

Regulatory alert

Incentive-based compensation arrangements rule

Re-proposed under Section 956 of the
Dodd-Frank Act

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Background

Section 956 of the July 2010 Dodd-Frank Act (Act) required the Securities and Exchange Commission, the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the National Credit Union Administration (the Agencies) to jointly write rules or guidelines covering incentive-based compensation (IC) arrangements. The rules were to require covered financial institutions to disclose to the appropriate federal regulator the structure of their IC program and to prohibit any type of IC program that encouraged inappropriate risks.

The Agencies published a proposed IC rule in April 2011. The Agencies received a number of comments but never finalized the rule. The Agencies issued a revised rule proposal in April and May 2016. Comments are due July 22, 2016, and the Agencies are aiming to issue a final rule by November 2016.

Overview of notice of proposed rulemaking (2016 NPR)

The 2016 NPR prohibits covered financial institutions from establishing and maintaining IC frameworks that encourage inappropriate risk taking. Importantly, the NPR's requirements expand significantly beyond the June 2010 principles-based federal banking agencies' IC guidance, as well as the initial April 2011 NPR. Of

note, the 2016 NPR broadens the scope of covered institutions (larger banks, insurance companies, and foreign banks) to include entities that were not subject to the 2010 inter-agency IC guidance, such as Investment Advisors, Credit Unions, Community Banks and the GSEs.

Covered institutions

The 2016 NPR identifies three categories (levels) of covered institutions based on average total consolidated assets:

- ▶ Level 1: Consolidated assets greater than or equal to \$250 billion
- ▶ Level 2: Consolidated assets greater than or equal to \$50 billion and less than \$250 billion
- ▶ Level 3: Consolidated assets greater than or equal to \$1 billion and less than \$50 billion¹

Compliance requirements vary according to the designated category, with the most stringent requirements applying to Level 1 and Level 2 covered institutions. Covered institutions that are subsidiaries of other covered institutions are generally required to comply with the level applicable to their top-tier parent rather than the level that would apply based on their own assets.

Level 3 covered institutions avoid many of the more prescriptive requirements but are nonetheless subject to the prohibition on excessive compensation and the requirements to embed risk-balancing features into their IC programs, supported by strong governance.

Covered person

The 2016 NPR defines a covered person as any person who receives IC from the covered institution. It identifies two specific employee groups subject to prescriptive requirements concerning their IC arrangements: senior executive officers (SEOs) and significant risk-takers (SRTs). SEOs are defined as individuals who hold the title or otherwise perform the function of any of the following:

- ▶ 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
- ▶ Head of a major business line or control function

In general, SRTs are individuals who are not SEOs, but are nonetheless in a position to put a Level 1 or Level 2 covered institution at risk of a material financial loss. Specifically, the NPR defines SRTs as individuals whose compensation is at least one-third incentive-based and who satisfy either the “relative compensation test” or the “exposure test.”

- ▶ Relative compensation test: Satisfied if the individual is among the organization's top 5% (for Level 1 covered institutions) or top 2% (for Level 2 covered institutions) of highest compensated covered persons (excluding SEOs)
- ▶ Exposure test: Satisfied if the person has the authority to commit or expose 0.5% or more of the capital of the covered institution

Note that individuals who are not captured by either test above may still be designated by the Agencies as an SRT to the extent that they are viewed as exposing the covered institution to risks that could lead to a material financial loss. Covered institutions should be prepared to respond to regulatory challenges requiring the identification of additional SRTs by proactively employing methodical risk-based assessments of the ability of individuals to generate material risks to the organization.

Mandatory deferral

The 2016 NPR would lengthen the IC deferral amount and time frame for the largest institutions.

- ▶ Level 1 covered institutions are required to defer at least 60% of an SEO's qualifying IC and 50% of an SRT's IC for at least four years.²
- ▶ Level 2 covered institutions must defer at least 50% of an SEO's qualifying IC and 40% of an SRT's qualifying IC for at least three years.

Deferred compensation may vest pro rata but no faster than on an annual basis beginning on the first anniversary of the end of the performance period to which the award relates. Acceleration of vesting is generally prohibited except in the case of death or disability.

For covered institutions that issue equity, deferred compensation must include substantial amounts of both deferred cash and deferred equity or equity-like instruments. Notably, the 2016 NPR does not define what pay mix would satisfy this requirement.

In addition, a portion of awards earned under long-term incentive programs must also be deferred beyond the end of the relevant performance period. This requirement would lengthen the period of time between the award of long-term IC and payment, as the deferral requirement cannot be satisfied during the performance period.

- ▶ Level 1 covered institutions must defer at least 60% of an SEO's long-term IC and 50% of an SRT's long-term IC for at least two years beyond the end of the plan's performance period.³
- ▶ Level 2 covered institutions must defer at least 50% of an SEO's long-term IC and 40% of an SRT's long-term IC for at least one year beyond the end of the plan's performance period.

