

May 11, 2016



SIDLEY UPDATE

Federal Regulators Re-Propose Joint Rule on Incentive-Based Compensation Arrangements at Large Financial Institutions

Six federal financial regulators are seeking comment on a joint <u>re-proposed rule</u> implementing Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) relating to incentive-based compensation arrangements and practices at certain financial institutions. In general, the proposed rule would prohibit covered institutions from awarding incentive-based compensation that is believed to encourage inappropriate risks and would impose mandatory deferral and clawback provisions. It would also require such institutions to disclose certain information regarding the structure of their incentive-based compensation arrangements to the applicable regulator.

The federal regulators that have re-proposed the rule are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA), the National Credit Union Administration (NCUA) and the Securities and Exchange Commission (SEC).

In response to the view that flawed incentive-based compensation practices in the financial industry contributed to the 2008 financial crisis, Section 956 of the Dodd-Frank Act mandated that the regulators jointly establish rules or guidelines governing incentive-based compensation practices at certain financial institutions they regulate with assets of \$1 billion or more.

The proposed rule revises a rule initially proposed by the regulators in April 2011,² which resulted in over 10,000 comments. The proposed rule is also intended to reflect certain developments since 2011 in compensation practices in the financial services industry.

General

Scope. The proposed rule would apply to any covered institution with average total consolidated assets greater than or equal to \$1 billion that offers incentive-based compensation to covered persons. It would assign covered institutions to one of three levels based on average total consolidated assets, with more rigorous requirements applying to covered institutions with \$50 billion or more of average total consolidated assets. Incentive-based compensation means any variable compensation, fees or benefits that serve as an incentive or reward for performance. The proposed rule would supplement any existing rules and guidance adopted by the federal

¹ The final text of the SEC's version of the re-proposed rule can be accessed <u>here</u>.

² We described the rule as previously proposed in 2011 here.

agencies relating to compensation, and would not be intended to affect the application of other federal compensation-related requirements.

For investment advisers that may consolidate assets of certain client vehicles, there is an important clarification in the proposed rule relating to the proposed method by which an investment adviser would determine its asset level. Specifically, as defined in the proposed rule, "average total consolidated assets" for an investment adviser would mean the investment adviser's total assets (exclusive of non-proprietary assets) as shown on its balance sheet for the most recent fiscal year end. Furthermore, in a footnote to the release, the SEC clarified that "non-proprietary assets, such as client assets under management would not be included, regardless of whether they appear on an investment adviser's balance sheet. The SEC notes that this method is drawn directly from section 956 [of the Dodd-Frank Act]. See section 956(f) (referencing "assets" only)." References in this Update to "consolidated assets" should be construed accordingly.

Compliance Date; Grandfathered Plans. The compliance date of the proposed rule would be no later than the beginning of the first calendar quarter that begins at least 540 days (approximately 18 months) after a final rule is published in the Federal Register. The proposed rule states that it would not apply to any incentive-based compensation plan with a performance period for measuring incentive-based compensation that began before the compliance date.

Requests for Comment. The regulators are seeking comment on the proposed rule and have included dozens of specific requests for comment throughout the description of the proposed rule. Comments on the proposed rule are due by July 22, 2016.

Practical Guidance. The regulators included an 18-page appendix covering a hypothetical incentive-based compensation arrangement to illustrate how the proposed rule would work in practice. Several additional illustrative examples are provided throughout the description of the proposed rule, many of which we have highlighted as Practice Pointers.

Covered Institutions and Persons

Covered Institutions

The financial institutions covered by the proposed rule would include, among others, the following types of entities with average total consolidated assets of at least \$1 billion:

- banks, savings associations, bank holding companies and savings and loan holding companies;
- state- and federally-licensed U.S. branches (insured or uninsured) and agencies of foreign banks;
- the U.S. operations of foreign banks that are treated as bank holding companies (determined by reference to total consolidated U.S. assets of the foreign bank);
- credit unions:
- broker-dealers and investment advisers;
- Fannie Mae and Freddie Mac: and
- any other financial institutions the regulators jointly determine should be subject to the rule.

Levels of Covered Institutions

The proposed rule would assign covered institutions to one of three levels based on average total consolidated assets, with more rigorous requirements applying to the Level 1 and Level 2 covered institutions:

- Level 1 greater than or equal to \$250 billion in average total consolidated assets;
- Level 2 greater than or equal to \$50 billion and less than \$250 billion in average total consolidated assets;
 and
- Level 3 greater than or equal to \$1 billion and less than \$50 billion in average total consolidated assets.

