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Agencies Issue Proposed Regulations on Incentive-Based Compensation

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Covered Institutions

Under Section 956 of Dodd-Frank, covered institutions include (i) depository institutions or depository institution holding companies, (ii) broker-dealers registered with the SEC, (iii) credit unions, (iv) investment advisors, (v) Fannie Mae and Freddie Mac, and (vi) any other financial institution that the regulators jointly determined should be treated as a covered financial institution.

Covered Persons

Under the proposed regulations, covered persons include senior executive officers and significant risk-takers of covered institutions. Senior executive officers includes individuals who hold the title or perform the function of, among others, president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief legal officer, or head of a major business line or control function. Significant risk-takers include individuals who, regardless of title or function, may be among the top 5% percent compensated individuals at Level 1 covered institutions or top 2 percent at Level 2 covered institutions or individuals who have the authority to commit or expose 0.5 percent of a Level 1 or Level 2 covered institution's capital to risk of loss.

Tiered Applicability

In general, the proposed regulations apply with varying degrees of stringency based on three tiers of covered institutions:

- Level 1: Consolidated assets equals or exceeds $250 billion.

- Level 2: Consolidated assets equals or exceeds $50 billion.
- Level 3: Consolidated assets equals or exceeds $1 billion.

Excessive Compensation

Compensation is excessive if amounts paid to a covered person are unreasonable or disproportionate to the value of the services performed, taking into consideration all relevant factors, including:

- 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
- 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.

Excessive Risk

An incentive-based compensation arrangement encourages inappropriate risks that could lead to material financial loss to a covered institution, unless the arrangement:

- Appropriately balances risk and reward
- Is compatible with effective risk management and controls
- Is supported by effective governance.

Mitigating Risk

An incentive-based compensation arrangement will not be considered to appropriately balance risk and reward unless:

(1) The arrangement includes financial and nonfinancial measures of performance.

(2) The arrangement is designed to allow nonfinancial measures of performance to override financial measures of performance when appropriate.

(3) 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 regulations require that a covered institution's board of directors, or a committee thereof, engage in governance measures to oversee incentive-based compensation programs and approve payment terms and adjustments to amounts.

Mandatory Deferral

The proposed regulations require that incentive compensation arrangements be subject to deferral and time-based vesting periods, which vary based on the tier of the covered institution and the covered person.

Minimum Required Deferral Amount:

- Level 1: at least 60 percent of a senior executive officer's and at least 50 percent of a significant risk-taker's qualifying incentive-based compensation awarded for each performance period.
- Level 2: at least 50 percent of a senior executive officer's and at least 40 percent of a significant risk-taker's qualifying incentive-based compensation awarded for each performance period.

Minimum Required Deferral Period:

- Level 1 senior executive officer or significant risk-taker: at least four years (or 2 years in the case of long-term incentive awards).
- Level 2 senior executive officer or significant risk-taker: at least three years (or one year in the case of long-term incentive awards).

In general, deferred amounts may not vest faster than on a pro rata annual basis beginning no earlier than the first anniversary of the end of the performance period for which the amounts were awarded subject to limited acceleration in the case of death or disability of the covered person.

Other Requirements

Under the proposal regulations, payments must be subject to clawback, downward adjustment and forfeiture in certain circumstances. The proposed regulations also impose certain disclosure and recordkeeping requirements and measures relating to risk management and compliance.

Effectiveness

Covered institutions must comply with the regulations 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. Incentive-based compensation plans with performance periods that are in effect prior to the compliance date will not be subject to the regulations.

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