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Details Emerge: Proposed Regulation of Incentive Compensation at Large Financial Institutions

FDIC, FHFA and OCC Issue Proposed Rules Consistent with NCUA's Proposal Last Week

Largest Financial Institutions Face New Risk Management and Governance Requirements and Tiered Restrictions on Incentive Pay

SUMMARY

Yesterday, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Office of the Comptroller of the Currency each issued a notice of proposed rulemaking for a new interagency rule on incentive-based compensation arrangements consistent with the one released by the National Credit Union Association last Thursday. 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 Board of Governors of the Federal Reserve System and the Securities and Exchange Commission are also expected to propose substantially the same rule, which replaces one originally released in the first half of 2011. This memorandum supplements our April 21 memorandum, which set forth the highlights from the NCUA's proposal. Annex A includes a summary chart comparing the new proposed rule with the original proposed rule and the analogous U.K. compensation rules.

The new proposed rule establishes general qualitative requirements applicable to all covered 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 (which replaces the annual reporting contemplated by the 2011 proposal).

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

- ***New 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 & 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 & 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. The proposed rule also contains specific risk management and control requirements.
- ***Greater Alignment with Non-U.S. Regulatory Regimes.*** The proposed rule adopts a number of concepts that appear in the analogous E.U. rules on remuneration (particularly the U.K. implementation), and would bring U.S. regulations largely in line with the European treatment of incentive-based compensation.

Although none of the proposals have been published in the Federal Register (and will not be published until all of the relevant Agencies have issued their versions), comments on the proposed rule are set to be due on July 22, 2016. The requirements of the proposed rule would become effective on the first day of the calendar quarter that begins at least 540 days (about 18 months) 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. Accordingly, the rules will not likely affect most covered institutions until the 2019 compensation year.

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")[1] 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. 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 Section 956 requirements 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 have

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[1] 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.

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. The Agencies received over 10,000 comments on the proposed rule before the comment period closed on May 31, 2011.

COVERED INSTITUTIONS AND PROPORTIONALITY

The new proposed rule would apply to a broad range of financial institutions with average total consolidated assets of $1 billion or more.

- ***Federal Reserve Rule.*** State member banks,[2] bank holding companies (that are not foreign banking organizations) and their subsidiaries, savings and loan holding companies and their subsidiaries, Edge and Agreement corporations, state-licensed uninsured branches or agencies of a foreign bank and the U.S. operations of foreign banking organizations and their subsidiaries. The covered subsidiaries of the foregoing exclude depository institutions, broker-dealers or investment advisers (which would be picked up by another Agency's rule).
- ***FDIC Rule.*** State non-member banks, state savings associations and state insured branches of foreign banks. Subsidiaries of the preceding are included if the subsidiary is not a broker, dealer, person providing insurance, investment company or investment advisor.
- ***FHFA Rule.*** Fannie Mae, Freddie Mac and the Federal Home Loan Banks.
- ***NCUA Rule.*** Insured credit unions and credit unions eligible to apply to become an insured credit union.
- ***OCC Rule.*** National banks, federal savings associations and federal branches or agencies of foreign banks. Subsidiaries of the preceding are included if the subsidiary is not a broker, dealer, person providing insurance, investment company or investment advisor.
- ***SEC Rule.*** Registered broker-dealers and all investment advisers (registered and unregistered) as defined in section 202(a)(11) of the Investment Advisers Act of 1940 (with an express exclusion for those excluded as investment advisers under that section 202(a)(11)).

Proportionality. The proposed rule creates three tiers of covered institutions based on asset size:

- ***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 and less than $50 billion

[2] For purposes of the proposed rule, state-chartered non-depository trust companies that are members of the Federal Reserve System would be regulated institutions under the definition of "state member bank."

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) or, for investment advisers, the investment adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year-end. The SEC rule will clarify that, for investment advisers, asset size is exclusive of non-proprietary assets on balance sheet, such as client assets under management.