A covered institution's level on the compliance date of the proposed rule would be determined based on average total consolidated assets as of the beginning of the first calendar quarter that begins after a final rule is published in the Federal Register. A covered institution that is a subsidiary of another covered institution with greater total consolidated assets would be defined to be the same level as its top-tier parent covered institution other than with respect to SEC-regulated broker-dealers and investment advisers.

If an increase in a covered institution's average total consolidated assets would cause it to become a Level 1, 2 or 3 covered institution, it would be required to comply with any newly applicable requirements under the proposed rule no later than the first day of the first calendar quarter that begins at least 540 days after the date on which the covered institution becomes a Level 1, 2 or 3 covered institution. Incentive-based compensation plans with a performance period that begins after the compliance date described in the preceding sentence would be subject to the rules that apply to the covered institution's new level. Upon a decrease in average total consolidated assets, a covered institution would remain subject to the provisions of the proposed rule that applied to it before the decrease until its average total consolidated assets fell below the applicable level (i.e., \$1 billion, \$50 billion or \$250 billion) for four consecutive quarters.

The proposed rule would give a regulator authority to impose the more stringent requirements of the proposed rule on a Level 3 covered institution with more than \$10 billion and less than \$50 billion in average total consolidated assets if the regulator determines that the complexity of its operations or compensation practices are consistent with those of a Level 1 or Level 2 covered institution.

Practice Pointer - Determination of Level of Covered Institution

If the final rule were published in the Federal Register on November 1, 2016 and the compliance date of the final rule were July 1, 2018, whether a covered institution was a Level 1, 2 or 3 covered institution on July 1, 2018 would be determined based on average total consolidated assets as of the beginning of the first quarter of 2017 (e.g., January 1, 2017).

Covered Persons

Under the proposed rule, a "covered person" would include any individual who is an executive officer, employee, director or principal shareholder who receives incentive-based compensation at a covered institution. The most significant limitations and prohibitions, described further below, would apply to covered persons who are "senior executive officers" and "significant risk-takers" because their positions or actions have the greatest potential to expose a covered institution to significant risk.

Senior Executive Officers (SEOs)

A "senior executive officer" would mean a covered person who holds the title or performs the function of one or more of the following positions at a covered institution for any period of time in the relevant performance period: 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 or the head of a major business line or control function.

Significant Risk-Takers (SRTs)

Under the proposed rule, a covered person at a Level 1 or Level 2 covered institution, other than a senior executive officer, would be a "significant risk-taker" if the person (i) received annual base salary and was awarded incentive-based compensation for the last calendar year that ended at least 180 days before the beginning of the performance period of which at least one-third consisted of incentive-based compensation and (ii) satisfied either the relative compensation test or the exposure test described below. In addition, the relevant regulator would be able to designate any covered person at a covered institution, other than a senior executive officer, as a "significant risk-taker" if that person has the ability to expose the covered institution to risks that could lead to material financial loss in relation to the institution's size, capital or overall risk tolerance.

Practice Pointer – Calculations

Mid-Year Change in Annual Base Salary. If a covered person was a manager during the first half of the year, with an annual base salary of \$100,000, and was then promoted to a senior manager with an annual base salary of \$150,000 on July 1 of that year, the annual base salary would be the \$50,000 that person received as a manager for the first half of the year plus the \$75,000 received as a senior manager for the second half of the year, for a total of \$125,000.

Incentive-Based Compensation Performance Periods. If a covered person is awarded incentive-based compensation relating to (i) a plan with a three-year performance period that began on January 1, 2017, (ii) a plan with a two-year performance period that began on January 1, 2018, and (iii) a plan with a one-year performance period that began on January 1, 2019, then all three of these awards would be included in the calculation of incentive-based compensation for calendar year 2019 because all three performance periods would end on December 31, 2019.

One-Third Threshold. A person who received \$180,000 in annual base salary during calendar year 2019 and was awarded incentive-based compensation of \$120,000 for performance periods that ended during calendar year 2019 could be a significant risk-taker because more than one-third (in this example, 40%) of the person's compensation was incentive-based. The person would be a significant risk-taker for a performance period beginning on or after June 28, 2020 if the person also met the relative compensation test or the exposure test.

