulations.

Please note that there are some differences between the proposed rules of each of the Agencies and that the information below is a high-level general summary. Depending on which of the Agencies regulates a particular financial institution, those proposed rules should be reviewed for the specific applicable requirements.

Expanded Definition of Covered Financial Institution

Section 956(e)(2) of the Dodd Frank Act defines the term ''covered financial institution'' to include: (a) a depository institution or depository institution holding company; (b) a broker-dealer; (c) a credit union; (d) an investment advisor; (e) the Federal National Mortgage Association; (f) the Federal Home Loan Mortgage Corporation, and; (g) any other financial institution that the Agencies, jointly, by rule, determine should be treated as a covered financial institution. Under the 2016 Proposal, the Agencies have expanded the definition of "covered financial institutions" to include:

- Federal Home Loan Banks,
- State-licensed uninsured branches and agencies of a foreign bank,

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- Edge and Agreement Corporations,
- Other US operations of foreign banking organizations that are treated as bank holding companies, and
- State-chartered non-depository trust companies that are members of the Federal Reserve.

Three Tiers of Covered Financial Institutions

The 2016 Proposal creates three tiers of covered financial institutions based on asset size:

- Level 1: covered financial institutions with assets of $250 billion or more.
- Level 2: covered financial institutions with assets of $50 billion but less than $250 billion.
- Level 3: covered financial institutions with assets of $1 billion but less than $50 billion.

The 2016 Proposal does not apply to financial institutions with less than $1 billion in assets. Detailed guidelines are contained in the 2016 Proposal about how to calculate a covered financial institution's assets in order to determine its applicable tier level. In addition, generally the Agencies have proposed that subsidiaries of other covered financial institutions would be subject to the same restrictions based on the tier level of the parent covered financial institution.

Requirements Applicable to All Tiers

All covered financial institutions must comply with the following requirements:

- Prohibit incentive-based compensation arrangements that encourage inappropriate risk by promising an employee excessive compensation or that could lead to material financial loss.
  - Compensation is considered excessive if it is unreasonable or disproportionate to the value of the services rendered after taking into account relevant factors including the total value of compensation paid, compensation history of the employee and others with comparable expertise, the financial condition of the institution, compensation at comparable institutions, cost and benefit of post-employment benefits and any connection between the employee and wrongful acts with respect to the institution.
  - Incentives arrangements must include financial and non-financial measures (including risk management) appropriate for the employee's role with the institution and the non-financial measures must be able to override the financial measures when appropriate. Any amount awarded under the arrangement must be subject to adjustment to reflect actual losses, inappropriate risk taken, compliance deficiencies or other measures or aspects of financial and non-financial performance.
- Incentive-based compensation arrangements must be compatible with effective risk management and controls, supported by effective governance and overseen by the board of directors (or a committee of the board) of the covered financial institution.
- Covered financial institutions must create and retain annual records that document the structure of all the institution's incentive-based compensation arrangements and demonstrate compliance with the final rules. The records must be maintained for seven years and be disclosed to the appropriate federal regulator upon request.

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Requirements for Level 1 and Level 2 Covered Financial Institutions

Under Proposal 2016, Level 1 and Level 2 covered financial institutions would be subject to significant additional requirements, including:

- All incentive-based compensation payable to a "senior executive officer" or "significant risk taker" must be subject to a seven-year clawback requirement.
  - The 2016 Proposal expands which executives are considered senior executive officers: president, CEO, executive chairman, CFO, COO, CIO, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit officer, chief credit officer, chief accounting officer or the head of a major business line or control function.
- Mandatory deferral and vesting periods (*i.e.*, subject to a substantial risk of forfeiture) of incentive-based compensation payable to senior executive officers or significant-risk takers. The amount required to be deferred, and the length of the vesting, vary depending on the tier level of the institution and whether the employee is a senior executive officer or a significant-risk taker.
- No acceleration of vesting of deferred incentive-based compensation except in the event of death or disability.
- Incentive-based compensation payable to a senior executive officer or significant-risk taker may not exceed targets by more than 125% of target for senior executive officers or 150% of target for significant-risk takers.
- Implement an independent risk-monitoring framework.

Conclusion

The requirements of the 2016 Proposal are significantly different than the compensation arrangements and governance procedures that are currently used by many financial institutions. Once a financial institution determines that it is a covered financial institution, it should review its incentive-based compensation arrangements to determine which will be subject to the proposed regulations. These arrangements must be analyzed to determine whether the incentive-based compensation provides excessive compensation or could expose the institution to a material financial loss. Covered financial institutions should also review their current written governance structure regarding risk analysis and awarding incentive compensation and current recordkeeping to insure compliance with the 2016 Proposal. Level 1 and Level 2 institutions should also consider whether changes to their compensation and equity compensation plans and arrangements are necessary to comply with the additional requirements for their covered employees and to establish appropriate governance protocols, including a review of the charter of the compensation committee to ensure the committee has sufficient authority to comply with its obligations under the 2016 Proposal.

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