Agencies Re-propose Incentive-Based Compensation Rules for Financial Institutions

April 27, 2016

Financial Institutions & Executive Compensation

Introduction

In late April 2016, federal financial regulators began the process of re-proposing rules (the "Proposal") to implement restrictions on incentive-based compensation required by Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 956 directs a number of federal regulators (the "Agencies")[1] to jointly issue regulations or guidelines with respect to incentive-based compensation practices at specific types of financial institutions that have $1 billion or more in assets.

The Proposal comes more than five years after the Agencies initially proposed rules to implement Section 956 (the "2011 Proposal").[2] In addition to refining the 2011 Proposal, the Proposal incorporates and expands upon principles relating to incentive compensation set forth in the federal banking agencies' 2010 interagency guidance implementing safety and soundness standards under Section 39 of the Federal Deposit Insurance Act (the "2010 Guidance").[3]

As noted in more detail below, the Proposal would not be effective with respect to incentive compensation with a performance period that begins within 18 months of the issuance of final rules. Comments on the Proposal are due July 22, 2016.

Overview of Proposal

The Proposal would apply to specified types of financial institutions (described under "Scope of Application" below) with $1 billion or more in average total consolidated assets ("Covered

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1 The Agencies are the Board of Governors of the Federal Reserve ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Securities and Exchange Commission ("SEC"), the National Credit Union Administration ("NCUA"), and the Federal Housing Finance Agency ("FHFA"). As of the date of this alert, only the NCUA, FDIC, and OCC had approved the Proposal for public comment. While each Agency will act independently, it is expected that the text of the rules proposed by each Agency will be substantially similar, and that each version will share a single, common preamble. The Proposal will not be published in the Federal Register until all of the Agencies have acted.

2 *See* 76 Fed. Reg. 21,170 (Apr. 14, 2011).

3 *See* Guidance on Sound Incentive Compensation Practices, 75 Fed. Reg. 36,395 (Jun. 25, 2010).

Institutions"), but would apply more stringent requirements to larger Covered Institutions using a three-tiered approach based on the size of the institution, as summarized in the chart below:

	Level 3 Institution ($1 billion ≥ Average Total Consolidated Assets > $50 billion)	**Level 2 Institution** ($50 billion ≥ Average Total Consolidated Assets > $250 billion)	**Level 1 Institution** (Average Total Consolidated Assets ≥ $250 billon)
Principles-Based Restrictions (p. 6)	Prohibition on incentive compensation arrangements that encourage inappropriate risks to the Covered Institution (1) by providing a Covered Person with excessive compensation, fees, or benefits, or (2) that could lead to material financial loss to the Covered Institution		
Mandatory Deferral of Incentive Compensation (p. 7)	N/A	Senior executive officers must defer 50% of incentive compensation for 1-3 years Significant risk-takers must defer 40% for 1-3 years	Senior executive officers must defer 60% of incentive compensation for 2-4 years Significant risk-takers must defer 50% for 2-4 years
Forfeiture and Downward Adjustment of Incentive Compensation (p. 9)	N/A	Incentive compensation must be subject to forfeiture and downward adjustment review in the event of inappropriate risk-taking or other specified triggering events	
Clawback of Incentive Compensation (p. 10)	N/A	Incentive compensation must be subject to clawback for at least 7 years after vesting	
Additional Restrictions on Incentive Compensation (p. 11)	N/A	Restrictions on company-arranged hedging, maximum incentive compensation opportunity, and use of relative or volume-based performance measures	
Risk Management and Controls (p. 11)	General requirement for incentive compensation to be compatible with effective risk management and controls	Specific requirements regarding risk management framework, roles and compensation of control personnel, and independent monitoring	
Governance (p. 12)	Board- or committee-level approval and oversight requirements	Independent compensation committee requirement and more specific governance requirements	
Policies and Procedures (p. 12)	N/A	Specific policies and procedures requirements	
Recordkeeping and Disclosure to Agency (p. 13)	Requirement to maintain basic records for 7 years and make disclosures to regulators upon request	Requirement to maintain more detailed records for 7 years, including requirement to maintain auditable records	

For Level 3 institutions, the Proposal is generally comparable to the 2011 Proposal and is less stringent in certain respects; some requirements from the 2011 Proposal, such as reporting and specific requirements regarding policies and procedures, are not included in the Proposal with respect to Level 3 institutions.