Forfeiture and downward adjustment

The 2016 NPR introduces parameters for triggering forfeiture and downward adjustments of IC. Level 1 or Level 2 covered institutions would have to incorporate tools that enable forfeiture or downward adjustment of IC upon the occurrence of certain defined adverse outcomes, including:

- ▶ Poor financial performance attributable to significant deviations from risk policies
- ▶ Inappropriate risk-taking
- ▶ Risk management or control failures
- ▶ Noncompliance with statutory, regulatory or supervisory standards that result in performance or legal action or financial restatement
- ▶ Other indicators of poor conduct or performance

Clawback

The 2016 NPR introduces specific language that requires Level 1 and Level 2 covered institutions to include clawback provisions in the IC arrangements for SEOs and SRTs, whereby vested awards can be recovered upon the occurrence of certain risk events associated with the conduct of the SEO or SRT, including misconduct, fraud or intentional misrepresentation of information. The clawback must apply for seven years following the compensation vesting date.

Material financial loss prohibition

The 2016 NPR would generally maintain the same requirements for material financial loss as the April 2011 proposal, which prohibits IC arrangements that encourage risk that could lead to a material financial loss to the covered institution and requires (1) balanced risk-taking incentives; (2) comparability with effective risk management and controls; and (3) effective corporate governance.⁴

However, the 2016 NPR defines the covered employee population more broadly than the April 2011 proposal such that any employee who receives IC would be covered by the rule.

Prohibition of excessive compensation

The 2016 NPR generally requires the same factors to be considered when assessing “excessive compensation” as the April 2011 proposal. These include combined value of all compensation, fees or benefits provided to the covered person; the compensation history of the covered person and other individuals with comparable expertise; the financial condition of the institution; compensation practices at comparable institutions, based upon such factors as 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.

However, the 2016 NPR defines the covered employee population subject to the “excessive compensation” prohibition more broadly than the April 2011 proposal, such that any employee who receives IC would be covered by the prohibition.

Prohibition of leveraged incentive compensation

The 2016 NPR requires Level 1 and Level 2 covered institutions to limit SEO IC to no more than 125% of the target compensation and SRT IC to no more than 150% of target compensation.

Risk management and controls

Level 1 and Level 2 covered institutions must have a risk management framework for their IC programs that is independent of any lines of business. The framework should also include an independent compliance program and be commensurate with the size and complexity of the institution’s operations.

The 2016 NPR is consistent with other supervisory guidance and expectations on the requirement for a risk management framework that includes individuals in roles independent of the risk-taking activities who have the ability and skill sets to influence the areas they monitor, provide input of risk measures (including those of risk appetite) and breaches that could lead to forfeiture and downward adjustment, and conduct periodic reviews of the compensation plans.

Governance

The board of directors must conduct oversight and approve IC arrangements for CEOs. The 2016 NPR requires Level 1 and Level 2 covered institutions to establish a compensation committee composed solely of non-senior executive officers to assist the board of directors in carrying out its responsibilities under the NPR. It also requires a formal independent written assessment of the effectiveness of a covered institution’s IC program.

Compliance date

The 2016 NPR provides a compliance date 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 final rule would not apply to any IC plan with a performance period that begins before the compliance date. Consequently, if the final rule is published in November 2016, as suggested by the preamble, then the rule will be effective only for IC plans with a performance period that begins after July 1, 2018.

Key implications and considerations

The 2016 NPR would expand industry obligations significantly beyond existing federal banking agency requirements. Covered institutions should anticipate the need to formalize their compensation programs to include several important new or expanded considerations. These include:

- ▶ Broader definition of a covered person
- ▶ Longer deferral and clawback time frames
- ▶ Specific rules for determining forfeiture and downward adjustments
- ▶ Specific rules for performance metrics, pay mix and leverage
- ▶ Formation of an independent compensation committee
- ▶ Expanded and specific policies and procedure requirements
- ▶ Appropriate independent risk management framework and governance
- ▶ Expanded record-keeping requirements

The program must be fully implemented within 18 months of the final rule’s effective date. Moreover, covered institutions must obtain independent written assessments (by risk management and internal audit) evaluating the effectiveness of compensation programs on an annual basis (or more frequently if necessary).

What’s next?

The proposed rule outlines a number of questions for comment by industry, including key areas such as the scope of the definition of covered institutions, categorization of the covered institutions in the three-level structure, tests for determining SRT status and appropriateness of the minimum deferral periods and percentages. Comments on the 2016 NPR are requested by July 22, 2016.

¹Given the agencies involved, the 2016 NPR will broadly apply to financial institutions such as banks, broker-dealers, investment advisors and credit unions that fall into one of the three categories

²“Qualifying incentive-based compensation” is defined under the 2016 NPR as “the amount of incentive-based compensation awarded to a covered person for a particular performance period, excluding amounts awarded to such covered person for that particular performance period under a long-term incentive plan.”

³“Long-term incentive compensation” is defined under the 2016 NPR as a plan that is based on a performance period of at least three years.

⁴The “material financial loss” provision of the 2016 NPR reflects the three principles for sound incentive compensation policies contained in the 2010 Federal Banking Agency Guidance and should be read in conjunction with such rules, which would remain in force.

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