The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 23, NO. 8 • AUGUST 2016

The SEC and Other Federal Agencies Issue Joint Proposed Rules on Incentive-Based Compensation at Large Financial Institutions

By Mark A. Holdsworth and Isabel D. Araujo

On May 6, 2016, the Securities and Exchange Commission (SEC) became the last of six federal agencies[1] to jointly approve substantially identical proposed rules pursuant to Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act that would impose significant restrictions on incentive-based compensation arrangements at large financial institutions. If finalized in their current form, these rules would prohibit banks, registered broker-dealers, investment advisers, and other covered financial institutions with average total consolidated assets of at least $1 billion from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risks (i) by providing excessive compensation, fees, or benefits to covered persons or (ii) that could lead to a material financial loss to the covered institution. The proposed rules replace rules that were initially proposed in 2011.

Covered Institutions

The proposed rules adopted by the agencies would cover each of the following financial institutions with total consolidated assets of $1 billion or more:

Agency	*Financial Institution*
SEC	Brokers or dealers registered under Section 15 of the Securities Exchange Act of 1934[2] Investment advisers, as defined in Section 202(a)(11) of the Investment Advisers Act of 1940 (whether or not registered)[3]
OCC	National banks, federal savings associations and federal branches or agencies of foreign banks
Federal Reserve	State member banks, bank holding companies, savings and loan holding companies, Edge and Agreement Corporations, state-licensed uninsured branches or agencies of foreign banks, and the US operations of foreign banking organizations
FDIC	State non-member banks, state savings associations and state-insured US branches of foreign banks

NCUA	Credit unions, as described in Section 19(b)(1)(A)(iv) of the Federal Reserve Act
FHFA	The Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal Home Loan Banks

In addition, any other financial institution that the appropriate agency, jointly or by rule, determines should be treated as a covered financial institution for purposes of the rules will be subject to the proposed rules.

The proposed rules identify three categories of covered institutions (referred to in the proposed rules as Level 1, Level 2, and Level 3 institutions) based on average total consolidated assets, applying less prescriptive incentive-based compensation program requirements to the smallest covered institutions within the statutory scope and progressively more rigorous requirements to the larger covered institutions:

- Level 1 ($250 billion or more);
- Level 2 (at least $50 billion but less than $250 billion); and
- Level 3 (at least $1 billion but less than $50 billion).[4]

For covered institutions, other than investment advisers, average total consolidated assets would be determined by reference to the average of the total consolidated assets reported on regulatory reports for the four most recent consecutive quarters (or, for those institutions that do not have regulatory reports for each of the four most recent consecutive quarters, the relevant regulatory report for the most recent quarter or consecutive quarters available).[5] For investment advisers, average total consolidated assets would be determined by the adviser's total assets (exclusive of nonproprietary assets) shown on the balance sheet for the adviser's most recent fiscal year-end. Importantly, most private equity fund managers will not be subject to the proposed rules because nonproprietary assets are excluded from the calculation of average total consolidated assets and thus will fall below the $1 billion threshold.

Covered Persons

"Covered persons" is generally defined as any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution. However, several of the more onerous provisions, such as the deferral and clawback rules (discussed below), would only apply to the senior executive officers and significant risk-takers of Level 1 and Level 2 institutions. A "senior executive officer" (SEO) is generally defined as 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 the head of a major business line or control function. A "significant risk-taker" (SRT) is generally defined as a person who either (i) receives at least one-third of his or her compensation from incentive compensation and who is among the highest 5 percent (for Level 1 institutions) or 2 percent (for Level 2 institutions) in compensation (excluding SEOs) of the institution or (ii) may commit or expose at least 0.5 percent of the covered institution's common equity tier 1 capital (or in the case of a registered broker or dealer, at least 0.5 percent of tentative net capital).

General Qualitative Standard Applicable to All Covered Institutions

All covered institutions would be prohibited from having incentive-based compensation arrangements that encourage inappropriate risk by providing covered persons with "excessive compensation" or that could lead to "material financial loss" to the covered institution. Incentive-based compensation arrangements are broadly defined to include any variable compensation, fees, or benefits that serve as an incentive or reward for performance. The proposed rules do not prescribe a rigid approach to the design of covered institutions' incentive-based compensation arrangements in order to maintain flexibility around their design and implementation in order to accommodate the size, complexity, risk tolerance, and business model of the covered institution.

Compensation would be considered "excessive" when the amounts paid are "unreasonable or disproportionate to the value of the services performed," taking into consideration all relevant factors, including the following:

- the 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 at the covered institution;
- the financial condition of the covered institution;
- compensation practices at comparable covered 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.

Further, the proposed rules maintain that every incentive-based compensation arrangement at a covered institution could encourage inappropriate risks that could lead to material financial loss to the covered institution unless the arrangement:

- balances risk and reward;
- is compatible with effective risk management; and
- controls and is supported by effective governance.

An incentive-based compensation arrangement will not be considered to appropriately balance risk and reward unless (i) it includes financial and nonfinancial measures of performance that are relevant to a covered person's role and to the type of business in which the covered person is engaged and that are appropriately weighted to reflect risk-taking; (ii) is designed to allow nonfinancial measures of performance to override financial measures when appropriate; and (iii) 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 nonfinancial performance.