For Level 1 and Level 2 institutions, on the other hand, the Proposal is significantly more stringent and prescriptive than the 2011 Proposal. For instance, the Proposal would:

- lengthen the mandatory deferral period and amount required to be deferred;
- require deferral of amounts under long-term incentive-based arrangements instead of just annual incentive-based arrangements;
- require mandatory deferral of incentive compensation paid to "significant risk-takers," not just senior executive officers; and
- require specific forfeiture, downward adjustment, and clawback requirements.

In addition, the Proposal's new clawback provisions would cover a significantly longer period (seven years) than the clawback provisions imposed on public companies under Section 954 of the Dodd-Frank Act (three years), and would call for the clawback of incentive compensation in more circumstances than under Section 954.[4] While the Proposal thus would impose significantly more stringent requirements on Level 1 and Level 2 institutions than the 2011 Proposal, in practice many larger institutions have already begun adopting incentive-based compensation practices that embody some of the principles and mechanisms reflected in the Proposal as a result of both market trends and supervisory expectations communicated to those institutions since the release of the 2010 Guidance and 2011 Proposal.

Compliance Date

The Proposal would require institutions to comply as of the first calendar quarter beginning at least 18 months after the publication of the final rules in the Federal Register. Any then-existing compensation plan with a performance period beginning before the compliance date would **not** be subject to the rules. For example, if the final rule is published in the Federal Register in the fourth quarter of 2016, it generally would not apply to incentive compensation with performance periods beginning before July 1, 2018, meaning that calendar year incentive awards would not be subject to the final rule until 2019. The term "performance period" refers to the period during which a person's performance is assessed for purposes of determining his or her incentive compensation.[5]

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[4] Under Section 954 of the Dodd-Frank Act, incentive compensation is subject to clawback if an issuer is required to prepare a financial restatement in order to correct a material error, and the incentive compensation was "received" during any of the three completed fiscal years immediately preceding the date the issuer is required to prepare such restatement. For this purpose, incentive compensation is considered to be "received" when the relevant financial reporting performance measure is attained (regardless of when the incentive compensation is granted, vested, or paid).

[5] Notably, this definition does not explicitly contemplate performance measures based on the *institution's* performance, though such measures may implicitly be included.

Scope of Application

Types and Sizes of Covered Institutions

By statute, Covered Institutions include depository institutions and depository institution holding companies, as defined under the Federal Deposit Insurance Act;[6] SEC-registered broker-dealers; investment advisers, as defined under the Investment Advisers Act of 1940 (whether or not registered with the SEC); credit unions; Fannie Mae and Freddie Mac; and any other financial institution that the Agencies determine by rule to treat as a Covered Institution. The Proposal would expand the set of Covered Institutions to further include state-licensed uninsured branches and agencies of foreign banks; all of the U.S. operations of foreign banking organizations that are treated as bank holding companies under the International Banking Act of 1978; Edge and Agreement Corporations; state-chartered non-depository trust companies that are Federal Reserve member banks; and the Federal Home Loan Banks.