Relative Compensation Test

The "relative compensation test" would depend on the amounts of annual base salary and incentive-based compensation of a covered person relative to other covered persons working for the covered institution and its affiliated covered institutions. This test would be met if the covered person is among the top 5% (for Level 1 covered institutions) or top 2% (for Level 2 institutions) of the most highly compensated covered persons (excluding senior executive officers) in the entire consolidated organization, including affiliated covered institutions.

Practice Pointer - Applicable Percentage Threshold

If the applicable regulator determines that a Level 1 covered institution's activities, complexity of operations, risk profile and compensation practices are similar to those of a Level 2 covered institution, the Level 1 covered institution may use the 2% (rather than 5%) threshold for purposes of the relative compensation test.

Exposure Test

The "exposure test" would be satisfied if the covered person has authority to commit or expose 0.5% or more of the capital of the covered institution or, in some cases, an affiliated covered institution. It would relate to the covered person's authority to cause the covered institution to be subject to credit risk or market risk but not other types of risk that are more difficult to quantify, such as compliance risk.

Practice Pointer – Determination of Authority to Commit or Expose Capital

Authorized Levels of Lending. If a Level 1 or Level 2 covered institution allocates \$10 million to a covered person as an authorized level of lending for a calendar year, the covered person's authority to commit or expose capital would be \$10 million for purposes of the exposure test. This would be true even if the person only made \$8 million in loans during the year or if the covered institution reduced the authorized amount to \$7.5 million at some point during the year. It would also be true even if the covered person did not have the authority through any single transaction to lend \$10 million, so long as over the course of the year the covered person could lend up to \$10 million in the aggregate. If, however, in the course of the year the covered person received authorization for an additional \$5 million in lending, \$15 million would become the authorization amount for purposes of the exposure test. If a covered person had no specific maximum amount of lending for the year, but instead his or her lending was subject to approval on a rolling basis, then the covered person would be assumed to have an authorized annual lending amount in excess of the 0.5% threshold.

Authorized Levels of Trading. If a Level 1 or Level 2 covered institution authorizes a covered person to trade up to \$5 million per day in a calendar year, the covered person's authorized annual lending amount would be \$5 million times the number of trading days in the year (for example, \$5 million times 260 days or \$1.3 billion) for purposes of the exposure test. This would be true even if the covered person only traded \$1 million per day during the year or if the covered institution reduced the authorized trading amount to \$2.5 million per day at some point during the year. If, however, in the course of the year the covered person received authorization for an additional \$2 million in trading per day, the covered person's authority to commit or expose capital for purposes of the exposure test would be \$1.82 billion (\$7 million times 260 days).

Voting Members of a Committee Deemed to Have Authority to Commit or Expose Capital. If a committee that is composed of five covered persons has the authority to make investment decisions with respect to 0.5% or more of a covered institution's capital, then each voting member of such committee would have the authority to commit or expose 0.5% or more of the covered institution's capital for purposes of the exposure test.

Requirements and Prohibitions Applicable to All Covered Institutions

Prohibition on Arrangements That Encourage Inappropriate Risks

The proposed rule would prohibit all covered institutions from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risks by providing covered persons with "excessive" compensation that could lead to material financial loss to the covered institution.

Excessive Compensation

The proposed rule would prohibit all covered institutions from granting excessive incentive-based compensation to any covered person that exposes the institutions to inappropriate risks. The standards for determining whether incentive-based compensation is "excessive" would be comparable to those developed under Section 39

of the Federal Deposit Insurance Act, which provides that compensation is "excessive" if the amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality and scope of services performed by the covered person. Under the proposed rule, the regulators would consider all relevant factors, including the following, when determining whether incentive-based compensation is "excessive":

- The combined value of all compensation, fees or benefits provided to a covered person;
- The compensation history of the covered person and other persons with comparable expertise;
- The financial condition of the covered institution;
- Compensation practices at comparable institutions, based upon such factors as asset size, geographic location and the complexity of the covered institution's operations and assets;
- With respect to post-employment benefits, the projected total cost and benefit to the covered institution; and
- Any connection between the covered person and any fraud, breach of trust or fiduciary duty or insider abuse at the covered institution.

The review of whether a compensation arrangement is "excessive" under this standard would be independent of the review described below as to whether the arrangement would contribute to the risk of material financial loss at the covered institution.

