

## Bank Regulators Revive Restrictions on Incentive-Based Compensation

By Mark C. Jones and Robert L. Tian

*Financial regulators have proposed new rules limiting the incentive pay of employees and other service providers at financial institutions.*

The Dodd-Frank Act of 2010 prohibits incentive compensation that encourages inappropriate risks or provides excessive compensation, and the National Credit Union Administration, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Securities and Exchange Commission have proposed new restrictions on how financial institutions pay their employees and other service providers.

### The Rules

The new rules seek to establish general requirements applicable to the incentive-based compensation arrangements of covered persons working in covered institutions. Covered persons are any executive officers, employees, directors or principal shareholders who receive incentive-based compensation<sup>1</sup> at a covered institution. Additional restrictions apply to senior executive officers<sup>2</sup> and significant risk-takers<sup>3</sup>.

“Covered institutions” include any of the following institutions that have \$1 billion or more in assets:

- A depository institution or depository institution holding company;
- A broker-dealer registered under section 15 of the Securities Exchange Act of 1934;
- A credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; and

<sup>1</sup> Incentive-based compensation is defined as any variable compensation, fees, or benefits that serve as an incentive or reward for performance.

<sup>2</sup> Senior executive officers include the 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.

<sup>3</sup> Significant risk takers are covered persons, other than senior executive officers, who receive annual base salary and incentive-based compensation of which at least one-third is incentive-based compensation, and are (i) among the top 5% (for Level 1 covered institutions) or top 2% (for Level 2 covered institutions) of highest compensated covered persons in the entire consolidated organization, or (ii) authorized to commit or expose 0.5% or more of the capital of a Level 1 or Level 2 institution. Federal agencies charged with enforcing the regulations may designate other service providers as significant risk takers.

- An investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940.

The proposed rules identify three categories of covered institutions based on average total consolidated assets:

- Level 1 (greater than \$250 billion);
- Level 2 (between \$50 and \$250 billion); and
- Level 3 (between \$1 and \$50 billion).

### Requirements for All Covered Institutions

Under the proposed rule, all covered institutions would be prohibited from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risks by the covered institution (1) by providing covered persons with excessive compensation, fees or benefits, or (2) that could lead to material financial loss to the covered institution. Each covered institution is responsible for its incentive-based compensation arrangements appropriately balancing risk and reward.

#### A) No Excessive Compensation

The proposed rules prohibit compensation, fees and benefits that are unreasonable or disproportionate to the value of the services performed. Relevant factors include:

- The combined value of all compensation, fees or benefits provided to the covered person;
- The compensation history of the covered person and the other individuals with comparable expertise at the covered institution;
- The financial condition of the covered institution;
- Compensation practices at comparable covered institutions, based upon asset size, geographic location and the complexity of the covered institution's operations and assets;
- For post-employment benefits, the projected total cost and benefit to the covered institution; and
- Any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered institution.

#### B) Appropriate Performance Measures

The performance measures used in an incentive-based compensation arrangement have an important effect on the incentives provided to covered persons. Such an arrangement would not appropriately balance risk and reward unless:

- It includes relevant financial and non-financial measures of performance of a covered person's role and to the type of business in which the covered person is engaged;
- It is designed to allow non-financial measures of performance to override financial measures when appropriate; and
- Any amounts to be awarded under the arrangement are subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.

**C) Effective Controls**

A covered institution must implement controls over the design, implementation and monitoring of incentive-based compensation appropriate to the institution's size and complexity.

**D) Approval of Board of Directors**

Under the proposed rules, a covered institution's board of directors, or a committee thereof, would be required to:

- Conduct oversight of the incentive-based compensation program;
- Approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and
- Approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

**E) Disclosure and Recordkeeping**

All covered institutions would be required to create and maintain records that document the structure of all of the institution's incentive-based compensation arrangements and disclose these records to the appropriate Federal regulator upon request. Such records must be maintained for at least seven year after they are created. At a minimum, a covered institution's records must include copies of all incentive-based compensation plans, a list of who is subject to each plan, and a description of how the covered institution's incentive-based compensation program is compatible with effective risk management and controls.

**Further Requirements for Level 1 and Level 2 Covered Institutions****A) Limits on Maximum Payouts**

Under certain incentive-based compensation plans, covered persons can be awarded amounts in excess of their target amounts if the covered institution or covered person's performance exceeds performance targets. Believing that these kinds of incentives may encourage inappropriate risk taking, the proposed rules limit maximum payouts under these plans to 125 percent of the pre-set target for senior executive officers and 150 percent of the pre-set target for significant risk-takers. This limitation would apply on a plan-by-plan basis, and, accordingly, would apply to long-term incentive plans separately from other incentive-based compensation plans.

**B) Deferral**

Significant risk-takers and senior executive officers must defer 40, 50 or 60 percent of their incentive-based compensation awards, depending on the size of the covered institution and whether the covered person receiving the incentive-based compensation is a senior executive officer or a significant risk-taker. Level 1 and Level 2 covered institutions would be prohibited from accelerating the payment of a covered person's deferred incentive-based compensation, even upon the covered person's termination of employment, except in the case of death or disability. Deferred compensation may vest no faster than on a pro rata annual basis, and, for covered institutions that issue equity, the deferred amount must consist of substantial amounts of both deferred cash and equity-like instruments throughout the deferral period.

**Level 1 Covered Institution**

A Level 1 covered institution must defer at least 60 percent of a senior executive officer's "qualifying incentive-based compensation" (performance period of less than three years) and 50 percent of a significant risk-taker's qualifying incentive-based compensation for at least four years. A Level 1 covered institution also would be required to defer for at least two years after the end of the related performance period at least 60 percent of a senior executive officer's incentive-based compensation awarded under a long-term incentive plan (performance period of three years or more) and 50 percent of a significant risk-taker's incentive-based compensation awarded under a long-term incentive plan.