Under the Proposal, an institution's average total consolidated assets would determine whether it is subject to the rules, and whether it is a Level 1, Level 2, or Level 3 institution. These determinations would be based on average total consolidated assets reported on the institution's regulatory reports for the four most recent consecutive quarters.[7]

However, the Proposal would reserve the Agencies' authority to apply the restrictions that apply to Level 1 or Level 2 institutions to a Level 3 institution that has $10 billion or more in average total consolidated assets if the applicable Agency finds that such Level 3 institution's complexity of operations or compensation practices are consistent with those of a Level 1 or Level 2 institution. The preamble to the Proposal indicates that the Agencies may make such designations for institutions that engage significantly in off-balance sheet activities, lending to distressed borrowers, or investing in illiquid assets; institutions that make significant use of incentive compensation to reward risk-takers; or institutions that are part of complex organizational structures such as those operating with multiple legal entities in multiple foreign jurisdictions.

For a Covered Institution that is a subsidiary of another Covered Institution, whether the subsidiary is above the $1 billion threshold would be determined by the subsidiary's own average total consolidated assets, but whether the subsidiary is treated as a Level 1, Level 2, or Level 3 institution would be determined by the parent company's average total consolidated assets. The Proposal would allow a parent Covered Institution to comply with the rules on behalf of its subsidiary Covered Institutions, for instance, by having the parent's board-level compensation committee approve incentive compensation arrangements for senior executive officers of the subsidiaries.

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[6] The definition of "depository institution" under the Federal Deposit Insurance Act includes any federal branch of a foreign bank, and any national bank that is a non-depository trust company.

[7] Foreign banking organizations with U.S. operations would determine the applicability of the rules based on their total consolidated U.S. assets, and would be required to report this measure (which ***includes*** so-called "Section 2(h)(2)" assets, which are not covered by the current form FR Y-7Q) to the Federal Reserve on a quarterly basis. Investment advisers would determine applicability based on their total assets as shown on the balance sheet for the most recent fiscal year-end, ***excluding*** non-proprietary assets such as client assets under management.

Covered Persons

The Proposal would apply to incentive-based compensation arrangements with respect to "Covered Persons," which would include executive officers, employees, directors, and principal shareholders who receive incentive compensation from the institution. **Executive officers** include senior executive officers and other individuals designated as executive officers by the Covered Institution. **Senior executive officers** include 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, head of a major business line or control function, and any person who performs the function of any of the foregoing positions. **Principal shareholders** include any natural person who, directly or indirectly, or acting in concert with others, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of the Covered Institution.[8]

The Proposal would also introduce restrictions for a new class of individuals at Level 1 and Level 2 institutions called "significant risk-takers." **Significant risk-takers** include:

- any Covered Person, other than a senior executive officer, who received[9] incentive compensation for the last calendar year ending at least 180 days before the beginning of the performance period, which incentive compensation constituted at least one-third of such person's annual base salary plus incentive compensation for such year; ***and***
- who meets either of the following tests:
  - *Relative Compensation Test:* the person's annual base salary and incentive compensation for the year of determination placed the person among the highest 5 percent (for Level 1 institutions) or 2 percent (for Level 2 institutions) of all Covered Persons (other than senior executive officers) of the institution[10]; ***or***
  - *Exposure Test:* the person may commit or expose 0.5 percent or more of a specified measure of capital[11] of the Covered Institution.[12]

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[8] The NCUA's proposed rules do not include principal shareholders because credit unions are not-for-profit cooperatives with member-owners.

[9] It is not clear whether amounts "received" for purposes of this definition would include amounts that the person has been awarded the opportunity to earn, amounts that the person has been awarded after a performance determination, or deferred amounts that have vested.

[10] The Proposal would include in this calculation individuals receiving incentive compensation from Covered Institutions that are affiliates of the Covered Institution.

[11] The capital measurement would depend on the type of Covered Institution. For depository institutions and most depository institution holding companies, the test would be based on common equity Tier 1 capital. For registered broker-dealers, the exposure test would be based on tentative net capital. For investment advisers that are not Covered Institutions in any other capacity, no exposure test would apply.

[12] The preamble explains that an employee could "expose" the institution's capital to credit risk and/or market risk.

