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FDIC, OCC and FHFA Re-Propose Incentive Compensation Rule

Agencies Seek to Revive a 2016 Proposal to Implement Section 956 of Dodd-Frank

- **Federal Reserve Board Does Not Join Proposal**
- **SEC Includes Rulemaking on its Agenda**
- **NCUA Expected to Adopt in the Near Future**

Rule Will Not Be Published in the Federal Register Until Proposed by All Six Federal Financial Agencies

Today, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Federal Housing Finance Agency adopted a notice of proposed rulemaking to address incentive-based compensation arrangements. The proposal is generally consistent with the proposed rule issued by the six federal financial agencies in April 2016. The proposed rule seeks to implement the Dodd-Frank requirement that federal financial regulators prohibit, at any financial institution with consolidated assets of at least $1 billion, incentive-based compensation that encourages inappropriate risks. The National Credit Union Administration is expected to propose the same rule in the near future. 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 FDIC's, OCC's and FHFA's proposal.[1]

The proposed rule comes as the latest iteration in a rulemaking process that has spanned more than a decade and is a restatement of the agencies' 2016 proposed rule, along with a new preamble that includes additional questions and alternative regulatory provisions under consideration by the agencies (which are generally more stringent than the proposed rule). 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 potential alternatives and questions discussed in the preamble of the notice of proposed rulemaking.

The FDIC approved the proposed rule by a 3-2 notational vote. Vice Chairman Travis Hill issued a dissenting statement criticizing the prescriptive requirements of the proposed rule as compared to the principles-based approach set forth in the incentive-based compensation guidance issued by the banking agencies in 2010, and noted that "[i]t is extremely odd to issue this proposal without all of the relevant agencies participating."

BACKGROUND

Section 956. Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in July 2010, requires the Federal Reserve, FDIC, FHFA, NCUA, OCC and SEC (collectively, the "Agencies")[2] to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. Section 956 requires that the Agencies (1) implement disclosure to the appropriate Agency that is sufficient to determine whether the compensation structure provides an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or could lead to a material financial loss and (2) jointly prescribe guidance or regulations that prohibit any types of incentive pay arrangements that encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss.

Banking Agency Guidance. Before the adoption of the Dodd-Frank Act, in June 2010, the Federal Reserve, FDIC and OCC jointly issued the Interagency Guidance on Sound Incentive Compensation Policies (the "Banking Agency Guidance"), which was designed to ensure that incentive compensation arrangements at banking organizations take into account risk and are consistent with safe and sound practices. The Banking Agency Guidance sets forth three key principles with respect to incentive compensation arrangements: (1) the arrangements should provide employees with incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk, (2) the arrangements should be compatible with effective controls and risk-management, and (3) the arrangements should be supported by strong corporate governance. The Banking Agency Guidance also requires banking institutions to have policies, procedures and systems to help ensure compliance with these principles.

2011 Proposed Rule. The Agencies issued a notice of proposed rulemaking to implement the requirements of Section 956 of the Dodd-Frank Act in the first half of 2011, which was published in the Federal Register on April 14, 2011. The original proposal contained specific requirements for "larger

covered financial institutions," generally defined as institutions with total consolidated assets of at least $50 billion; namely, that at least 50% of incentive-based compensation for executive officers be deferred for at least three years. Deferred amounts would have been permitted to be released no faster than pro rata on an annual basis and would have been required to be adjusted to reflect actual losses or other aspects of performance that were realized or became known during the deferral period. The original proposal did not contain any limits on the amount or form of incentive-based compensation and did not contain any clawback requirement. It also required the board of directors or a board committee of a larger covered financial institution to identify, and directly approve incentive arrangements for, employees that could expose the institution to losses that are substantial in relation to its size, capital or overall risk tolerance, and required annual reporting of incentive structures to the appropriate Agency.

2016 Proposed Rule. The Agencies subsequently issued a new notice of proposed rulemaking to implement the Section 956 requirements in the second half of 2016, which was published in the Federal Register on June 10, 2016. Today's proposed rulemaking re-proposes the regulatory text of the 2016 proposed rule. The FDIC, OCC and FHFA note that today's proposed rule continues to include the provisions of the regulatory text from the 2016 proposed rule that address covered institutions on a consolidated basis, that they recognize this may implicate Federal Reserve-supervised entities and SEC-regulated entities and that they will continue to coordinate with the Federal Reserve and the SEC on these and other issues.