**Level 2 Covered Institutions**

A Level 2 covered institution would be required to defer at least 50 percent of a senior executive officer's qualifying incentive-based compensation and 40 percent of a significant risk-taker's qualifying incentive-based compensation for at least three years. A Level 2 covered institution also would be required to defer for at least one year after the end of the related performance period at least 50 percent of a senior executive officer's incentive-based compensation awarded under a long-term incentive plan and 40 percent of a significant risk-taker's incentive-based compensation awarded under a long-term incentive plan.

Covered institutions may satisfy the deferral requirements by aggregating qualifying incentive-based compensation, but the deferral percentages applicable to long term incentive plans must be applied plan by plan.

**C) Downward Adjustment and Forfeiture**

A Level 1 or Level 2 covered institution would be required to subject to downward adjustment all incentive-based compensation amounts not yet awarded to any senior executive officer or significant risk-taker, including amounts payable under long-term incentive plans. In addition, all unvested deferred incentive-based compensation of any senior executive officer or significant risk-taker of a Level 1 or Level 2 covered institution must be subject to forfeiture.

Forfeiture or downward adjustments must be considered if any of the following adverse outcomes occur:

- Poor financial performance attributable to a significant deviation from the covered institution's risk parameters set forth in the covered institution's policies and procedures;
- Inappropriate risk-taking, regardless of the impact on financial performance;
- Material risk management or control failures;
- Non-compliance with statutory, regulatory or supervisory standards resulting in enforcement or legal action brought by a federal or state regulator or agency, or a requirement that the covered institution restate a financial statement to correct a material error; and
- Other aspects of conduct or poor performance as defined by the covered institution.

**D) Clawback**

The proposed rules would require a Level 1 or Level 2 covered institution to include clawback provisions in the incentive-based compensation arrangements for senior executive officers and significant risk-takers pursuant to which the institution may recover vested incentive-based compensation from a senior executive officer or significant risk-taker if such officer or risk-taker engaged in misconduct that resulted in significant financial or reputational harm to the covered institution, fraud or intentional misrepresentation of

information used to determine the person's compensation. Clawbacks are to remain in effect for at least seven years after vesting and would apply even to former employees who have left the company.

### **E) Risk Management and Governance**

Level 1 and Level 2 covered institutions must adopt compliance and control processes that manage and monitor risk and establish managerial responsibility. In addition, the management and internal audit or risk management functions of each covered institution must prepare written assessments for the Compensation Committee of the incentive-based compensation programs and compliance and control processes in balancing risk with reward.

### **F) Disclosure and Recordkeeping**

Finally, Level 1 and Level 2 covered institutions would be subject to additional and more detailed recordkeeping requirements, including creating annually and maintaining for at least seven years records of:

- A list of senior executive officers and significant risk-takers, by legal entity, job function, organizational hierarchy, and line of business;
- The incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on the percentage of incentive-based compensation deferred and form of award;
- Any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and
- Any material changes to the covered institution's incentive-based compensation arrangements and policies.

These records must be maintained in a manner that would allow for an independent audit of incentive-based compensation arrangements, policies, and procedures.

For institutions subject to these rules, the new restrictions are largely consistent with the practices many banks have developed since the financial crisis, but impose greater specificity on duration and amounts. For example, it is already an industry standard to wait three years to release stock-based bonuses. The new rules aim to push that to four years. The proposed rules do not address existing restrictions on deferred compensation and clawbacks, such as those under state wage and hour laws and section 409A of the Internal Revenue Code.

The public has until July 22 to comment on the new rules, and the compliance date of the proposed rules would be no later than the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register. The proposed rules would grandfather any incentive-based compensation plan with a performance period that begins before the compliance date.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or one of the following members of the Financial Services practice team:

Peter J. Hunt [\(bio\)](#)  
+1.212.858.1139  
[peter.hunt@pillsburylaw.com](mailto:peter.hunt@pillsburylaw.com)

Mark C. Jones [\(bio\)](#)  
+1.213.488.7337  
[mark.jones@pillsburylaw.com](mailto:mark.jones@pillsburylaw.com)

Rodney R. Peck [\(bio\)](#)  
+1.415.983.1516  
[rodney.peck@pillsburylaw.com](mailto:rodney.peck@pillsburylaw.com)

Susan P. Serota [\(bio\)](#)  
+1.212.858.1125  
[susan.serota@pillsburylaw.com](mailto:susan.serota@pillsburylaw.com)

Robert L. Tian [\(bio\)](#)  
+1.415.983.1020  
[robert.tian@pillsburylaw.com](mailto:robert.tian@pillsburylaw.com)

Brian M. Wong [\(bio\)](#)  
+1.415.983.6372  
[brian.wong@pillsburylaw.com](mailto:brian.wong@pillsburylaw.com)

Patricia F. Young [\(bio\)](#)  
+1.415.983.1845  
[patricia.young@pillsburylaw.com](mailto:patricia.young@pillsburylaw.com)

**Pillsbury Winthrop Shaw Pittman LLP** is a leading international law firm with 18 offices around the world and a particular focus on the energy & natural resources, financial services, real estate & construction, and technology sectors. Recognized by *Financial Times* as one of the most innovative law firms, Pillsbury and its lawyers are highly regarded for their forward-thinking approach, their enthusiasm for collaborating across disciplines and their unsurpassed commercial awareness.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.

© 2016 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.