Both of these tests raise potential concerns. For example, the Relative Compensation Test seems to be based on a premise that there is a direct link between higher levels of compensation and the ability to engage in inappropriate risk-taking, but this may not necessarily be the case. In addition, the Exposure Test would require each Level 1 and Level 2 institution to make judgments about the annual dollar amount that each employee (other than senior executive officers) is able to commit, either through his or her own decisions or as a result of his or her voting or veto rights in committee decisions, a potentially difficult and burdensome exercise on which the Agencies have requested comment.

Each Agency would also be able to designate additional Covered Persons who are not executive officers as significant risk-takers because of their ability to expose the Covered Institution to risks that could lead to material financial losses.

Types of Compensation Covered

The Proposal would broadly define "incentive-based compensation"[13] as any variable compensation, fees, or benefits that serve as an incentive or reward for performance, such as annual bonuses or amounts paid under a long-term incentive plan.[14]

Principles-Based Restrictions Applicable to All Covered Institutions

Under the Proposal, all Covered Institutions would be required to abide by a general restriction on certain forms of incentive-based compensation. Covered Institutions could not establish or maintain incentive compensation arrangements that "encourage inappropriate risks" to the Covered Institution (1) by providing a Covered Person with "excessive" compensation, fees, or benefits, or (2) that "could lead to material financial loss" to the Covered Institution. These two categories track very closely the restrictions on compensation in the 2010 Guidance.

Excessive Compensation

The Proposal, like the 2011 Proposal and the 2010 Guidance, provides that compensation, fees, and benefits would be considered **excessive** when amounts paid are unreasonable or disproportionate to the value of services performed by the 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;

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[13] This alert uses the terms "incentive-based compensation" and "incentive compensation" interchangeably.

[14] However, compensation, fees or benefits that are paid for reasons other than to induce performance would be excluded from the scope of the Proposal. Accordingly, the Proposal would not cover, for instance, salary, signing or hiring bonuses, amounts paid solely based on continued employment or employer matching contributions to a 401(k) plan.

- 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;[15]
- for post-employment benefits, the projected total cost and benefit 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

The Proposal also provides, again similar to the 2011 Proposal and the 2010 Guidance, that an incentive compensation arrangement would be considered to encourage inappropriate risks that **could lead to material financial loss** unless the arrangement:

- "appropriately balances risk and reward";
- is compatible with "effective risk management and controls"; and
- is supported by "effective governance."

These requirements are principles-based, and leave much to be interpreted in practice and through application by the regulators. However, unlike the 2011 Proposal or the 2010 Guidance, the Proposal includes additional guidance that an incentive compensation arrangement will not be considered to **appropriately balance risk and reward** unless:

- the arrangement includes financial and non-financial measures of performance, including considerations of risk-taking;[16]
- the arrangement is designed to allow non-financial measures of performance to override financial measures of performance, when appropriate; and
- amounts to be awarded are subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.

The Proposal would also include specific requirements for Level 1 and Level 2 institutions to be considered to have "effective risk management and controls" and "effective governance" for purposes of the rules, as described in greater detail below.

Deferral, Forfeiture and Downward Adjustment, and Clawback Requirements

The Proposal would impose additional specific requirements for incentive compensation arrangements at Level 1 and Level 2 institutions, in order for such arrangements to be

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15 The preamble to the Proposal states that the Agencies intend to work closely with institutions with uncommon forms, such as grandfathered unitary savings and loan holding companies with retail operations and mutual savings banks, to identify comparable institutions.

16 The preamble to the Proposal clarifies that "non-financial" measures of performance could include, for example, assessments of the Covered Person's risk-taking or compliance with limits on risk-taking, the institution's policies and procedures, or applicable laws.

considered to appropriately balance risk and reward. These include mandatory deferral, forfeiture and downward adjustment reviews, and clawbacks. Each of these is discussed below.