Material Financial Loss

The proposed rule would prohibit covered institutions from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risks by the covered institutions that could lead to material financial loss. Specifically, the proposed rule provides that covered institutions would be prohibited from providing incentive-based compensation to covered persons unless the arrangement:

- Appropriately balances risk and financial rewards;
- Is compatible with effective risk management and controls; and
- Is supported by effective governance, including active oversight by the board of directors (or a committee thereof).

Furthermore, an incentive-based compensation arrangement would not be considered to appropriately balance risk and reward unless it:

- Includes both financial and non-financial measures of performance;
- Is designed to allow non-financial measures of performance to override financial measures of performance, when appropriate; and
- Is subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and non-financial compliance.

Practice Pointer – Use of Non-Financial Measures of Performance

Covered institutions that are publicly traded likely will want to ensure that non-financial goals do not cause compensation payable to their "covered employees" under Section 162(m) of the Internal Revenue Code (generally those reported in the company's annual proxy statement, other than the principal financial officer) to be nondeductible for federal income tax purposes under Section 162(m). This can be done by using the non-financial goals to reduce, through the exercise of "negative discretion," the amount otherwise earned upon the achievement of the financial goals.

The regulators emphasize the importance of strong risk management and internal controls, noting that employees may otherwise seek to evade or weaken a covered institution's processes to achieve balance in its incentive-based compensation structures. The regulators encourage covered institutions to consider how the following features of an incentive-based compensation arrangement work together when developing arrangements that appropriately balance risk and reward: (i) how performance measures are combined; (ii) whether performance measures take into account both current and future risks; (iii) which criteria govern the use of risk-based adjustments before the awarding and vesting of incentive-based compensation; and (iv) what form incentive-based compensation takes (i.e., equity-based or cash-based).

Practice Pointer – Examples of Features That Could Lead to Material Financial Loss

- The use of performance measures that are closely tied to short-term revenue or profit of business generated by a covered person, without any adjustments for the longer-term risks associated with the business generated.
- If there is no mechanism for factoring risk outcomes over a longer period of time into compensation decisions, traders who have incentive-based compensation plans with performance periods that end at the end of the calendar year could have an incentive to take large risks towards the end of the calendar year to either make up for underperformance earlier in the performance period or to maximize their year-end profits.
- If performance measures are poorly designed or can be manipulated inappropriately by the covered persons receiving incentive-based compensation.

Required Approval of Incentive-Based Compensation of Senior Executive Officers

Under the proposed rule, the board of directors (or committee thereof) of each covered institution would be required to:

- Conduct oversight of the covered institution's incentive-based compensation program;
- Approve incentive-based compensation arrangements for senior executive officers, including amounts of awards and, at the time of vesting, payouts under such arrangements; and
- Approve material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

Disclosure and Recordkeeping Requirements

The proposed rule would require all covered institutions to create annually and maintain for at least seven years records that document the structure of incentive-based compensation arrangements and demonstrate compliance with the proposed rule. At a minimum, the records must include (i) copies of all incentive-based compensation plans, (ii) a record of who is subject to each plan and (iii) a description of how the incentive-based

compensation program is compatible with effective risk management and controls. Covered institutions must provide these records to the appropriate federal regulators at their request but, unlike the 2011 proposed rule, the rule does not require covered institutions to file annual reports relating to incentive-based compensation. The proposed rule indicates that the regulators would consider the information non-public and expect to maintain the confidentiality of the information to the extent permitted by law. If a covered institution were to provide information to a regulator pursuant to the proposed rule, according to the rule, the covered institution should request confidential treatment by such regulator.

Anti-Evasion Provision

The proposed rule would prohibit covered institutions from doing indirectly, or through or by any other person, anything that would be unlawful for the covered institution to do directly under the proposed rule.

Additional Requirements and Prohibitions Applicable to Level 1 and Level 2 Covered Institutions

Enhanced Disclosure and Recordkeeping Requirements

In addition to the disclosure and recordkeeping requirements applicable to all covered institutions, the proposed rule would require all Level 1 and Level 2 covered institutions to create annually and maintain for at least seven years records that document the structure of incentive-based compensation arrangements and demonstrate compliance with the proposed rule including:

- The covered institution's senior executive officers and significant risk-takers, listed by legal entity, job function, hierarchy and line of business;
- The incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on the percentage of incentive-based compensation deferred and form of award;
- Any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and
- Any material changes to the covered institution's incentive-based compensation arrangements and policies.

