Simpson Thacher

Memorandum

Some U.S. Regulators Re-Propose Incentive-Based Compensation Rules for Financial Institutions Under Dodd-Frank

May 14, 2024

Summary

On May 6, 2024, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA) and the National Credit Union Administration (NCUA) (collectively, the Agencies) jointly issued proposed rules for financial institutions' incentive-based compensation arrangements as required under Section 956 of the Dodd-Frank Act, more than a decade after the rules were initially proposed in 2011 (and eight years after the agencies published additional updated proposals in 2016).[1] The latest proposal re-proposes the regulatory text from the 2016 proposal without change, while seeking public comment on alternative approaches to certain regulatory provisions under consideration by the Agencies based on their experiences in reviewing and supervising incentive-based compensation at covered institutions. These proposed rules are intended to discourage the use of excess compensation that could lead covered financial institutions to take inappropriate risk.

The Dodd-Frank Act requires incentive compensation rules to be issued jointly by six federal financial regulators, the Agencies, the SEC and the Federal Reserve. In addition, the proposed rule cannot be published in the Federal Register until it has been officially proposed by all six agencies, after which it would be subject to a 60-day comment period. Notably, however, the recent proposal has not been joined by the SEC or the Federal Reserve. The SEC has included an incentive compensation rulemaking on its Fall 2023 rulemaking agenda, but to date has not taken action to re-propose any specific rules. The Federal Reserve has not indicated any intent to join the Agencies' most recent proposal. To the contrary, Federal Reserve Chair Powell has recently expressed reluctance to advance an incentive compensation rulemaking, noting his desire to first "understand the problem we're solving and then…to see a proposal that addresses that problem."

If the SEC and the Federal Reserve were to eventually issue the same proposals, and if ultimately adopted by all six agencies, 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,

[1] The proposal includes the NCUA as joining the OCC, FDIC and FHFA in the proposed rulemaking. While the NCUA has not formally approved the notice of proposed rulemaking as of the date of this memorandum, it is expected to do so in the near future.

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 at least 18 months following formal publication in the Federal Register by all six agencies. Compensation arrangements in place before the rules become effective will be "grandfathered" for any performance periods that are then in effect, but not subsequent performance periods.

"Covered Institutions" and "Covered Persons"

If the SEC and the Federal Reserve were to eventually issue the same proposals, the rules would 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* registered under the Investment Advisers Act of 1940

In the absence of proposals by the SEC and the Federal Reserve, however, the recent proposal by the Agencies would not cover broker-dealers, investment advisers, bank holding companies, savings and loan holding companies, or state agencies and uninsured state branches of foreign banks.

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

- *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 institutions) or 2% (for Level 2 institutions) 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 would be generally tailored based on the following asset levels, with progressively more rigorous requirements applying to larger institutions:

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

For investment advisers, the determination of whether the initial $1 billion threshold level is met would correspond to the method of calculation (as proposed by the SEC in 2016) used for purposes of its 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, would, under the SEC's 2016 proposal, be excluded from the calculation (regardless of whether they appear on the adviser's balance sheet under accounting rules).

Subsidiaries of a covered institution that are themselves a covered institution (except, under the SEC's 2016 proposal, subsidiaries that are covered broker-dealers or investment advisers) would generally be subject to the same requirements as the parent covered institutions, even if the subsidiary is smaller than its parent. For registered broker-dealers and investment advisers that are not part of a banking organization, the rules (as proposed by the SEC in 2016) would only apply to the SEC-registered entities and not to their parent companies or other non-registered affiliates.

To avoid "cliff" effects, an 18-month transition period would apply for Level 1 covered institutions that later fall within the Level 2 or Level 3 asset thresholds (or a Level 2 institution that falls to a Level 3). 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 would have 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 2016 proposal cited 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.

