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Bank Regulators Issue New Proposed Rule on Incentive Compensation

The National Credit Union Administration is the first of a group of six federal bank regulators[1] to make available a joint proposed rule on incentive compensation arrangements maintained by financial institutions.

Initially, these bank regulators issued a jointly proposed rule on incentive compensation arrangements back in 2011. The new proposed rule, which supersedes the 2011 rule, is updated based on developments in incentive-compensation programs maintained by financial institutions, bank regulators' experience with these programs and comments received on the initial proposed rule.

> The proposed regulations would apply to financial institutions with assets of $1 billion or more. The rules vary by size, with institutions $50 billion or greater subject to significantly more prescriptive requirements. Requirements include, but are not limited to deferrals, forfeitures, downward adjustments and clawbacks for "senior executive officers" and "significant risk takers". Depending on the timing of final rules, the effective date of these requirements isn't likely until 2019.

Background and Effective Date

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires bank regulators to jointly issue regulations or guidelines: (i) prohibiting incentive-based compensation arrangements that encourage inappropriate risks that provide excessive compensation or that could lead to a material financial loss, and (ii) requiring those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate Federal regulator.

The bank regulators are under no deadline by which to issue a final rule. Once a final rule is adopted by the bank regulators, covered financial institutions would become subject to the final rule 540 days after its publication in the federal register. An incentive-based compensation arrangement plan with a performance period that begins before the final rule's effective date would not be subject to the final rule. If the final rules are adopted by year end, they would initially apply to calendar year incentive-based compensation arrangements with performance periods beginning in 2019.

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[1] The bank regulators issuing the joint proposed rule are the Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation; the Federal Housing Finance Agency; the National Credit Union Administration and the Securities and Exchange Commission.

Covered Institutions

The proposed rules would apply to financial institutions ("Covered Institutions") with assets greater than or equal to $1.0 billion. The proposed rules would create three tiers of covered institutions based on asset size:

- Level 1 Institutions: Financial institutions with assets of $250 billion or more
- Level 2 Institutions: Financial institutions with assets of at least $50 billion but less than $250 billion
- Level 3 Institutions: Financial institutions with assets of at least $1 billion but less than $50 billion

Level 1 and Level 2 Institutions would be subject to significantly more prescriptive rules than the rules that would be applicable to Level 3 Institutions. However, regulators would have the discretionary authority to subject a Level 3 Institution with assets of $10 billion or more to the more rigorous rules on a case-by-case basis.

Requirements Applicable to All Covered Institutions

Every covered institution would be subject to the following requirements:

- Incentive arrangements cannot encourage inappropriate risk by providing excessive compensation or encourage inappropriate risk that could lead to a material financial loss.
- Incentives must include both financial and non-financial measures of performance (including risk-based measures), and the non-financial measures must be able to override the financial results. Additionally, amounts to be awarded must be subject to downward adjustment to reflect actual losses, inappropriate risks or compliance deficiencies.
- Incentive arrangements must include effective controls and governance, including oversight by the Board of Directors.
- Covered financial institutions must create annual records documenting the structure of incentives and compliance with these regulations. The records must be maintained for seven years and be available for regulators to review upon request.

Requirements Solely Applicable to Level 1 and Level 2 Financial Institutions

Level 1 and 2 Institutions would be subject to significant additional requirements, which would include:

- Mandatory deferral of incentive award payments;
- Downward adjustment, forfeiture or clawback of incentive award payments;
- Restrictions on incentive plan design; and
- Governance requirements.

Certain of these additional requirements would solely apply to "senior executive officers" and "significant risk takers". Senior executive officers would include thirteen specific roles identified in the proposed rule (e.g., CEO, CFO, COO), the heads of major business lines and the heads of control functions. Significant risk takers would include individuals whose compensation is among the highest in the organization (top 5% for Level 1 Institutions and top 2% for Level 2 Institutions) or who may commit or expose 0.5% or more of the institution's capital.

Mandatory Deferral of Incentive Award Payments (Level 1 and Level 2 Institutions)

Amounts earned under incentive compensation plans would be subject to the following deferral requirements:

	Level 1 Institutions		Level 2 Institutions	
	Senior Executive Officer	Significant Risk Taker	Senior Executive Officer	Significant Risk Taker
Incentive Plan with Performance Periods of Less than 3 years ("Qualifying")				
Required Deferral	60%	50%	50%	40%
Length of Deferral	4 years	4 years	3 years	3 years
Incentive Plan with Performance Periods of at Least 3 years ("Long-Term")				
Required Deferral	60%	50%	50%	40%
Length of Deferral	2 years	2 years	1 year	1 year

The deferral cannot vest faster than on a pro rata annual basis. Deferred amounts cannot accelerate except in the cases of death or disability. The deferred amounts cannot increase except based on share price, interest payments or a change in interest rates.

Downward Adjustments, Forfeitures and Clawbacks (Level 1 and Level 2 Institutions)

Level 1 and Level 2 Institutions' incentive arrangements would need to allow for downward adjustment, forfeiture and clawback of incentive awards under the circumstances described in the following table:

<table>
<tr><th>Type of Potential Adjustment</th><th>Events Triggering Review for Potential Adjustment</th><th>Applicable Time Period</th></tr>
<tr><td>Downward Adjustment (reduction of earned incentive awards)</td><td rowspan="2">▪ Poor financial performance resulting from a significant deviation from risk parameters
▪ Inappropriate risk taking
▪ Material risk management or control failures
▪ Non-compliance with statutory, regulatory or supervisory standards resulting in enforcement or legal action or a financial restatement</td><td>Prior to Deferral Period (before incentive amounts are determined)</td></tr>
<tr><td>Forfeiture</td><td>During Deferral Period (after incentive amounts are determined and deferred but prior to payment)</td></tr>
<tr><td>Clawback</td><td>▪ Misconduct resulting in significant financial or reputational harm
▪ Fraud
▪ Intentional misrepresentation of information used to determine payouts</td><td>7 years after the end of Deferral Period</td></tr>
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Restrictions on Incentive Plan Design (Level 1 and Level 2 Institutions)

Level 1 and Level 2 Institutions' incentive plans would be subject to the following design restrictions:

- Maximum incentive payout opportunity would be limited to 125% of target for senior executive officers and 150% of target for significant risk-takers;
- The sole use of relative performance measures would be prohibited; and
- The sole use of transaction revenue or volume without regard to transaction quality or compliance with sound risk management would be prohibited.

Governance and Documentation Requirements (Level 1 and Level 2 Institutions)

Level 1 and 2 institutions would be subject to certain governance and documentation requirements, which would include the following:

- Extensive recordkeeping requirements that would allow for an independent audit of compliance;
- A prohibition on purchasing hedging instruments on behalf of a covered person to offset any potential decrease in incentive compensation;
- Establishment of a risk-management framework for incentive-based compensation that is independent of any line of business and includes an independent compliance program which monitors incentive plans;
- Establishment of a Compensation Committee comprised solely of independent directors that receives written input from the Risk and Audit Committees as well as management on compliance; and
- Establishment of a number of specific policies related to incentive compensation and related governance.

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These proposed rules, once finalized, will have significant impact on the pay mix and program structures for many U.S.-based financial institutions. Meridian will continue to provide updates on these new rules and their impact on emerging compensation practices.

The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.