SULLIVAN & CROMWELL LLP

s&c memo

May 13, 2024

Agencies to Consider Variety of Restrictive Alternatives as Part of Incentive Compensation Rule Re-Proposal

Including:

- **Subjecting all Covered Institutions with More than $50 Billion of Assets to the Most Restrictive Provisions**
- **Eliminating Board Discretion with Respect to Forfeiture, Downward Adjustment, and Clawback**

OVERVIEW

On May 6, 2024, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Federal Housing Finance Agency re-proposed their joint rule to implement Section 956 of the Dodd-Frank Act, which requires federal financial regulators to prohibit, at any financial institution with consolidated assets of at least $1 billion, incentive-based compensation that encourages inappropriate risks. The re-proposed rule is the same as the agencies proposed in 2016, but is accompanied by alternative regulatory provisions that reflect the agencies' thinking since that time and are potentially much more stringent than the proposed rule. This memorandum summarizes these potential alternatives.

The National Credit Union Administration is expected to re-propose the same rule in the near future, and the Securities and Exchange Commission has included a rulemaking to implement Section 956 of Dodd-Frank on its rulemaking agenda. The Board of Governors of the Federal Reserve System has not joined the proposal. For further details with respect to the 2024 re-proposal and the 2016 proposal, please refer to our May 6, 2024 memorandum, *FDIC, OCC and FHFA Re-Propose Incentive Compensation Rule*, and our April 27, 2016 memorandum, *Details Emerge: Proposed Regulation of Incentive Compensation at Large Financial Institutions*.

SPECIFIC ALTERNATIVES

Forfeiture and Downward Adjustment.

- **Proposed Rule:** Provides for downward adjustment and forfeiture reviews for senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions triggered on the occurrence of certain events, including (1) poor financial performance attributable to a significant deviation from the institution's risk parameters, (2) inappropriate risk-taking, (3) material risk management or control failures, (4) non-compliance with statutory, regulatory or supervisory standards that results in enforcement or legal action by a regulator or a required restatement to correct a material error, and (5) any additional triggers based on conduct or poor performance defined by the institution.
- **Alternative:** The agencies are considering, as an alternative, whether to require forfeiture and downward adjustment on the occurrence of the same events. Covered institutions would also be required, through policies and procedures, to formalize the governance and review processes surrounding such decision-making, and to document the decisions made.

Clawback.

- **Proposed Rule:** Level 1 and Level 2 covered institutions must allow for clawback of all vested incentive-based compensation awarded to current or former senior executive officers or significant risk-takers for at least seven years after the vesting date. The clawback provisions would be triggered if the covered institution determines that the senior executive officer or significant risk-taker engaged in (1) misconduct that resulted in significant financial or reputational harm to the covered institution, (2) fraud or (3) intentional misrepresentation of information used to determine the individual's incentive-based compensation. Covered institutions may also include other triggering events.
- **Alternative:** The agencies are considering, as an alternative, whether to require clawback on the occurrence of the same events. All vested incentive-based compensation would be subject to the required clawback for a period of no less than seven years following the date on which such incentive-based compensation vests. This alternative would include an exception to the recovery requirement if the institution can document that clawback is impracticable or an equivalent amount of incentive-based compensation has been impacted through forfeiture or downward adjustment.

Compliance Date.

- **Proposed Rule:** The compliance date would generally be the first day of the first calendar quarter that begins at least 540 days after the date on which the institution is or becomes a Level 1, Level 2, or Level 3 covered institution. Whether a covered institution is a Level 1, Level 2, or Level 3 covered institution would be determined based on the average total consolidated assets as of the date of the beginning of the first calendar quarter that begins after a final rule is published in the Federal Register.
- **Alternative:** The agencies are considering whether the compliance date should instead be the start of the first calendar quarter that begins at least 365 days after a final rule is published in the Federal Register. The agencies are also contemplating whether the compliance date should be (1) the beginning of the first performance period that begins at least 365 days after the date on which the regulated institution becomes a Level 1, Level 2, or Level 3 covered institution or (2) the first day of the first calendar quarter that begins at least 365 days after the date on which the regulated institution becomes a Level 1, Level 2, or Level 3 covered institution (in order to have the governance/procedures requirements coincide with the date on which the requirements applicable to plans begin).

