SULLIVAN & CROMWELL LLP

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# Financial Regulators Begin Rollout of New Proposed Rule on Incentive Pay at Large Financial Institutions

## For Executives at America's Biggest Financial Institutions, Proposal Contemplates 60% of Incentive Pay at Risk for Up to 11 Years

### SUMMARY

Earlier today, the National Credit Union Administration issued a notice of proposed rulemaking for a new interagency rule on incentive-based compensation that applies to financial institutions with consolidated assets of at least $1 billion. Today's new proposal replaces one originally issued 5 years ago in the first half of 2011. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency and the Securities and Exchange Commission are all expected to propose the same new rule.

The new proposed rule establishes general qualitative requirements applicable to all covered companies, 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 applicable to all covered institutions 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).

This memorandum provides initial highlights of the substantive requirements of the new proposed rule. A more detailed memorandum discussing the full scope of the proposed rule will be forthcoming.

## COVERED INSTITUTIONS

The proposed rule covers each of the following with total consolidated assets of $1 billion or more:

- ***Covered by Federal Reserve Rule.*** State member banks, bank holding companies, savings and loan holding companies, Edge and Agreement corporations, state-licensed uninsured branches and agencies of foreign banks, as well as the U.S. operations of foreign banks.
- ***Covered by FDIC Rule.*** State non-member banks, state savings associations and state insured U.S. branches of foreign banks.
- ***Covered by FHFA Rule.*** Fannie Mae, Freddie Mac and the Federal Home Loan Banks.
- ***Covered by NCUA Rule.*** Insured credit unions and credit unions eligible to apply to become an insured credit union.
- ***Covered by OCC Rule.*** National banks, federal savings associations and federal branches or agencies of foreign banks.
- ***Covered by SEC Rule.*** Registered broker-dealers and all investment advisers (registered and unregistered) as defined in Section 202(a)(11) of the Investment Advisers Act.[1]

Consistent with the underlying requirements of Section 956 of the Dodd-Frank Act, the Agencies are proposing to cover any firm that meets the definition of "investment adviser" under the Investment Advisers Act, without regard to whether the firm is registered with the SEC. However, the new proposal clarifies that investment advisers should include only proprietary assets in calculating their consolidated assets—non-proprietary assets, such as client assets under management, would not be included, regardless of whether they appear on an investment adviser's balance sheet. It therefore seems likely that only a limited number of investment advisers will ultimately be included as covered financial institutions because of the asset-size requirement.

## INITIAL HIGHLIGHTS OF SUBSTANTIVE REQUIREMENTS

***Proportionality.*** The proposed rule creates 3 tiers of covered institutions based on asset size, with the most stringent requirements applying to the "Level 1" covered institutions.

- ***Level 1:*** average total consolidated assets greater than or equal to $250 billion
- ***Level 2:*** average total consolidated assets greater than or equal to $50 billion and less than $250 billion
- ***Level 3:*** average total consolidated assets greater than or equal to $1 billion and less than $50 billion

***Covered Persons.*** "Covered person" is defined as any executive officer, employee, director or principal shareholder who receives incentive-based compensation at a covered institution. However, some of the most significant requirements of the proposed rule apply only to a subset of covered persons at Level 1 and Level 2 covered institutions:

1 In some cases, subsidiaries of the preceding are also included.

- ***"Senior executive officer":*** 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
- ***"Significant risk-taker":*** generally, any covered person who (1) receives at least one-third of total compensation in incentive-based compensation and is in the highest 5% (Level 1 covered institutions) or 2% (Level 2 covered institutions) of all covered persons (calculated based on salary and incentive-based compensation and excluding senior executive officers), (2) may commit or expose 0.5% or more of the net worth or total capital of the institution or (3) is specifically designated as a "significant risk-taker" by the relevant Agency

***Limits on Incentives.*** The proposed rule sets forth general requirements regarding performance determination that apply to all covered institutions and, for Level 1 and Level 2 covered institutions, prescribes specific limits on leverage and performance measures.

- ***Leverage:*** For Level 1 and Level 2 covered institutions, the maximum earned incentive for senior executive officers is limited to 125% of the target amount for that incentive-based compensation and for significant risk-takers is limited to 150% of target. The proposed rule does not limit the absolute size of potential targets.
- ***Performance Measures:*** For Level 1 and Level 2 covered institutions, performance measures may not be *solely* based on either (1) relative performance comparisons or (2) transaction revenue or volume without regard to transaction quality or compliance with risk management. A covered institution may, however, use relative performance measures in combination with absolute performance measures.
- ***General Requirements for Performance Determination:*** For all covered institutions, incentive compensation plans must (1) include both financial and non-financial measures of performance appropriately weighted to reflect risk-taking, (2) allow non-financial measures of performance to override financial measures and (3) be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and non-financial performance.