Mandatory Deferral of Incentive-Based Compensation

Under the Proposal, the vesting of a portion of the incentive compensation awarded to senior executive officers and significant risk-takers of a Level 1 or Level 2 institution would be required to be deferred for a specified period of time, as summarized in the chart below:

	Level 1		**Level 2**	
	Senior Executive Officer	**Significant Risk-Taker**	**Senior Executive Officer**	**Significant Risk-Taker**
Long-Term Incentive Plan Compensation[17]	60% for 2 years	50% for 2 years	50% for 1 year	40% for 1 year
Other Incentive-Based Compensation	60% for 4 years	50% for 4 years	50% for 3 years	40% for 3 years

The Proposal provides the following specific requirements regarding these mandatory deferrals:

- ***Deferral Period*****.** The deferral period would run from the end of the incentive compensation's performance period. This is intended to provide a "look back" opportunity on any adverse consequences that may arise from the individual's risk-taking decisions during the performance period.
- ***Vesting of Deferred Amounts*****.** Vesting of deferred amounts would be allowed to occur no faster than on a pro-rata annual basis beginning on the first anniversary of the end of the performance period.[18]
- ***Restrictions on Accelerated Vesting*****.** Vesting of deferred amounts would not be permitted to be accelerated except in the case of the Covered Person's death or disability.[19] As a result, the deferred amounts generally cannot be accelerated in connection with the Covered Person's retirement or other termination of employment, or a change in control of the institution.

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17 The Proposal defines long-term incentive plans as those with a performance period of at least three years.

18 While the institution may provide for a different amount to vest each year, each installment may not exceed the amount that would have vested had a pro-rata annual vesting schedule been used.

19 For senior executive officers or significant risk-takers at credit unions, acceleration of vesting would also be permitted to the extent income tax is due on unvested deferred amounts.

***Example*:** A senior executive officer of a Level 1 institution is awarded incentive compensation equal to $1,000,000 based on performance during the three-year performance period from January 1, 2018 to December 31, 2020. 60% of such incentive compensation (*i.e.*, $600,000) must be deferred for two years. During the two-year deferral period, up to $300,000 may vest on the first anniversary of the end of the performance period (*i.e.*, December 31, 2021) and the remainder may vest on the second anniversary (*i.e.*, December 31, 2022).

- ***Deferral Amount and Composition***
  - *Mix of Cash and Equity*. For Covered Institutions that issue equity or are affiliates of Covered Institutions that issue equity, the deferred amounts would be required to consist of substantial portions of both cash and "equity-like instruments." The Proposal would not, however, require specific amounts or percentages to be paid in cash or equity.
  - *Limitation on Stock Options*. The total amount of stock options that could be used to meet the minimum deferral requirements could not exceed 15% of the amount of total incentive compensation awarded for a given performance period.
  - *Valuation Method*. To determine the amount of incentive compensation that must be deferred, the institution would generally use the present value of the incentive compensation at the time the final determination of the incentive compensation is communicated to the individual. The present value would be determined using reasonable valuation methods consistent with methods used in other contexts.
- ***No Increase in Deferred Amount.*** During the deferral period, an institution would not be permitted to increase deferred amounts. However, increases in the value of the deferred amount due solely to a change in share price or interest rates or the payment of a reasonable interest or rate of return would not be prohibited.

Downward Adjustment and Forfeiture Requirements

The Proposal would require incentive compensation at Level 1 and Level 2 institutions to be at risk of forfeiture or downward adjustment. At a minimum, the institution would be required to consider reducing all or a portion of a senior executive officer or significant risk-taker's incentive compensation when such individual has direct responsibility, or responsibility due to his or her role or position in the institution's organizational structure, for specified triggering events, including:

- 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 statutory, regulatory or supervisory standards resulting in enforcement or legal action against the institution or a financial restatement; and
- any additional triggers that the institution may define based on conduct or poor performance.

