Simpson Thacher

Memorandum

U.S. Regulators Propose Revised Incentive-Based Compensation Rules for Financial Institutions

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On Thursday, revised draft rules for financial institutions' incentive-based compensation arrangements were released, more than five years after the rules were initially proposed. The National Credit Union Administration was the first regulator to release rules (which are mandated under Section 956 of Dodd-Frank), and in the coming weeks, the federal banking regulators and the SEC are expected to issue substantially identical proposals. If finalized, these regulations would prohibit banks, broker-dealers, investment advisers and other financial institutions with at least $1 billion in assets from having incentive-based compensation arrangements that encourage inappropriate risk (x) by providing "excessive compensation" to employees or (y) that could lead to "material financial loss" to the covered institution. To effectuate this open-ended "inappropriate risk" standard, the rules would impose significant procedural checks on executive compensation programs at all covered institutions, as well as more meaningful substantive and structural limitations on institutions with at least $50 billion in assets, including minimum deferral periods and clawbacks for senior executive officers and significant risk-takers at these institutions.

Compliance Timing and Grandfathering

If finalized, the rules would not become effective until the first calendar quarter that begins 18 months following formal publication. After accounting for at least a three-month comment period and the additional time it will take for the six regulators to finalize the rules, the requirements are not likely to come into force for at least two years. Compensation arrangements in place before the rules become effective will be "grandfathered" for any performance periods that are then in effect.

"Covered Institutions" and "Covered Persons"

The rules apply to a wide array of specified financial institutions with at least $1 billion in total consolidated assets ("covered institutions"), including:

- *Banking organizations* such as bank holding companies and savings and loan holding companies; banks, thrifts and credit unions; and federal and state branches and agencies of foreign banks and certain U.S. subsidiaries of foreign banks
- *Broker-dealers* registered under the Securities Exchange Act of 1934
- *Investment advisers* under the Investment Advisers Act of 1940

The rules apply to incentive compensation payable to "covered persons," including any executive officer, employee or director of a covered institution. However, several of the more onerous provisions (such as deferral and clawback) would only apply to the following employees of Level 1 and Level 2 institutions:

- *Senior Executive Officers ("SEOs")* such as most C-suite executives, including the chief executive officer, chief financial officer and chief operating officer, but also the heads of major business lines and control functions; and
- *Significant Risk-Takers ("SRTs")* including employees other than SEOs who received at least one-third of their compensation from incentive compensation and who (i) are among the highest 5% (for Level 1) or 2% (for Level 2) in compensation (excluding SEOs) of the institution or (ii) may commit or expose at least 0.5% of the institution's capital.

Tiered Application Based on Asset Levels

Requirements are generally tailored based on the following asset levels, with progressively more rigorous requirements applying to larger institutions:

- *Level 1* – $250 billion or more in consolidated assets
- *Level 2* – $50 billion to $250 billion in consolidated assets
- *Level 3* – $1 billion to $50 billion in consolidated assets

For investment advisers, to determine whether the initial $1 billion threshold level is met, the proposed method of calculation corresponds to Form ADV (which requires an adviser to check a box to indicate if it has assets itself of $1 billion or more). Average total consolidated assets would then be determined by the adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year end. Non-proprietary assets, such as client/fund assets under management, are excluded from the calculation (regardless of whether they appear on the adviser's balance sheet under accounting rules).

For banking organizations, covered institutions that are subsidiaries of other covered institutions would generally be subject to the same requirements as the parent covered institutions, even if the subsidiary is smaller than its parent.

To avoid "cliff" effects, an 18-month transition period would apply for covered institutions that later fall within the Level 2 or Level 3 asset thresholds. Upon a decrease in total consolidated assets, an institution would remain subject to the requirements that applied to it before the decrease, until its assets fell below the relevant asset threshold level for four consecutive quarters.

For a Level 3 institution, the appropriate regulator has discretion to require that the institution comply with some or all of the requirements applicable to a Level 1 or Level 2 institution based on the institution's "complexity of operations or compensation practices." The proposal cites a Level 3 institution's involvement in high-risk business lines (such as distressed lending or trading illiquid assets) and having significant levels of off-balance sheet activities as examples of items that may be considered in such a determination. However, the regulators expect to use this authority on an "infrequent basis."

General Prohibition on "Excessive" Compensation and Incentive-Based Compensation that Could Lead to "Material Financial Loss"

All covered institutions would be prohibited from having incentive-based compensation arrangements that encourage inappropriate risk by (x) providing covered persons with "excessive compensation" or (y) that could lead to "material financial loss" to the covered institution. Incentive-based compensation arrangements are broadly defined to include any "variable" compensation, fees, or benefits that incentivize or reward performance. The term would include annual and multi-year bonuses, equity-based awards, profit-sharing pools, and similar arrangements.

- *Excessive Compensation* – Compensation would be considered "excessive" when amounts paid are "unreasonable or disproportionate to the value of the services performed." There are various factors used to make this determination, including: the combined value of all compensation, fees, or benefits provided to the person; the compensation history of the person and others with comparable expertise at the institution; the financial condition of the institution; compensation practices at comparable institutions; for post-employment benefits, the projected total cost and benefit to the 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 institution.
- *Material Financial Loss* – Every incentive-based compensation arrangement at a covered institution would be deemed to "encourage inappropriate risk that could lead to material financial loss" to the institution, *unless* the arrangement appropriately balances risk and reward and also is compatible with effective risk management and controls and supported by effective governance. An incentive-based compensation arrangement would not be considered to appropriately balance risk and reward *unless*: (i) it includes financial and non-financial measures of performance (relevant to a covered person's role and to the type of business in which he or she is engaged); (ii) it is designed to allow non-financial measures of performance to override financial measures of performance when appropriate; (iii) any amounts to be awarded under the arrangement are subject to adjustment to reflect actual losses,

compliance deficiencies, inappropriate risks taken or other performance measures; and (iv) in the case of Level 1 and Level 2 institutions, also contain features for minimum vesting/deferral and potential forfeiture, downward adjustment, and clawback.