Consolidation. For covered institutions that are subsidiaries of other covered institutions, the applicable level would generally be determined by the asset size of the top-tier parent covered institution, even if the subsidiary covered institution is smaller than the parent covered institution. (The SEC will not be proposing this approach, except in the case of subsidiaries of depository institution holding companies, because it has concluded that the operations, services and products of broker-dealers and investment advisers are not typically effected through subsidiaries and that management of risk in incentive-based compensation programs should be localized at the broker-dealer and investment adviser.) A covered institution that is subject to the Federal Reserve's, FDIC's or OCC's proposed rule and that is a subsidiary of another institution covered by the same regulator may meet any requirement of the proposed rule if the parent covered institution complies with the requirement in a way that causes the relevant portion of the incentive-based compensation program of the subsidiary to comply with that requirement.

***Agency Discretion for Certain Level 3 Institutions*.** An Agency may require a covered institution with average total consolidated assets of at least $10 billion and less than $50 billion to comply with some or all of the more stringent requirements applicable to Level 1 and Level 2 covered institutions based on the covered institution's activities, complexity of operations, risk profile, compensation practices or any other relevant factors. Any designation would generally require reasonable advance written notice (including a description of the basis for the proposed action) and opportunity for the covered institution to respond.

COVERED PERSONS AND COMPENSATION

Covered Persons. "Covered person" is defined as any executive officer, employee, director or principal shareholder who receives incentive-based compensation at a covered institution. For this purpose, "principal shareholder" is defined by reference to direct or indirect ownership of 10% or more of any class of voting securities. However, the proposed rule applies some of the most significant requirements only to a subset of these covered persons who are "senior executive officers" or "significant risk-takers."

Senior Executive Officers. A senior executive officer is 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 head of a major business line or control function[3] at the covered institution. This

[3] A "control function" is a compliance, risk management, internal audit, legal, human resources, accounting, financial reporting or finance role responsible for identifying, measuring, monitoring or controlling risk-taking.

determination is made with regard to the individual's function for the covered institution, even if the individual's title, salary or compensation does not reflect the role or is employed by a different entity.

Significant Risk-Takers. 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 the following tests:

- ***Relative compensation test:*** For a Level 1 covered institution, any person in the highest 5% of all covered persons (based on salary and incentive-based compensation and excluding senior executive officers); and for a Level 2 covered institution, any person in the highest 2% of all covered persons. In determining which individuals fall within the 5% or 2% threshold, the test would analyze the salary and incentive-based compensation of all covered persons at the covered institution and any subsidiaries that are also covered institutions.
- ***Exposure test:*** Any individual who may commit or expose 0.5% or more of the net worth or total capital of the covered institution (or any affiliated covered institution), regardless of whether the individual is employed by that specific entity. The measure of capital would be based on the maximum amount the individual has authority to commit or expose, in the aggregate, over the course of the most recent calendar year. This includes persons who are voting members of a committee that has the decision-making authority to commit or expose 0.5% or more of the net worth or total capital of the covered institution (or any affiliate covered institution).

The Agencies may also designate other covered persons as significant risk-takers if they are deemed to have the ability to expose the covered financial 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 have requested comment on the use of a dollar threshold test in lieu of the relative compensation test. Under the dollar threshold test, a covered person who receives annual base salary and incentive-based compensation in excess of a specific dollar threshold would be designated as a significant risk-taker without regard to their relative pay or exposure ability. (The European remuneration rules provide that, subject to exceptions, individuals who receive total compensation of €500,000 or more are deemed to be material risk-takers.)

Incentive-Based Compensation. Incentive-based compensation means any variable compensation, fees or benefits that serve as an incentive or reward for performance. The preamble to the new proposed rule clarifies that this does not include:

- compensation, fees or benefits awarded solely for, or the payment of which is tied to, continued employment (e.g., salary or a retention award);
- signing or hiring bonuses not conditioned on performance achievement;

- payments solely for achieving or maintaining a professional certification or level of educational achievement;
- compensation arrangements that are determined solely based on the covered person's level of compensation and do not vary based on performance measures (e.g., employer contributions to a 401(k) plan computed based on a fixed percentage of salary); and
- dividends paid and appreciation on stock or other equity-like instruments owned outright by a covered person (i.e., not subject to any vesting or deferral arrangement).

REQUIREMENTS ON ALL COVERED INSTITUTIONS

All covered institutions must comply with the proposed rule's prohibitions on incentive arrangements that encourage inappropriate risks by providing covered persons with excessive compensation, fees or benefits or that could lead to a material financial loss.