If the institution determines that a reduction is appropriate, the reduction could be carried out through downward adjustment, forfeiture or a combination of both. Downward adjustment would apply to any incentive compensation that has not yet been awarded for a particular performance period. Forfeiture would apply to any deferred incentive compensation that has not yet vested.

***Example*:** $60,000 of a senior executive officer's incentive compensation has been deferred and is not yet vested. She is also eligible to receive additional incentive compensation of $200,000 based on performance during a performance period not yet completed. Upon the occurrence of a triggering event, the $60,000 deferred amount would be subject to possible forfeiture, while the $200,000 amount for the uncompleted performance period would be subject to possible downward adjustment.

In determining any amount to be reduced, the institution would be required, at a minimum, to consider the following factors:

- the individual's intent to deviate from the institution's policies and procedures or risk governance framework;
- the individual's level of participation in, awareness of, and responsibility for the events triggering the review;
- any actions the individual took or could have taken to prevent the events triggering the review;
- the financial and reputational impact of the events triggering the review;
- the causes of the events triggering the review; and
- any other relevant information, including past behavior and risk outcomes attributable to the individual.

Clawback Requirements

Under the Proposal, incentive compensation arrangements at Level 1 and Level 2 institutions would be required to include provisions permitting the institution to recover all vested incentive compensation (including any amounts that were not deferred) paid to a senior executive officer or significant risk-taker for a period of at least seven years following the applicable vesting date, regardless of whether the individual remains employed at the time of recovery. Events that would require the institution to consider exercising a clawback include:

- misconduct that resulted in significant financial or reputational harm to the institution;
- fraud; or
- intentional misrepresentation of information used to determine the individual's incentive compensation.

The Proposal would not mandate a clawback in any particular circumstance, and does not prescribe the process that institutions must use in seeking to recover vested amounts. Rather, the institution would consider the applicable facts, circumstances and other relevant information to determine whether and to what extent it is reasonable to seek recovery. However, as discussed under "Recordkeeping and Disclosure to Agency" below, the institution would be required to document its forfeiture, downward adjustment, and clawback reviews and decisions.

Additional Restrictions on Incentive Compensation for Level 1 and Level 2 Institutions

The Proposal would impose the following additional restrictions on the incentive compensation practices of Level 1 and Level 2 institutions:

- ***Prohibition on Hedging*.** Institutions would not be permitted to purchase instruments on behalf of Covered Persons to hedge or offset against any decrease in the value of the Covered Person's incentive compensation. This prohibition would apply to all Covered Persons at the Level 1 or Level 2 institution, not just senior executive officers and significant risk-takers.
- ***Maximum Incentive Compensation Opportunity*.** The Proposal would cap the incentive compensation that may be paid to senior executive officers and significant risk-takers.
  - For senior executive officers, the maximum payout would be limited to 125 percent of the target amount.[20]
  - For significant risk-takers, the maximum payout would be limited to 150 percent of the target amount.
- ***Restrictions on Performance Measures*.** The Proposal would limit the use of relative and volume-driven performance measures for all Covered Persons at a Level 1 or Level 2 institution.
  - *Relative Performance Measures*. Performance measures may not be based solely on comparisons with industry peer performance, such as Relative Total Shareholder Return, but such measures could be used in combination with absolute performance measures.
  - *Volume-Driven Performance Measures*. Performance measures may not be based solely on transaction or revenue volumes, but could be used in combination with other factors that are designed to consider quality or compliance with risk management policies.