Asset Thresholds.

- **Proposed Rule:** There are three levels of covered institutions based on asset size subject to progressively more rigorous requirements:
  - ***Level 1:*** greater than or equal to $250 billion
  - ***Level 2:*** greater than or equal to $50 billion and less than $250 billion
  - ***Level 3:*** greater than or equal to $1 billion but less than $50 billion

  Asset size would generally be determined based on the average total consolidated assets reported on regulatory reports for the four most recent consecutive quarters (e.g., Call Reports). As discussed further below, certain covered persons at Level 1 and Level 2 covered institutions are subject to mandatory deferral requirements ranging from 40% to 60% for three to four years depending on the level of covered institution and status as a senior executive officer or significant risk-taker.

- **Alternative:** The agencies are considering whether to have a two-level structure, whereby the general prohibitions and requirements of the rule could apply to all covered institutions (i.e., assets above $1 billion), and the proposed additional prohibitions and requirements (including deferral, forfeiture/downward adjustment and clawback requirements) could apply to institutions with average total consolidated assets of more than $50 billion. The agencies also have requested comment as to what other asset thresholds would be appropriate to differentiate between levels in a two-level structure. The agencies are further considering, and have requested comment on, whether, in a two-level approach, the proposed rule's provisions should be simplified by using a single deferral percentage of 60% and a single deferral period of four years for both senior executive officers and significant risk-takers at covered institutions with average total consolidated assets of more than $50 billion. This two-level structure appears to reflect a more general approach at certain regulatory agencies to abandon tailoring above the $50 billion level.

Significant Risk-Taker.

- **Proposed Rule:** The proposed rule introduces the concept of significant risk-taker, intended to capture individuals who are not "senior executive officers" but may still expose a Level 1 or Level 2 covered institution to material financial loss. A significant risk-taker means any covered person who receives at least one-third of his or her total compensation (i.e., base salary and incentive-based compensation) in incentive-based compensation (based on the last calendar year that ended at least 180 days before the beginning of the performance period (effectively, a two-year look-back)) and meets either of two tests:
  - ***Relative Compensation Test.*** Covered persons among the top 5% (for Level 1 covered institutions) or 2% (for Level 2 covered institutions) of highest compensated covered persons (excluding senior executive officers) in the entire consolidated organization, including affiliated covered institutions; or
  - ***Exposure Test.*** Whether the covered person has the authority to commit or expose 0.5% or more of the capital of the covered institution or any affiliated covered institution.
- **Alternative:** As an alternative to this approach, the agencies are considering whether to replace the relative compensation test and exposure test with a more flexible risk-based approach under which the agencies would require a covered institution to identify its significant risk-takers and submit a notice of its identification methodology to its primary federal regulator.[1] Under this alternative approach, "significant risk taker" would be defined as any covered person at a Level 1 or Level 2 covered institution, other than a senior executive officer, identified by that institution because of that covered person's ability to expose the covered institution to risks that could lead to material financial loss in relation to the covered institution's size, capital, or overall risk tolerance. The agencies note

that they could allow the self-identification methodology to be left to the discretion of the covered institution (subject to the agency's authority to designate additional significant risk-takers), or they could require that a covered institution's identification methodology, at a minimum, capture covered persons who receive annual base salary and incentive-based compensation that places the covered persons among the top 2% of all covered persons (excluding senior executive officers) of a Level 1 or Level 2 covered institution. The agencies also are considering whether this option could contain two percentage thresholds for measuring whether an individual is a significant risk-taker depending on whether the covered institution is a Level 1 (top 5%) or a Level 2 (top 2%) covered institution. In considering these alternatives, the agencies have requested comment as to whether to remove the separate exposure test and thus only the relative compensation test applies and whether they should adopt a definition that includes a single bright-line threshold for identifying significant risk-takers for both Level 1 and Level 2 covered institutions (e.g., top 2%).

Setting Performance Measures and Targets Before Performance Period Begins.