***Minimum Deferral Requirements.*** For Level 1 and Level 2 covered institutions, the following minimum deferral requirements apply to both short-term and long-term incentives:

- ***Minimum Deferral Amount:*** 60% for senior executive officers and 50% for significant risk-takers for Level 1 covered institutions, and 50% and 40%, respectively, for Level 2 covered institutions.
- ***Minimum Deferral Period:*** 4 years (Level 1) or 3 years (Level 2) for short-term incentives, and 2 years (Level 1) or 1 year (Level 2) for long-term incentives, in each case from the end of the relevant performance period. To constitute a long-term incentive, the plan must have at least a 3-year performance period.
- ***Maximum "Vesting":*** During a deferral period, incentive compensation may not vest faster than on a pro rata annual basis beginning on the first anniversary of the end of the performance period (other than death or disability). The proposal refers to "vesting" as the time when an award is no longer subject to forfeiture based on a set of adverse events (listed under "Triggering Events" below). The proposal does not require that "unvested" compensation be lost when a person ceases to perform services for the institution, which is the more common use of term "vesting."
- ***Form of Deferral:*** Although not included in the rule proposed by the NCUA this morning, the preamble accompanying the proposal states that other Agencies will require a "substantial portion" of deferred incentive compensation to be paid in the form of both equity-like instruments and deferred

cash. It does not appear, however, that the Agencies are proposing to define what will constitute a substantial portion.

- ***Upside During the Deferral Period:*** Increases in the value of deferred incentive compensation based solely on 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.
- ***Options:*** Options and stock appreciation rights are permitted; however, they can only count toward deferral of 15% of incentive compensation.

***Downward Adjustment and Forfeiture:*** For Level 1 and Level 2 covered institutions, incentive compensation must be subject to downward adjustment and forfeiture.

- ***Downward Adjustment:*** Downward adjustment occurs during the performance period or between the end of the performance period and before performance is determined (which the proposed rule calls "awarded"). All incentive compensation for senior executive officers and significant risk-takers must be subject to downward adjustment.
- ***Forfeiture:*** Occurs between "award" and "vesting." All unvested deferred incentive compensation for senior executive officers and significant risk-takers must be subject to forfeiture.
- ***Triggering Events (including enforcement or other regulatory action):*** A downward adjustment and forfeiture review by the institution must be triggered for (1) poor financial performance attributable to a significant deviation from the risk parameters, (2) inappropriate risk-taking, regardless of the impact on financial performance, (3) material risk management or control failures and (4) non-compliance with statutory, regulatory or supervisory standards that results in enforcement or legal action by a Federal or state regulator or agency or a restatement of a financial statement to correct a material error.
- ***Review of Specific Officers or Risk-Takers:*** Downward adjustment and forfeiture must be considered for a senior executive officer or significant risk-taker with direct responsibility for a "Triggering Event" or with responsibility due to role or position in the organizational structure.

***Clawback:*** For Level 1 and Level 2 covered institutions, incentive compensation must be subject to clawback.

- ***Clawback:*** Occurs after incentive compensation vests.
- ***Minimum Clawback Period:*** All incentive compensation for senior executive officers and significant risk-takers must be subject to clawback for 7 years following vesting.
- ***Clawback Events:*** Clawback must be permissible for (1) misconduct that resulted in significant financial or reputational harm to the covered institution, (2) fraud and (3) intentional misrepresentation of information used to determine incentive-based compensation.

***Effectiveness:*** The proposed rule has an effective date intended to represent 18 months after the <u>final</u> rule is published. Any plans with an open performance period beginning before the effective date would be grandfathered.

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## CONTACTS


| | | |
|---|---|---|
| **New York** | | |
| H. Rodgin Cohen | +1-212-558-3534 | cohenhr@sullcrom.com |
| Heather L. Coleman | +1-212-558-4600 | colemanh@sullcrom.com |
| Mitchell S. Eitel | +1-212-558-4960 | eitelm@sullcrom.com |
| Matthew M. Friestedt | +1-212-558-3370 | friestedtm@sullcrom.com |
| Glen T. Schleyer | +1-212-558-7284 | schleyerg@sullcrom.com |
| Marc Trevino | +1-212-558-4239 | trevinom@sullcrom.com |
| Michael M. Wiseman | +1-212-558-3846 | wisemanm@sullcrom.com |
| **Washington, D.C.** | | |
| Samuel R. Woodall III | +1-202-956-7584 | woodalls@sullcrom.com |