Substantive Considerations for Level 1 and Level 2 Institutions

Level 1 and Level 2 institutions will be required to adopt mandatory deferral/vesting, forfeiture and downward adjustments, clawbacks, and maximum "outperformance" payouts for SEOs and SRTs.

- *Mandatory Vesting/Deferral* – SEOs and SRTs will be required to defer between 40-60% of each incentive-based compensation award for a period ranging from 3-to-4 years following the end of the applicable performance period, in each case depending on whether the institution is Level 1 or Level 2, the role of the employee, and whether the performance period is designated as "short-term" (less than 3 years) or "long-term" (3+ years). If the performance period is "long-term," then the required deferral period is shorter.

Level and Role	Deferral Percentage	Deferral Period for Short-Term Compensation	Deferral Period for Long-Term Compensation
Level 1, Senior Executive Officer	60%	4 years	2 years
Level 1, Significant Risk-Taker	50%	4 years	2 years
Level 2, Senior Executive Officer	50%	3 years	1 year
Level 2, Significant Risk-Taker	40%	3 years	1 year

While the rules use the term "deferral" to describe the additional 1-to-4 year period, it may be better to think of this requirement as additional vesting (as opposed to tax-based "deferral"). As a result, incentive-based compensation would, at a minimum, need a vesting schedule that provides for straight line vesting over the minimum vesting period, beginning no earlier than the first anniversary of the end of the performance period for which the amounts were awarded (for example, a 4-year "deferral" could vest no faster than 25% after one year and thereafter 25% annually, 6.25% quarterly or 2.08% monthly). These minimum vesting terms may not be accelerated except upon death or disability of the individual or for the payment of income taxes due on deferred amounts prior to vesting. This may require changes to executive employment agreements that sometimes provide for accelerated vesting upon a

termination of employment without "cause" or resignation for "good reason." During the deferral/vesting period, amounts to be paid cannot be increased, except as a result of an increase attributable solely to a change in share value, interest rates, or the payment of interest, as required by the award.

- *Forfeiture and Downward Adjustment* – All unvested deferred incentive compensation of SEOs and SRTs, and any incentive compensation of SEOs and SRTs not yet awarded for the current performance period, must be at "risk of forfeiture" or subject to "downward adjustment" upon the occurrence of certain events for which the SEO or SRT had responsibility, which include: poor financial performance attributable to a significant deviation from the risk parameters set forth in the institution's policies and procedures; inappropriate risk taking, regardless of the impact on financial performance; material risk management or control failures; non-compliance with legal or supervisory standards resulting in enforcement or legal action by a regulator or agency, or a requirement that the institution issue a financial restatement; and other incidents of misconduct or poor performance as defined by the institution.

- *Clawback* – Level 1 and Level 2 institutions must include clawback provisions in incentive-based compensation arrangements for SEOs and SRTs that, at a minimum, allow the covered institution to recover incentive-based compensation from a current or former SEO or SRT for 7 years following the date on which such compensation vests, if the institution determines that the SEO or SRT engaged in: misconduct that resulted in significant financial or reputational harm to the institution; fraud; or intentional misrepresentation of information used to determine the SEO's or SRT's incentive-based compensation. These clawback periods are considerably longer than those proposed under Dodd-Frank for other public companies.

- *Additional Prohibitions* – Level 1 and Level 2 institutions may not: (i) hedge on behalf of a covered person to offset any decrease in value of incentive-based compensation; (ii) award incentive-based compensation to SEOs in excess of 125%, or to SRTs in excess of 150%, of the target amount for that incentive-based compensation; (iii) use incentive-based compensation performance measures that are based solely on industry peer performance comparisons; or (iv) provide incentive-based compensation to a covered person that is based solely on transaction revenue or volume without regard to transaction quality or compliance by the covered person with sound risk management.

Procedural Considerations: Governance, Risk Management and Recordkeeping

- *Governance* – Every covered institution's board (or a committee thereof) must approve incentive-based compensation arrangements for SEOs (including award amounts and, at the time of vesting, payouts) and approve material exceptions or adjustments for SEOs. In addition, Level 1 and Level 2 institutions must have compensation committees composed solely of directors who are not SEOs. Compensation

committees must obtain input from the risk and audit committees on specified matters and, at least annually, receive an assessment from management and a separate independent assessment from the internal audit or risk management function relating to the effectiveness of the institution's incentive-based compensation program.

- *Risk Management* – For Level 1 and Level 2 institutions to demonstrate that their incentive-based compensation arrangements are compatible with effective risk management and controls, they must, among other things, have a risk management framework for their incentive-based compensation programs that is independent of business lines and provides for independent monitoring of all incentive-based compensation plans and events related to forfeiture and downward adjustment.
- *Recordkeeping* – Every covered institution must create annually and maintain for at least 7 years records that document the structure of its incentive-based compensation arrangements and demonstrate compliance with the rules. Unlike the initial proposal from 2011, there is no annual reporting requirement, but records must be disclosed to regulators upon request. Among other things, records must include copies of all incentive-based compensation plans and a description of how the incentive-based compensation program is compatible with effective risk management and controls. In addition, Level 1 and Level 2 institutions must retain identifying information on SEOs and SRTs, as well as details on deferred compensation, clawback reviews and other decisions.

For more information on the proposed rules and their impact, please contact your relationship partner or any member of the Firm's Executive Compensation and Employee Benefits or Financial Institutions practices.

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