Excessive Compensation. Compensation, fees and benefits would be considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into account 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 factors such as asset size, geographic location and the complexity of the covered institution's operations and assets;
- the projected total cost and benefit of post-employment benefits 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.

Material Financial Loss**.** To avoid encouraging inappropriate risks that could lead to a material financial loss, a covered institution's incentive-based compensation arrangement must (1) appropriately balance risk and reward (including through the appropriate use of performance measures and determinations), (2) be compatible with effective risk management and controls and (3) be supported by effective governance, which is generally consistent with the Banking Agency Guidance. In order to appropriately balance risk and reward, an incentive-based compensation arrangement must meet the following performance requirements:

- ***Financial and non-financial measures of performance:*** Both financial and non-financial measures of performance must be considered, relevant to the covered person's role and type of business engaged in and appropriately weighted to reflect risk-taking. Examples of non-financial measures of performance include assessing compliance with policies and procedures, adherence to risk framework or conduct standards or compliance with applicable laws.

- ***Discretionary override:*** Non-financial measures of performance must be allowed to override financial measures when appropriate (for example, when a covered person takes action that increases a covered institution's profits but creates an inappropriate compliance risk).
- ***Subject to downward adjustment:*** Any amounts to be awarded must be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and non-financial performance.

Board Requirements. A covered institution's board of directors (or a committee) must (1) oversee the covered institution's incentive-based compensation program, (2) approve incentive-based compensation arrangements for senior executive officers (including the amounts and, at the time of vesting, payouts) and (3) approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

Disclosure and Recordkeeping. A covered institution must create annually, and maintain for at least seven years, records documenting the structure of all of the institution's incentive-based compensation arrangements and demonstrating compliance with the proposed rule. These records must be disclosed to the appropriate Agency on request. At a minimum, the records must include 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. Unlike the 2011 proposal, however, the proposed rule does not require covered institutions to file annual reports with an Agency.

Anti-Evasion Rule. Covered institutions may not indirectly do anything that is prohibited under the proposed rule, whether undertaken indirectly or through or by any other person.

ADDITIONAL REQUIREMENTS ON LEVEL 1 AND LEVEL 2 INSTITUTIONS

Incentive Limits. In addition to the general requirements regarding performance determinations that apply to all covered institutions, Level 1 and Level 2 covered institutions must comply with specific limits on leverage and performance measures.

Leverage. The maximum incentive-based compensation opportunity (which the proposed rule refers to as "leverage") may not exceed 125% of the target amount for senior executive officers and 150% of the target amount for significant risk-takers, determined on a plan-by-plan basis. Increases in the amount of awarded incentive-based compensation due to changes in share value, changes in interest rates or the payment of reasonable interest or a reasonable rate of return would not be counted as increases in the target amount awarded. There are no proposed limits on the absolute size of potential targets.

Performance Measures. Performance measures may not be based solely on (1) relative performance comparisons (i.e., measures that compare a covered institution's performance to other peer institutions or an industry average) or (2) transaction revenue or volume without regard to transaction quality or

compliance with risk management. Relative performance measures may be used if in combination with absolute performance measures, and performance measures may take into account transaction or revenue volume so long as they also consider other factors to cause covered persons to account for the risks of their activities.

Required Deferral. The proposed rule contains mandatory deferral requirements for Level 1 and Level 2 covered institutions, which distinguish between incentive-based compensation under a "long-term incentive plan" (i.e., with a performance period of at least three years) and "qualifying incentive-based compensation" (i.e., incentive-based compensation awarded for a particular performance period, excluding amounts awarded for that same period under a long-term incentive plan).

Minimum Deferrals.

- ***Level 1 Covered Institutions:*** For senior executive officers, at least 60% of qualifying incentive-based compensation must be deferred for at least four years and at least 60% of long-term incentive-based compensation must be deferred for at least two years, in each case after the end of the performance period. For significant risk-takers, at least 50% of qualifying incentive-based compensation must be deferred for at least four years and at least 50% of long-term incentive-based compensation must be deferred for at least two years.
- ***Level 2 Covered Institutions*:** For senior executive officers, at least 50% of qualifying incentive-based compensation must be deferred for at least three years and at least 50% of incentive-based compensation under a long-term incentive plan must be deferred for at least one year, in each case after the end of the performance period. For significant risk-takers, at least 40% of qualifying incentive-based compensation must be deferred for at least three years and at least 40% of incentive-based compensation under a long-term incentive plan must be deferred for at least one year, in each case after the end of the performance period.