Governance

The proposed rules require that a covered institution's board of directors (or a committee thereof):

- conduct oversight of the covered institution's incentive-based compensation program;
- approve incentive-based compensation arrangements for SEOs, 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 SEOs.

Disclosure and Recordkeeping Requirements

The proposed rules would require covered institutions to create annually and maintain for at least seven years records that document the structure of their incentive-based compensation arrangements and their compliance with the rules. Such records must include, at a minimum, copies of all incentive-based compensation plans, a record of who is subject to each plan, and a description of how the incentive-based compensation program is compatible with effective risk management and controls.

Additional Requirements and Prohibitions Applicable Only to Level 1 and Level 2 Institutions

Level 1 and Level 2 institutions will be required to adopt mandatory deferral of payments, risk of downward adjustments and forfeiture and clawbacks to appropriately balance risk and reward.[6] These requirements generally will not apply to Level 3 institutions.[7]

Disclosure and Recordkeeping Requirements

The proposed rules would require Level 1 and Level 2 institutions to create annually and maintain for at least seven years records that document the identity of SEOs and SRTs of a covered institution, the incentive-based compensation arrangements for such SEOs and SRTs, including information on the percentage of incentive-based compensation deferred and the form of award, any forfeiture, downward adjustment or clawback reviews and any material changes to the covered institution's incentive-based compensation arrangements and policies.

Deferral

Under the proposed rules, the mandatory deferral requirements for Level 1 and Level 2 institutions for incentive-based compensation awarded during each performance period would be as follows:

Level	*Deferral Percentage of Qualifying Incentive-Based Compensation*	*Deferral Period (other than under a Long-Term Compensation Plan)*	*Deferral Period (under a Long-Term Compensation Plan[8])*
Level 1	SEO: 60% SRT: 50%	4 years	2 years
Level 2	SEO: 50% SRT: 40%	3 years	1 year

The proposed rules would also prohibit Level 1 and Level 2 institutions from accelerating the payment of a covered person's deferred incentive-based compensation, other than in the event of the covered person's death or disability. In addition, vesting of deferred amounts may occur no faster than on a pro rata annual basis beginning on the first anniversary of the end of the performance period. For covered institutions that issue equity or are subsidiaries of covered institutions that issue equity, the deferred amount would be required to consist of substantial amounts of both deferred cash and equity-like instruments throughout the deferral period. In addition, if an SEO or SRT receives incentive-based compensation in the form of options for a performance period, the amount of such options used to meet the minimum required deferred compensation may not exceed 15 percent of the amount of total incentive-based compensation awarded to the SEO or SRT for that performance period.

Forfeiture and Downward Adjustment

The proposed rules would require Level 1 and Level 2 institutions to make subject to forfeiture all unvested deferred incentive-based compensation of any SEO or SRT, including unvested deferred amounts awarded under long-term incentive plans. Similarly, Level 1 and Level 2 institutions would also be required to make subject to downward adjustment all incentive-based compensation amounts not yet awarded to any SEO or SRT for the current performance period, including amounts payable under long-term incentive plans. Forfeitures and downward adjustments would have to be considered after one of the following events: (i) poor financial performance attributable to a significant deviation from the covered institution's risk parameters set forth in the institution's policies and procedures; (ii) inappropriate risk-taking, regardless of the impact on financial performance; (iii) material risk management or control failures; (iv) noncompliance with statutory or other standards resulting in enforcement or legal action brought by a federal or state agency (or a requirement that the covered institution report a restatement of a financial statement to correct a material error); and (v) other aspects of conduct of poor performance as defined by the covered institution.

Clawback

The proposed rules would require clawback provisions that allow the covered institution to recover incentive-based compensation from a current or former SEO or SRT for seven years following the date on which such compensation vests if the covered institution determines that the covered person 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 covered person's incentive-based compensation.

Additional Prohibitions

The proposed rules provide that Level 1 and Level 2 institutions are subject to the following additional prohibitions:

- *Hedging.* Hedge on behalf of a covered person (that is, any executive officer, employee or director who receives incentive-based compensation) to offset any decrease in the value of incentive-based compensation;
- *Maximum Incentive-Based Compensation Opportunity.* Award incentive-based compensation to SEOs or SRTs in excess of 125 percent or 150 percent, respectively, of the target amount for that incentive-based compensation;
- *Relative Performance Measures.* Use incentive-based compensation performance measures that are based solely on industry peer performance comparisons; or
- *Volume Driven Incentive-Based Compensation.* Provide incentive-based compensation to a covered person that is based solely on transaction or revenue volume without regard to transaction quality or the compliance of the covered person with sound risk management.

Risk Management and Controls Requirements

The proposed rules require that Level 1 and Level 2 institutions have a risk management framework for their incentive-based compensation programs that:

- is independent of any lines of business;
- includes an independent compliance program that provides for internal controls, testing, monitoring and training with written policies and procedures consistent with the rest of the proposed rules; and
- is commensurate with the size and complexity of the covered institution's operations.

