

Several Regulators Re-Propose Rules to Curb Incentive Compensation at Financial Institutions

WRITTEN BY

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On May 6, the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Federal Housing Finance Agency (FHFA) issued a [notice of proposed rulemaking and request for public comment](#) to implement Section 956 of the Dodd-Frank and Wall Street Reform and Consumer Protection Act (Dodd-Frank). Under Section 956, the FDIC, OCC, FHFA, National Credit Union Association (NCUA), Securities and Exchange Commission (SEC), and Board of Governors of the Federal Reserve System (the Fed) are tasked with jointly prescribing regulations that (1) prohibit incentive-based compensation at covered financial institutions that encourages inappropriate risk-taking because it is excessive or could lead to material financial loss, and (2) require the disclosure of information concerning these compensation arrangements to the appropriate federal regulator.

The NCUA is expected to take action on the notice in the near future, and the rule is currently on the SEC's rulemaking agenda. However, there is significant doubt as to whether the Fed will join the other regulators at this time. At a House Financial Services Committee hearing on March 6, Representative Rashida Tlaib pressed Chairman Jerome Powell on whether the Fed would "commit to helping finalize the Dodd-Frank section of 956 this year." Powell responded, "I would like to understand the problem we're solving and then I would like to see a proposal that addresses that problem." Importantly, the proposed rule cannot progress through the rulemaking process, unless and until it is proposed by all six regulators.

Background

Dodd-Frank was enacted in 2010 in the wake of the 2008 financial crisis, with sweeping measures aimed at protecting the American public from practices that were viewed as having contributed to the financial crisis. Dodd-Frank sought to create guardrails around executive compensation by, among other things, requiring recoupment of incentive compensation received by executives resulting from faulty financials; mandating more robust disclosures to shareholders regarding executive compensation; and, under Section 956, reining in incentive-based compensation practices that were seen as promoting overly risky behavior at financial institutions. Regulations to enforce Section 956 were initially proposed jointly by all of the relevant regulators in 2011, and updated regulations were proposed in 2016. The current notice of proposed rulemaking includes the same rule text that was put forth in 2016, while also exploring potential alternatives to certain provisions. In the notice, the participating regulators request renewed review and public commentary on the entirety of the proposal, given the passage of time, intervening developments and industry changes over the past eight years.

Which Institutions Are Covered?

Under Section 956, the term “covered financial institution” applies to the following types of institutions that have at least \$1 billion in assets: depository institutions and their holding companies, broker-dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac, and other financial institutions as determined in the regulators’ discretion. Covered financial institutions are broken down into three tiers in the proposed regulations, based on the value of the entity’s assets, with more stringent requirements applying to Level 1 and 2 entities:

Level 1	Greater than or equal to \$250 billion
Level 2	Greater than or equal to \$50 billion and less than \$250 billion
Level 3	Greater than or equal to \$1 billion and less than \$50 billion

Which Individuals Are Covered?

A “covered person” means any executive officer, employee, director, or principal shareholder (10% holder or more) who receives incentive-based compensation at a covered institution. Additional rules apply to covered persons at a Level 1 or 2 institution who are “senior executive officers” or “significant risk-takers.” Senior executive officers generally include those who hold the title of, or function as, 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, and the heads of a major business line or control function. Significant risk-takers generally include nonsenior executives whose compensation is at least one-third incentive-based and who either (1) are among the top 2%-5% (depending on whether the institution is Level 1 or 2) of highest compensated nonsenior executive covered persons at the relevant institution, or (2) have the authority to commit or expose at least 0.5% of the institution’s capital.

What Kind of Compensation Is Being Regulated?

The proposed rules regulate “incentive-based compensation,” which is defined broadly as “any variable compensation, fees or benefits that serve as an incentive or reward for performance.” Under the proposed regulation, incentive-based compensation should not encourage inappropriate risk-taking by covered individuals, either by being excessive or by being designed in a way that could lead to material financial loss.

Incentive-based compensation is considered excessive when amounts paid are “unreasonable or disproportionate to the value of the services performed” by the individual, taking into account the following nonexhaustive factors: (1) the combined value of all compensation and benefits provided to the individual; (2) the compensation history of the individual and relevant benchmarking of individuals with the same expertise at comparable entities; (3) the institution’s financial condition; (4) compensation practices at peer entities; (5) the projected cost of post-employment benefits, if applicable; and (6) any fraudulent act or omission, breach of trust or fiduciary duty, or other “insider abuse” by the individual.

Incentive-based compensation encourages inappropriate risks that could lead to a material financial loss, according to the proposed regulation, unless it appropriately balances risk and reward, is compatible with effective risk management, and is supported by strong corporate governance. To appropriately balance risk and reward, the proposed regulation provides that an incentive-based compensation arrangement must include both financial and nonfinancial performance measures, provide a mechanism for nonfinancial measures to override financial

measures where appropriate, and allow for award adjustments in the case of actual losses, inappropriate risks taken, and compliance deficiencies.