Fastest Permitted "Vesting." During the deferral period, incentive-based compensation may vest no faster than on a pro rata annual basis, beginning no earlier than the first anniversary of the end of the performance period. Under the proposed rule, vesting is defined as the time at which a covered person's right to the incentive-based compensation is no longer contingent on the occurrence of any event, such as deferral and forfeiture upon an adverse event (listed under "Triggering Events" below). Accelerated vesting of amounts required to be deferred is prohibited except in the case of death or disability (no exception is provided for change in control transactions).

Composition of Deferred Pay. For covered institutions that issue equity or are subsidiaries of covered institutions that issue equity, deferred incentive-based compensation must consist of "substantial portions" of both deferred cash and equity-like instruments throughout the deferral period. Equity-like instruments that are settled in the form of cash would not be considered to be cash, so long as the final value of the award or payment is linked to the price of the covered institution's equity. In order to provide covered institutions with flexibility in meeting these composition requirements, the proposed rule does not specifically define what would constitute a substantial portion, but the Agencies request comment on whether the required proportion should be defined and, if so, vary among covered institutions and/or

types of covered persons. Options and stock appreciation rights are permitted as equity-like instruments; however, they can only count toward deferral of up to 15% of incentive-based compensation.

Upside During the Deferral Period. Increases in the value of deferred incentive-based compensation based solely on a change in share value or the payment of interest (or based on a change in interest rates) are permitted. Other upside during the deferral period is prohibited.

Downward Adjustment, Forfeiture and Clawback. The proposed rule includes requirements to keep incentive-based compensation for senior executive officers and significant risk-takers at risk during a performance period (through downward adjustment), through the deferral period (through forfeiture) and after the compensation has vested (through clawback).

Downward Adjustment and Forfeiture. All incentive-based compensation for senior executive officers and significant risk-takers must be subject to downward adjustment and forfeiture. A downward adjustment refers to a reduction in the amount of incentive-based compensation for a performance period that has not yet ended, while forfeiture refers to a reduction in the amount of deferred incentive-based compensation for which the performance period has ended but has yet to vest.

Downward Adjustment and Forfeiture "Triggering Events." Under the proposed rule, mandatory downward adjustment and forfeiture reviews would be triggered on the occurrence of one or more of the following:

- poor financial performance attributable to a significant deviation from the covered institution's risk parameters;
- inappropriate risk-taking, regardless of the impact on financial performance;
- material risk management or control failures;
- non-compliance with statutory, regulatory or supervisory standards that results in enforcement or legal action against the covered institution brought by a federal or state regulator or agency, or a requirement that the covered institution report a restatement of a financial statement to correct a material error; and
- any additional triggers based on conduct or poor performance defined by the covered institution.

If a review is triggered, at a minimum, the following factors must be considered in determining the amount of incentive-based compensation to downward adjust or forfeit:

- the intent of the senior executive officer or significant risk-taker to operate outside of the risk governance framework approved by the covered institution's board of directors or to depart from the covered institution's policies and procedures;
- the senior executive officer's or significant risk-taker's level of participation in, awareness of and responsibility for the events triggering the review;
- any actions the senior executive officer or significant risk-taker took or could have taken to prevent the triggering event;

- the financial and reputational impact of the triggering event on the covered institution, line or sub-line of business and the individuals involved (including the magnitude of any financial loss and the cost of known or potential subsequent fines, settlements and litigation);
- the causes of the triggering event, including any decision-making by other individuals; and
- any other relevant information, including past behavior and risk outcomes linked to the senior executive officer's or significant risk-taker's past behavior.

In addition, if downward adjustment or forfeiture review is triggered, the covered institution must consider downward adjustment and forfeiture for a senior executive officer or significant risk-taker with direct responsibility, or responsibility due to his or her role or position in the organization, for the triggering events.

Clawback. Clawback is a mechanism by which a covered institution may recover vested incentive-based compensation. Under the 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.