SUMMARY

The proposed rule establishes general qualitative requirements applicable to all covered financial institutions, additional specific requirements for institutions with total consolidated assets of at least $50 billion and further, more stringent requirements for those with total consolidated assets of at least $250 billion. The general qualitative requirements include (1) prohibiting incentive arrangements that encourage inappropriate risks by providing excessive compensation, (2) prohibiting incentive arrangements that encourage inappropriate risks that could lead to a material financial loss, (3) establishing requirements for performance measures to appropriately balance risk and reward, (4) requiring board of director oversight of incentive arrangements and (5) mandating appropriate recordkeeping.

The key provisions contemplated by the proposed rule include the following:

- ***Approach to Proportionality.*** Covered institutions are categorized into three tiers based on average total consolidated assets, with increasingly stringent requirements applying to institutions with over $1 billion, $50 billion and $250 billion in assets (Level 3, Level 2 and Level 1 covered institutions, respectively).
- ***Defining Covered Persons.*** Additional, more stringent rules apply to incentive-based compensation paid to "senior executive officers" and "significant risk-takers" at Level 1 and Level 2 covered institutions. The proposed rule provides a list of roles that would be classified as

senior executive officers and identifies significant risk-takers based on relative compensation levels or ability to commit or expose 0.5% of the covered institution's capital.

- ***Limits on Incentive Opportunity & Structures.*** At Level 1 and Level 2 covered institutions, the maximum earned incentive for senior executive officers is limited to 125% of the target amount, and for significant risk-takers is limited to 150% of target. (There are no fixed limits on the absolute size of potential targets.) General requirements for performance determinations would apply to all covered institutions, and Level 1 and Level 2 covered institutions would face prohibitions on the use of relative or volume-driven performance measures in isolation.
- ***Mandatory Deferral Requirements.*** The proposed rule introduces longer deferral periods (up to four years after the end of the performance period) and higher minimum deferral amounts (up to 60%) for incentive-based compensation depending on whether the covered institution is Level 1 or Level 2 and whether the individual is a senior executive officer or significant risk-taker. Deferred incentive-based compensation generally may not vest faster than on a pro rata annual basis beginning on the first anniversary of the end of the performance period and must include a "substantial portion" of both equity-like instruments and deferred cash.
- ***Putting and Keeping Pay at Risk.*** All incentive-based compensation for senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions must be subject to downward adjustment, forfeiture and clawback. The proposed rule includes a list of triggering events that require a downward adjustment and forfeiture review at Level 1 and Level 2 covered institutions. In addition, it would subject incentive pay to clawback for seven years after compensation vests.
- ***Governance, Risk Management and Recordkeeping Requirements.*** New requirements would apply to board of director and compensation committee oversight and approvals. Covered institutions would be subject to annual recordkeeping and seven-year retention requirements, with records disclosed to the appropriate Agency on request. The proposed rule also contains specific risk management and control requirements.

The requirements of the proposed rule would become effective on the first day of the calendar quarter that begins at least 540 days after publication of the final rule in the Federal Register, and incentive-based compensation plans with an open performance period beginning before the effective date would be grandfathered. For a summary of the 2016 proposed rule, please refer to our 2016 Memorandum, *Details Emerge: Proposed Regulation of Incentive Compensation at Large Financial Institutions*.

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ENDNOTES

[1] At the March 6, 2024 House Financial Services Committee hearing, Federal Reserve Chair Powell testified "I would like to understand the problem we're solving, and then I would like to see a proposal that addresses that problem." *The Federal Reserve's Semi-Annual Monetary Policy Report: Hearing Before the H. Fin. Servs. Comm.*, 117th Cong. (Mar. 6, 2024), *available at* https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=409159.

[2] The Office of Thrift Supervision is also included in the Dodd-Frank mandate but merged with the OCC and ceased to exist on July 21, 2011.

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