Risk Management and Controls

As noted above, the incentive compensation arrangements of all Covered Institutions must be compatible with "effective risk management and controls." For Level 1 and Level 2 institutions, the Proposal would include additional risk-management requirements:

- ***Risk Management Framework.*** A Level 1 or Level 2 institution would be required to maintain a risk management framework for its incentive compensation program that (1) is independent of any lines of business, (2) includes an independent compliance program that provides for internal controls, testing, monitoring and training, and (3) is commensurate with the institution's size and complexity of operations.
- ***Role and Compensation of Control Personnel.*** A Level 1 or Level 2 institution must provide individuals engaged in control functions the authority to influence the risk-taking

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[20] The target amount refers to the amount of incentive compensation that would be payable if each applicable performance measure is achieved at the target level (which is equivalent to 100% for financial performance measures) established at the beginning of the performance period.

of the business areas they monitor. A Level 1 or Level 2 institution must also ensure that Covered Persons engaged in control functions are compensated in accordance with the achievement of performance objectives linked to their control functions, not to the business areas they monitor.

- ***Independent Monitoring.*** A Level 1 or Level 2 institution must provide for independent monitoring of incentive compensation plans, events and decisions relating to forfeiture and downward adjustment reviews, and compliance with policies and procedures.

Governance Requirements

As noted above, the incentive compensation arrangements of all Covered Institutions must be supported by "effective governance." For all Covered Institutions, the board of directors, or a committee thereof, would be required to (1) oversee the Covered Institution's incentive compensation program; (2) approve incentive compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and (3) approve any material exceptions or adjustments to incentive compensation policies or arrangements for senior executive officers.

Level 1 and Level 2 institutions would face additional governance requirements. Those institutions would be required to establish a board-level[21] compensation committee composed solely of directors who are not senior executive officers to assist the board in carrying out its responsibilities under the Proposal.

The Level 1 or Level 2 institution's compensation committee would be required to obtain input from the board's risk and audit committees and risk management function on the effectiveness of the institution's risk measures and adjustments used to balance risk and reward in incentive compensation arrangements. Management would be required to prepare and submit to the compensation committee an annual written assessment of the effectiveness of the institution's incentive compensation program and related processes in providing risk-taking incentives that are consistent with the risk profile of the institution. The internal audit or risk management function would also be required to prepare and submit to the compensation committee an annual independent written assessment that is developed independently of the institution's management.

Policies and Procedures

A Level 1 or Level 2 institution would be required to develop specific policies and procedures for its incentive compensation program that, among other things:

- specify the substantive and procedural criteria for forfeiture, clawback, and the acceleration of payments of deferred incentive compensation to a Covered Person;
- identify the identity of any employees, committees, or groups authorized to make incentive compensation decisions;

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[21] For a foreign banking organization or its branch or agency, the institution's board of directors would mean the relevant oversight body for the institution's U.S. branch, agency, or operations, consistent with the foreign banking organization's overall corporate and management structure; the federal banking agencies would work with the institution to determine the appropriate persons to carry out these responsibilities.

- describe how discretion is expected to be exercised to appropriately balance risk and reward; and
- ensure there are appropriate roles for risk management, risk oversight, and other control function personnel in the Covered Institution's processes for designing incentive compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback, and vesting.

Recordkeeping and Disclosure to Agency

All Covered Institutions would be required to create and maintain for a period of at least seven years records that document the structure of their incentive compensation requirements and demonstrate compliance with the rules. Covered Institutions would be required to disclose the records to the applicable Agency upon request, but importantly, and unlike the 2011 Proposal, Covered Institutions would **not** be required to provide reports to the Agency absent such a request.

Level 1 and Level 2 institutions would be required to maintain more detailed records, including lists of senior executive officers and significant risk-takers; specific information about incentive compensation, forfeitures, downward adjustments, or clawback decisions made; and material changes to incentive compensation arrangements. Level 1 and Level 2 institutions must also create and maintain records in a manner that allows for an **independent audit** of their incentive compensation arrangements, policies, and procedures.

Anti-Evasion Provision

The Proposal would include a general anti-evasion provision designed to prevent Covered Institutions from taking indirect actions to avoid application of the proposed rules, for instance, by classifying Covered Persons as employees of different entities or as independent contractors.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Financial Institutions and Executive Compensation practice groups:

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