Governance Requirements

Prohibition on Facilitating Hedging. The proposed rule prohibits a Level 1 or Level 2 covered institution from purchasing hedging or similar instruments on behalf of covered persons to hedge or offset any decrease in the covered person's incentive compensation.

Risk Management Requirements. Level 1 and Level 2 covered institutions would be subject to the following risk management and controls requirements:

- ***Risk management framework:*** The covered institution must have a risk management framework for its incentive-based compensation program that: (1) is independent of any lines of business, (2) includes an independent compliance program[4] that provides for internal controls, testing, monitoring and training with written policies and procedures and (3) is commensurate with the size and complexity of the covered institution's operations.
- ***Independent controls:*** Individuals in control functions must have the authority to influence the risk-taking of the business areas they monitor and be compensated in accordance with the achievement of performance objectives linked to their control functions and independent of the performance of those business areas.

[4] To be considered independent under the proposed rule, the group or person responsible for the monitoring should generally have a reporting line to senior management or the board of directors that is separate from the covered persons whom the group or person is responsible for monitoring.

- ***Independent monitoring:*** There must be independent monitoring of: (1) incentive-based compensation plans to identify whether those plans appropriately balance risk and reward, (2) events relating to forfeiture and downward adjustment reviews and decisions related thereto and (3) compliance of the incentive-based compensation program with the covered institution's policies and procedures.

Governance. Level 1 and Level 2 covered institutions must establish a compensation committee composed solely of directors who are not senior executive officers to assist the board of directors in carrying out its duties related to incentive-based compensation. The compensation committee must obtain and review written assessments of the effectiveness of the covered institution's compensation program and related compliance and control processes from both management (with input from the covered institution's risk and audit committees of the board of directors, or groups performing similar functions) and the internal audit or risk management function on the effectiveness of the covered institution's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the risk profile of the covered institution. The two reports must be developed independently from another and submitted to the compensation committee at least annually. In addition, the compensation committee must receive input from the risk and audit committees of the board of directors (or groups performing similar functions) and the risk management function on the effectiveness of risk measures and adjustments used to balance risk and reward in incentive-based compensation arrangements.

Recordkeeping, Policies and Procedures

Disclosure and Recordkeeping. In addition to the general record maintenance requirements, Level 1 and Level 2 covered institutions also must maintain records of:

- senior executive officers and significant risk-takers listed by legal entity, job function, organizational hierarchy and line of business;
- incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on percentage of incentive-based compensation deferred and form of award;
- any forfeiture, downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and
- material changes, if any, to the covered institution's incentive-based compensation arrangements and policies.

Policies and Procedures. Level 1 and Level 2 covered institutions would be required to develop and implement new policies and procedures for its incentive-based compensation. At a minimum, the policies and procedures must:

- 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 documentation of final forfeiture, downward adjustment and clawback decisions be maintained;
- 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 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 institution's 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 (1) designing incentive-based compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback and vesting and (2) assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.

ALIGNMENT WITH NON-U.S. REGULATORY REGIMES

The new proposed rule reflects greater alignment with European standards under the Capital Requirements Directive IV ("CRD IV"), which contains a set of compensation requirements that applies to all banks and investment firms subject to the Capital Requirements Directive, and the U.K. implementation of CRD IV in particular.

In June 2015, the Bank of England Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA") jointly released a final policy statement and remuneration rules governing financial institution incentive-based compensation (or variable pay) in the U.K. The U.K. remuneration rules create three proportionality levels based on relevant total assets: proportionality level 1 applies to firms with greater than £50 billion in total assets, proportionality level 2 applies to those with greater than £15 billion but less than £50 billion in total assets and proportionality level 3 applies to any firm that does not fall into proportionality level 1 or proportionality level 2. If firms are grouped together, then the highest proportionality level applicable to any individual firm within the group applies to the others in the group.

Both the U.K. remuneration rules and the new proposed U.S. rule include minimum deferral and vesting requirements that vary based on the covered individual's role and the covered institution's asset size. In both regimes, the amount that must be deferred varies from 40% to 60%. However, the new proposed U.S. rule only limits the leverage of incentive-based compensation compared to target, whereas the U.K. remuneration rules (consistent with CRD IV) cap variable pay at 100% of total fixed pay (or 200% with shareholder approval). In addition, although the proposed U.S. rule requires that deferred incentive-based compensation include substantial portions of both cash and equity-like instruments, the U.K.

remuneration rules prescribe that at least half of variable pay be equity-based. Both rules would require that vested incentive-based compensation be subject to clawback for at least seven years, starting from the award date for the U.K. and from the vesting date for the U.S., with the U.K. rules permitting the period to be extended for up to three years if the firm or a regulatory authority has commenced an investigation that may lead to the application of a clawback.