The proposed rules contain a grandfathering provision, which ensures that incentive-based compensation plans whose performance periods begin prior to the date on which a covered institution is required to comply with these regulations, are grandfathered and not subject to these regulations.

What Additional Limitations Apply to Incentive Compensation at Level 1 and 2 Institutions?

Incentive-based compensation arrangements provided to senior executive officers and significant risk-takers at Level 1 and 2 covered institutions (as well as any Level 3 institution that the applicable regulator deems should be subject to the strictures applied to Level 1 or 2 institutions) are subject to the following additional requirements:

- *Cap on Incentive-Based Compensation:* No incentive-based compensation award may be made in excess of 125% (for senior executive officers) or 150% (for significant risk-takers) of the target amount for such award.
- *Minimum Vesting (“Deferral”) Period:* Between 40%-60% of a senior executive’s or significant risk-taker’s incentive-based compensation must be subject to minimum vesting after performance conditions are fulfilled.
 - For incentive-based compensation with a performance period of less than three years, the minimum subsequent vesting period is three years (Level 2) or four years (Level 1).
 - For incentive-based compensation with a performance period equal to at least three years (a “long-term incentive”), the minimum subsequent vesting period is two years (Level 1) or one year (Level 2).
 - During the minimum vesting period, amounts may not vest sooner than on a pro rata annual basis, with the first tranche vesting no earlier than the first anniversary of the date the relevant performance period ended. Accelerated vesting is not permitted, except in the case of an individual’s death or disability.
 - Incentive-based compensation subject to minimum vesting requirements must include substantial portions of both cash and equity-like instruments. The total number of incentive-based options or similar instruments such as stock appreciation rights that may be used to meet the minimum vesting requirement is 15% of the total incentive-based compensation awarded to the covered individual for that performance period.
- *Forfeiture and Downward Adjustment:* Upon the occurrence of one of the following events, a financial institution must consider whether forfeiture or downward adjustment is appropriate with respect to incentive-based compensation of a senior executive officer or significant risk-taker with responsibility related to such event: (1) poor financial performance attributable to significant noncompliance with the institution’s risk policies; (2) inappropriate risk taking, regardless of the impact on financial performance; (3) material risk management failures; (4) noncompliance with laws or regulations resulting in an enforcement action or a requirement to restate financials; or (5) other aspects of conduct or poor performance as defined by the institution.
- *Clawback:* In addition to any other clawback policies maintained by the institution, the proposed regulation would require that covered institutions be allowed to claw back incentive-based compensation arrangements for

current and former senior executive officers or significant risk-takers for **seven** years following vesting if the individual engages in misconduct that results in significant financial or reputational harm to the institution, fraud, or intentional misrepresentation of the information used to determine such individual's incentive-based compensation. Note that this clawback requirement focuses on misconduct, whereas the [separate clawback requirement that applies to public companies under rules implemented in 2023 pursuant to Section 954 of Dodd-Frank](#) is triggered by a restatement of financial statements — whether or not misconduct exists.

- *Other Requirements and Limitations:*

- Performance measures for incentive-based compensation may not be based solely on comparisons to peers (e.g., relative measures such as relative total shareholder return).
- No hedging instruments may be purchased by the institution on behalf of the covered person to offset any potential loss related to the incentive-based compensation.
- Incentive-based compensation arrangements may not be based solely on transaction revenue or volume without regard to transaction quality, compliance, and risk management.

Documentary Compliance and Governance

In addition to limitations on the award of incentive-based compensation, the proposed regulation also imposes robust documentary compliance and governance requirements for covered institutions. For example, institutions must maintain detailed records regarding incentive-based compensation for seven years and be ready to provide the records to the appropriate federal regulator upon request. Enhanced disclosure, compliance, and recordkeeping obligations apply to Level 1 and 2 institutions.

Request for Comments and Possible Alternatives

The participating regulators have included specific questions for public consideration on nearly every aspect of the proposed rule within the notice of proposed rulemaking. In addition, the notice specifically contemplates numerous alternatives to the proposed rule's current iteration for consideration, including whether Level 1 and 2 institutions should be collapsed into a single category, the appropriate test for determining a "significant risk-taker," whether forfeiture and downward adjustments should be mandated or discretionary, and if additional risk management requirements should be imposed. Although the official comment period on the proposed rule cannot commence until it is published in the *Federal Register* (which requires approval by all six regulators), participating regulators are separately soliciting comments in the meantime.

Looking Ahead

Given the necessity for all six regulators to collaborate on the proposed rule, the number of issues under consideration in the most recent notice of proposed rulemaking, and the general climate of uncertainty in an election year, the impact of the proposed regulation remains unclear. Troutman Pepper will continue to monitor developments in this area. To discuss incentive-based compensation arrangements at your financial institution,

please reach out to any of the authors of this alert or your regular Troutman Pepper contacts.

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