- **Proposed Rule:** Not applicable.
- **Alternative:** The agencies are considering whether to require covered institutions to establish performance measures and targets before the beginning of a performance period. Under this approach, covered institutions would be unable to make changes to any target after the performance period begins without documentation and approval of such actions from appropriate personnel (e.g., in the case of senior executive officers, such approval would need to come from the board of directors). Decisions about deferral, downward adjustment, or forfeiture would have to account for all performance measures.

Options.

- **Proposed Rule:** The total amount of options for senior executive officers or significant risk-takers at Level 1 and Level 2 covered institutions that may be used to meet the minimum deferral amount requirements is limited to no more than 15% of total incentive-based compensation awarded for the performance period.
- **Alternative:** The agencies are considering whether to modify this limit to 10%.

Hedging.

- **Proposed Rule:** Prohibits firm-initiated hedging and provides that a Level 1 or Level 2 covered institution must not purchase a hedging instrument or similar instrument on behalf of a covered person to hedge or offset any decrease in the value of the covered person's incentive-based compensation (meaning a personal hedging transaction by covered persons would still be permitted unless the institution prohibits such transactions).
- **Alternative:** The agencies are considering whether to require institutions to ban personal hedging by including an additional prohibition to prohibit a Level 1 and Level 2 covered institution from offering incentive-based compensation arrangements that allow a covered person to purchase a hedging instrument or similar instrument to offset any decrease in the value of the covered person's incentive-based compensation. This would include requiring covered institutions to have contracts with employees that ban personal hedging.

Volume-Driven Incentive-Based Compensation.

- **Proposed Rule:** A Level 1 or Level 2 covered institution may not provide incentive-based compensation to a covered person that is based solely on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management.

- **Alternative:** The agencies are considering whether to expand the prohibition to cover all incentive-based compensation based on transaction revenue or volume (rather than limiting the provision to incentive-based compensation based solely on transaction revenue or volume) by prohibiting Level 1 and Level 2 covered institutions from providing incentive-based compensation to a covered person that is based on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management.

Risk Management and Controls Requirement for Level 1 and Level 2 Covered Institutions.

- **Proposed Rule:** Level 1 and Level 2 covered institutions must: (1) have independent risk management and compliance frameworks for their incentive-based compensation programs that are commensurate with the firm's size and complexity; (2) provide covered persons engaged in control functions with the authority to influence the risk-taking of the business areas they monitor; (3) compensate covered persons in control functions in accordance with the achievement of performance objectives linked to their control function, and independent of the performance of the business area(s) they oversee; and (4) independently monitor all incentive-based compensation plans, events related to forfeiture and downward adjustment reviews, the results reached by those reviews, and compliance with policies and procedures.
- **Alternative:** The agencies are considering whether to add a requirement for a Level 1 or Level 2 covered institution to include, as part of its risk management framework, a requirement that a risk management and controls assessment from the independent risk and control functions be considered when setting incentive-based compensation for senior executive officers and significant risk-takers.

Including CUSOs.

- **Proposed Rule:** The NCUA did not include credit union service organizations ("CUSOs") under the definition of "affiliate," but the proposed rule clarified that covered credit unions may not use CUSOs to avoid requirements of the proposed rule.
- **Alternative:** As an alternative, the agencies are considering whether CUSOs should be included under the definition of affiliate (pursuant to the regulators' general authority to designate financial institutions under section 956(e)(2)(G) for the final rule) on the basis that, since 2016, CUSOs have grown more complex and involved in routine credit union operations, and it is reasonable to subject CUSO employees to the same incentive-based compensation requirements as federally insured credit union employees.

COMMENTS

The notice of proposed rulemaking will not be published in the Federal Register, and a formal comment period will not commence, unless and until all six agencies propose the same rule. However, the FDIC, OCC and FHFA have each made the proposed rule available on their respective websites and will accept comments on the re-proposed regulatory text as well as on the specific regulatory alternatives.

* * *

Copyright © Sullivan & Cromwell LLP 2024

ENDNOTE

[1] In the 2016 proposed rulemaking, the Agencies discussed an alternative dollar threshold test, which is not mentioned in the 2024 re-proposal. This test would have used a specific absolute compensation threshold, measured in dollars, to determine whether an individual is a significant risk-taker (without regard to how that covered person's annual base salary and incentive-based compensation compared to others in the consolidated organization).

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.