For a side-by-side comparison of the provisions of the 2011 proposed rule, U.K. remuneration rules and the new proposed rule, please see the chart in Annex A.

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ANNEX A

	Originally Proposed Joint Rule (April 2011)	U.K. Remuneration Rules (June 2015)	New Proposed Joint Rule (April 2016)
Proportionality	Specific requirements apply to covered financial institutions with $50 billion or more in total consolidated assets ("LBOs")	Three proportionality levels, based on relevant total assets **Proportionality level 1**: Greater than £50 billion **Proportionality level 2**: Greater than £15 billion but less than £50 billion **Proportionality level 3**: Any firm that does not fall within proportionality levels 1 or 2 If a firm is part of a group containing one or more other firms, each individual firm must determine its own proportionality level without regard to the group; if individual firms fall into different levels based on such determinations, then the highest proportionality level applies to all in the group	Three categories of covered institutions, based on average total consolidated assets **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 and less than $50 billion For covered institutions that are subsidiaries of other covered institutions, the applicable level is generally determined by the asset size of the top-tier parent covered institution, even if the subsidiary covered institution is smaller than the parent covered institution. This does not apply for broker-dealers or investment advisers, except in the case of subsidiaries of depository institution holding companies
Covered Persons	Any executive officer, employee, director or principal shareholder More stringent requirements apply to executive officers of LBOs	Any firm employee whose professional activities have a material impact on the firm's risk profile (including identified "significant influence functions" which include both front and back office functions) ("material risk takers") Specifically includes any employee who meets certain qualitative or quantitative criteria, including: total compensation for the preceding fiscal year of at least €500,000, within the top 0.3% of staff or	Any executive officer, employee, director or principal shareholder who receives incentive-based compensation at a covered institution More stringent requirements apply to senior executive officers and significant risk-takers **Senior executive officer**: Holds the title or performs the function (without regard to title, salary or compensation) of a specified position at a covered institution (generally,

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		greater than or equal to the lowest total compensation awarded to a member of senior management; and authority with regard to credit risk exposures of a per transaction amount representing 0.5% of the firm's common equity tier 1 capital and at least €5 million or with regard to trading transactions which in aggregate represent 0.5% of more of the firm's common equity tier 1 capital More stringent requirements apply to senior managers and risk managers with senior, managerial or supervisory roles **Senior managers**: Individuals performing certain designated senior management functions and requiring regulatory approval, generally including board members, executive committee members (or their equivalent), heads of key business areas, individuals in group or parent companies exercising significant influence on the firms' decision-making, individuals responsible for important business, control or conduct-focused functions within the firm **Risk managers with senior, managerial or supervisory roles** (for PRA-regulated firms): Excludes senior managers but generally includes members of the management body, risk managers and direct reports, heads of material business units and their direct reports, heads of functions and managers of risk-taking material risk takers	the C-suite and heads of major business lines or control functions) **Significant risk-taker**: Non-senior executive officers whose total compensation the previous year was at least one-third incentive-based compensation, and, based on the relative compensation test or the exposure test (below), may put a Level 1 or Level 2 covered institution at risk of material financial loss Significant risk-taker tests *Relative compensation test*: For Level 1 institutions, among the top 5% of all covered persons in salary and incentive-based compensation, excluding senior executive officers, for the last calendar year ending at least 180 days before the beginning of the performance period (top 2% for Level 2 covered institutions) *Exposure test*: Individual may commit or expose 0.5% or more of the covered institution's net worth or total capital

