Banks Must Prepare to Change Common Pay Practices

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by Mark Jones

Mark Jones
Executive Compensation & Benefits
+1.213.488.7337
mark.jones@pillsburylaw.com

Mark Jones is a partner in Pillsbury's Executive Compensation and Benefits practice and is based in the firm's Los Angeles and San Diego offices.

Earlier this year, six federal regulatory agencies proposed regulations that would expand the scope of existing restrictions on incentive compensation at banks and other financial institutions.

Issued under the Dodd-Frank Act, the regulations would require financial institutions with total assets of $50 billion or more to:

- Defer payment of 40 percent to 60 percent of incentive compensation to highly compensated employees, senior executives and other key employees for up to four years;
- Prohibit acceleration of vesting in circumstances other than death, disability or tax recognition; and
- Recoup payments for up to 7 years in the event that a key employee engages in fraud, intentional misrepresentation or misconduct.
- In addition, the rules would require covered financial institutions of all sizes to:
- Include both financial and nonfinancial measures in all performance targets;
- Benchmark incentive compensation payments against comparable institutions; and
- Have the compensation committee or full board of directors approve all incentive compensation arrangements for and payments to senior executive officers.

These rules reflect a belief, long shared by federal regulators, that pay caps and extended vesting and deferral periods reduce systemic risk. Timothy Geithner and Ben Bernanke both identified short-term bonus arrangements as one of the factors that contributed to the 2008 financial crisis, and limits on incentive compensation were a key component of the 2009 Troubled Asset Relief Program. At the international level, the European Union revised its Capital Requirements Directive after the financial crisis to mandate the deferral of variable pay by key employees and again in 2013 to cap variable pay. Last year, the United Kingdom published regulations requiring financial institutions to recoup variable pay in the event of misbehavior, material error or risk management failure within seven years after the grant date (10 years if the bank is under investigation).

While similar in intent to the European rules, the regulations proposed under Dodd-Frank are broader in scope and place a greater importance on the process by which compensation is determined. One of the challenges for U.S. branches and subsidiaries of financial institutions headquartered outside the United States will be to comply with two sets of compensation regulations. In particular, dual foreign and domestic supervision will complicate the administration of any compensation arrangement sponsored by the foreign parent and any arrangement covering employees who move between the United States and the parent's home country.

Domestic financial institutions will also need to make changes. Since 2009, most large and many midsize banks have operated in a state of perpetual audit. But whereas the current rules are expressed as general principals—financial institutions are in the position of demonstrating to the supervising agency how their compensation systems take risk into account—the proposed regulations are specific and prescriptive. For example, the Sound Incentive Compensation Policies issued by the **Federal Reserve**, the **Federal Deposit Insurance Corp**. and the **U.S. Department of the Treasury** in 2010 provide that if an incentive compensation arrangement would expose a bank to imprudent risks, it may consider a number of methods for making the compensation more sensitive to risk, including extending performance periods, deferring payment and capping maximum payment amounts. By contrast, the proposed regulations require all of these measures to be taken and impose quantitative and durational requirements on the compensation that must be capped or deferred or otherwise placed at risk. These requirements are, in general, stricter than the limits agreed to under the Sound Incentive Compensation Policies. The deferral and clawback requirements would cause long-term incentive pay to be at risk for up to 12 years, which is much longer than current practice within and outside the financial services industry. In addition, the requirement to include both financial and nonfinancial measures in performance targets would cause banks to revisit the steps they have already taken, in consultation with applicable regulatory agencies, to create balanced incentive compensation programs. These changes are likely to have unfavorable tax and accounting consequences and would thwart standard equity compensation programs. Finally, the prohibition on acceleration of vesting absent death, disability or tax realization would require financial institutions to remove common provisions that would also accelerate vesting in the event of retirement, involuntary termination, or change in control.

The regulations also have a broader scope than the existing Sound Incentive Compensation Policies. The existing policies apply primarily to state and national banks and savings and loan companies; the proposed regulations extend to credit unions, broker-dealers and investment advisers that meet the minimum asset requirement. The existing policies treat as "covered employees" only senior executives and other employees who, individually or as a group, may expose the organization to material amounts of risk. The proposed regulations would cover all employees who receive incentive compensation, with heightened requirements for, among others, employees who are highly compensated or have the title of a senior executive on a parent or subsidiary level, even if their authority is too limited to have a material impact on the institution's risk profile. And whereas the existing policies apply only to compensation that is tied to achievement of one or more specific metrics, the regulations define "incentive compensation" so broadly that it could include cash bonus pools, stock grants, service-based awards, and broad-based profit-sharing contributions.

The new incentive compensation rules will become effective 18 months after they are finalized. This lag is intended to give financial institutions time to implement the risk management framework necessary to comply. In doing so, they will need to give consideration to the interplay of the new rules with existing tax and wage-and-hour laws. For example, some state wage-and-hour laws impose restrictions on the unilateral recoupment of wages, including bonus pay, after it has otherwise been earned. In addition, federal tax regulations generally require the time and form of any deferred payment of performance-based compensation to be set at least six months before the end of the performance period or, if earlier, when the amount of the compensation has become readily ascertainable. These issues can be managed, but doing so requires advance planning and coordination.

Pillsbury Winthrop Shaw Pittman LLP | 1540 Broadway | New York, NY 10036 | +1.877.323.4171