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 (x) by 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 that would be used to make this determination, including: (i) the combined value of all compensation, fees, or benefits provided to the person; (ii) the compensation history of the person and others with comparable expertise at the institution; (iii) the financial condition of the institution; (iv) compensation practices at comparable institutions; (v) for post-employment benefits, the projected total cost and benefit to the institution; and (vi) 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:
    1. 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);
    2. it is designed to allow non-financial measures of performance to override financial measures of performance when appropriate;
    3. 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
    4. 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 also would be required to adopt mandatory deferral/vesting, forfeiture and downward adjustments, clawbacks, and maximum "outperformance" payouts for Senior Executive Officers and Senior Risk-Takers.

- *Mandatory Vesting/Deferral* – Senior Executive Officers and Senior Risk-Takers would 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 Office	60%	4 years	2 years
Level 1, Significant Risk-Taker	50%	4 years	2 years
Level 2, Senior Executive Officer	50%	3 years	1 years
Level 2, Significant Risk-Taker	40%	3 years	1 years

While the rules use the term "deferral" to describe the additional 1-to-4 year period, this requirement may be more accurately viewed 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 common executive arrangements that sometimes provide for accelerated vesting upon a termination of employment by the institution without "cause" or resignation by the SEO or SRT 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, would need to be subject to a "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 would be required to 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: (i) misconduct that resulted in significant financial or reputational harm to the institution; fraud; or (ii) intentional misrepresentation of information used to determine the SEO's or SRT's incentive-based

compensation. These clawback periods are considerably longer than those adopted under the Dodd-Frank Act for other public companies and are based on employee misconduct rather than financial restatements.

- *Additional Prohibitions* – Level 1 and Level 2 institutions would not be permitted to: (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 person's 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) would be required to 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 would be required to have compensation committees composed solely of directors who are not SEOs. Compensation committees would need to 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, the institutions would be required to, 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 would be required to 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 would be no annual reporting requirement, but records would need to 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 would be required to retain identifying information on SEOs and SRTs, as well as details on deferred compensation, clawback reviews and other decisions.

Modifications Being Considered by the Agencies

Although the Agencies re-proposed the 2016 proposed rule text without change, they signaled in the proposal's preamble that they are considering certain updates to reflect "additional supervisory experience, changes in

industry practice, and other developments." Acting Comptroller of the Currency Mike Hsu referred to the proposal as only a "place to start," while encouraging commenters to focus on the suggested modifications and requests for feedback included in the proposal's preamble. Based on these preamble discussions and Agency requests for public feedback, notable modifications to the 2016 proposal that the Agencies appear to be considering include the below:

- A two-tier (rather than three-tier) approach with one level including covered institutions with average total consolidated assets more than $1 billion but less than $50 billion, and a second level including covered institutions with more than $50 billion in average total consolidated assets.
- Requiring covered institutions to establish performance measures and targets before the beginning of the performance period.
- For SEOs and SRTs who receive options at Level 1 and Level 2 covered institutions, requiring that the total amount of such options be limited to no more than 10% (rather than 15%) of the amount of total incentive-based compensation awarded to the SEO or SRT for that performance period.
- Limiting the discretion of a Level 1 or Level 2 covered institution to seek to recover incentive-based compensation by requiring (rather than requiring *consideration* of) forfeiture and downward adjustment of incentive-based compensation for certain adverse outcomes.
- Requiring a Level 1 or Level 2 covered institution to claw back (rather than requiring the institution to *consider* clawing back) any vested incentive-based compensation from a current or former SEO or SRT under specified circumstances.
- Including an additional prohibition on Level 1 and Level 2 covered institutions offering incentive-based compensation arrangements that allow a covered person to purchase a hedging instrument or similar instrument to offset any decrease in the value of the covered person's incentive-based compensation.
- Prohibiting Level 1 and Level 2 covered institutions from providing incentive-based compensation to a covered person that is based (in whole or in part, rather than *solely*) on transaction revenue or volume, without regard to transaction quality or compliance of the covered person with sound risk management.

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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