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		Exclusion from more stringent requirements provided for employees with total pay of no more than £500,000 of which no more than 33% is variable	
Limit on Amount of Variable Pay	No specific limit	Variable pay for a material risk taker must not exceed 100% of total fixed pay or 200% with shareholder approval (with a discount permitted to be applied to 25% of an employee's total variable pay that is deferred for at least 5 years) May not apply to proportionality level 3 firms	No limit on amount of incentive-based compensation For Level 1 or Level 2 covered institutions, incentive-based compensation for senior executive officers must not exceed 125% of the target amount (150% of the target amount for significant risk-takers)
Limit on Form of Variable Pay	No specific limit	For proportionality level 1 and level 2 firms, at least 50% of variable pay for material risk takers must be equity-based and subject to a minimum retention period (generally 6 months) This requirement applies separately to deferred and non-deferred variable pay	For Level 1 and Level 2 covered institutions, deferred incentive-based compensation must include substantial portions of both deferred cash and equity-like instruments
Minimum Deferral of Variable Pay	For executive officers of LBOs, at least 50% of incentive-based compensation must be deferred for at least 3 years	For proportionality level 1 and level 2 firms: Senior managers: Effectively, 60% of variable pay must be deferred for at least 7 years, with vesting starting no earlier than 3 years and occurring no faster than on a pro rata basis, for proportionality level 1 and level 2 firms Risk managers with senior, managerial or supervisory roles: At least 40% of variable pay must be deferred for at least 5 years, with vesting occurring no faster than on a pro rata basis for proportionality level 1 and	Level 1: At least 60% of incentive-based compensation for senior executive officers (50% for significant risk-takers) must be deferred for at least 4 years, and at least 60% (50% for significant risk-takers) of compensation awarded under a long-term incentive plan must be deferred at least 2 years, beyond the end of the performance period Level 2: At least 50% of incentive-based compensation for senior executive officers (40% for significant risk-takers) must be deferred for at least 3 years, and at least

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		level 2 firms Other material risk takers: At least 40% of variable pay must be deferred for at least 3 years, with vesting occurring no faster than on a pro rata basis for proportionality level 1 and level 2 firms These requirements apply separately to the cash and equity-based components of variable pay	50% (40% for significant risk-takers) of compensation awarded under a long-term incentive plan must be deferred at least 1 year, beyond the end of performance period
Performance Adjustment (Malus) Requirements	For executive officers of LBOs, deferred amounts must be adjusted to reflect actual losses or other aspects of performance that become realized or known during the deferral period	Proportionality level 1 and level 2 firms should reduce unvested deferred variable pay for material risk takers when there is reasonable evidence of employee misbehavior or material error, the firm or relevant business unit suffers a material downturn in its financial performance, or the firm or relevant business unit suffers a material failure of risk management	Level 1 and Level 2 covered institutions must review senior executive officers and significant risk-takers for downward adjustment of not yet awarded incentive-based compensation and forfeiture of unvested incentive-based compensation upon triggering events including poor financial performance attributable to a significant deviations from risk parameters, inappropriate risk-taking, material risk management or control failures, regulatory action due to noncompliance and restatement to correct a material error If a review is triggered, factors considered in determining the downward adjustment or forfeiture amount must include intent to operate outside approved risk governance framework or policies/procedures, participation, awareness and responsibility level, financial and reputational impact of the triggering event, causes of the triggering event and past behavior

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Clawback	No requirement	All variable pay for material risk takers must be subject to clawback for at least 7 years from the date of the award, which period may be extended for up to an additional 3 years for senior managers where the firm or a regulatory authority has commenced an investigation that could lead to the application of clawback Must make all reasonable efforts to recover an appropriate amount of vested variable pay if there is reasonable evidence of employee misbehavior or material error, or the firm or relevant business unit suffers a material failure of risk management, taking into account all relevant factors including proximity to a risk failure and level of responsibility	All incentive-based compensation awarded to current or former senior executive officers or significant risk-takers at Level 1 and Level 2 covered institutions must be subject to clawback for at least 7 years from the vesting date Clawback triggered upon engaging in misconduct that resulted in significant financial or reputational harm to the covered institution, fraud, or intentional misrepresentation of information used to determine the individual's incentive-based compensation
Other Restrictions		Prohibition on guaranteed variable pay unless it is exceptional, occurs in the context of hiring a new employee, is limited to the first year of service and the firm has a sound and strong capital base	Level 1 and Level 2 covered institutions may not base incentive-based compensation performance measures solely on industry peer performance comparisons or on transaction or revenue volume without regard to transaction quality or compliance with sound risk management