In addition, Level 1 and Level 2 institutions must provide individuals engaged in control functions with the authority to influence the risk-taking of the business areas they monitor and ensure that covered persons engaged in control functions are compensated in accordance with the achievement of performance objectives linked to their control functions and independent of the performance of those business areas. Level 1 and Level 2 institutions must also provide for the independent monitoring of (i) all incentive-based compensation plans in order to identify whether those plans provide incentives that appropriately balance risk and reward; (ii) events related to forfeiture and downward adjustment reviews and decisions of forfeiture and downward adjustment reviews; and (iii) compliance of the incentive-based compensation program with the covered institution's policies and procedures.

Governance

The proposed rules contain specific governance requirements that would apply to Level 1 and Level 2 institutions, including the establishment of a compensation committee composed solely of directors who are not SEOs, to assist the board of directors in carrying out its responsibilities related to incentive-based compensation. The rules provide that the compensation committee must obtain input from the risk and audit committees on certain specified matters and, in addition, obtain from management, on an annual or more frequent basis, a written assessment of the covered institution's incentive-based compensation program and related compliance and control processes. In addition, the proposed rules require that the board of directors approve incentive-based compensation arrangements for SEOs, including the amounts of awards, the vesting schedule and payouts under such arrangements, and that the board of directors approve material exceptions or adjustments to incentive-based compensation policies or arrangements for SEOs.

Policies and Procedures Requirements

Level 1 and Level 2 institutions must develop and implement policies and procedures for their incentive-based compensation programs that, at a minimum:

- specify the substantive and procedural criteria for the application of forfeiture and clawback, including the process for determining the amount of incentive-based compensation to be clawed back;
- require that the covered institution maintain documentation of final forfeiture, downward adjustment, and clawback decisions;
- specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person;
- identify and describe the role of any employees, committees or groups authorized to make incentive-based compensation decisions, including when discretion is authorized;
- describe how discretion is expected to be exercised to appropriately balance risk and reward;
- require that the covered institution maintain documentation of the establishment, implementation, modification and monitoring of incentive-based compensation arrangements, sufficient to support the covered institutions' decisions;
- describe how incentive-based compensation arrangements will be monitored;
- specify the substantive and procedural requirements of the independent compliance program; and
- ensure appropriate roles for risk management, risk oversight, and other control function personnel in the covered institution's processes for (i) designing incentive-based compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback, and vesting; and (ii) assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.

Effective Date

The rules would become effective no later than the beginning of the first calendar quarter that begins at least 540 days after the final rules are published in the Federal Register and would not apply to any incentive-based compensation plans with a performance period that begins prior to the effective date. The agencies accepted comments on the proposed rules until July 22, 2016.

Mr. Holdsworth is a partner and **Ms. Araujo** is an associate in the Executive Compensation and Employee Benefits Department in the New York office of Willkie Farr & Gallagher LLP. Mr. Holdsworth and Ms. Araujo focus on the executive compensation and employee benefits-related aspects of mergers, acquisitions, public offerings, restructurings, spin-offs and other corporate transactions.

NOTES

1 The other federal agencies (collectively, with the SEC, the "agencies") that have approved the proposed rules are the (i) Office of the Comptroller of the Currency (OCC), (ii) Board of Governors of the Federal Reserve System (Federal Reserve), (iii) Federal Deposit Insurance Corporation (FDIC), (iv) National Credit Union Administration (NCUA) and (v) Federal Housing Financing Agency (FHFA).

2 As of December 31, 2014, there were 131 broker-dealers with assets over $1 billion, of which seven would be classified as Level 1 institutions, 13 as Level 2 institutions and 111 as Level 3 institutions.

3 As of December 31, 2014, there were 669 investment advisers registered with the SEC that had total assets of at least $1 billion.

4 In addition, the proposed rules provide that covered institutions that are subsidiaries of other covered institutions would be subject to the same

requirements and defined to be in the same level as the parent covered institution, even if the subsidiary is smaller than the parent.

5 A Level 1, Level 2, or Level 3 institution, other than an investment adviser, will remain subject to the requirements applicable to such covered institution until the average total consolidated assets of such covered institution falls below $250 billion, $50 billion or $1 billion, respectively, for each of four consecutive quarters. A Level 1, Level 2, or Level 3 institution that is an investment adviser will remain subject to the requirements applicable to such covered institution until the average total consolidated assets of such covered institution falls below $250 billion, $50 billion or $1 billion, respectively, as of the most recent fiscal year-end.

6 Under the proposed rules, Level 1 and Level 2 institutions are generally subject to the same requirements except with respect to the thresholds for determining the SRTs and the deferral percentages and deferral periods.

7 For Level 3 institutions with average total consolidated assets of at least $10 billion, the appropriate agency has discretion to require that the institution comply with some or all of the requirements applicable to a Level 1 or Level 2 institution based on the covered institution's "complexity of operations or compensation practices."

8 A "long-term incentive plan" is defined as a plan that provides incentive-based compensation that is based on a performance period of at least three years.