Level 1 and Level 2 covered institutions would be required (i) to create and maintain records in a manner that would allow for an independent audit of incentive-based compensation arrangements, policies and procedures, and (ii) to provide the records to the appropriate federal regulator upon request.

Deferral, Forfeiture and Downward Adjustment of Incentive-Based Compensation

Under the proposed rule, an incentive-based compensation arrangement for a senior executive officer or a significant risk-taker at a Level 1 or Level 2 covered institution would not be considered to appropriately balance risk and reward unless it satisfies the deferred vesting, forfeiture and downward adjustment requirements set forth in the proposed rule.

Mandatory Deferral of Incentive-Based Compensation

Relevant Definitions

- **Deferral:** The delay of vesting (not merely the timing of payment) of incentive-based compensation beyond the date at the end of the performance period on which the incentive-based compensation is awarded.
- **Deferral Period:** The period of time between the date a performance period ends and the last date on which the incentive-based compensation awarded for such performance period vests.
- **Long-Term Incentive Plan (LTIP):** A plan to provide incentive-based compensation that is based on a performance period of at least three years.
- **Qualifying Incentive-Based Compensation:** Incentive-based compensation awarded to a senior executive officer or significant risk-taker for a performance period of less than three years.

A Level 1 covered institution would be required to defer at least 60% of a senior executive officer's qualifying incentive-based compensation and 50% of a significant risk-taker's qualifying incentive-based compensation for at least four years. In addition, a Level 1 covered institution would be required to defer for at least two years after the end of the related performance period at least 60% of a senior executive officer's incentive-based compensation awarded under an LTIP and 50% of a significant risk-taker's incentive-based compensation awarded under an LTIP.

A Level 2 covered institution would be required to defer at least 50% of a senior executive officer's qualifying incentive-based compensation and 40% of a significant risk-taker's qualifying incentive-based compensation for at least three years. Furthermore, a Level 2 covered institution would be required to defer for at least one year after the end of the related performance period at least 50% of a senior executive officer's incentive-based compensation awarded under an LTIP and 40% of a significant risk-taker's incentive-based compensation awarded under an LTIP.

Deferral Percentages and Periods				
	Level 1 Covered Institutions		Level 2 Covered Institutions	
	SEOs	SRTs	SEOs	SRTs
Qualifying Incentive- Based Compensation	60% for 4 years	50% for 4 years	50% for 3 years	40% for 3 years
LTIP Compensation	60% for 2 years	50% for 2 years	50% for 1 year	40% for 1 year

Under the proposed rule, deferred incentive-based compensation of senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions would also have to meet the following requirements:

- Acceleration of vesting of deferred incentive-based compensation would generally be permitted only in the
 case of death or disability of the covered person (but not other events, such as change in control);
- Deferred amounts may not vest more quickly than on a pro rata annual basis beginning on the first anniversary of the end of the performance period (e.g., one-third in each year of a three-year deferral period);
- The percentage of incentive-based compensation awarded that would be required to be deferred would apply separately to incentive-based compensation awarded under an LTIP and to qualifying incentive-based

compensation, although all qualifying incentive-based compensation arrangements (but not LTIPs) may be aggregated for this purpose, allowing the covered institution to choose which qualifying incentive-based compensation arrangement or combination of arrangements will be subject to deferral;

- Unvested deferred amounts may not be increased during the deferral period;
- "Substantial portions" (without a percentage specified in the proposed rule) of deferred incentive-based compensation must generally be paid in the form of both equity or "equity-like" instruments and deferred cash throughout the deferral period, although equity or equity-like instruments may nonetheless be settled in cash; and
- If a senior executive officer or significant risk-taker receives incentive-based compensation for a performance period in the form of options, the total amount of such options used to meet the minimum required deferred compensation threshold may not exceed 15% of the amount of total incentive-based compensation awarded to the person for that performance period.

Practice Pointer - Deferral-Related Requirements

Pace of Vesting of Deferred Compensation. If a Level 1 covered institution is required to defer \$100,000 of a senior executive officer's incentive-based compensation for four years, the covered institution could choose to make \$25,000 available for vesting on each anniversary of the end of the performance period for which the \$100,000 was awarded. The Level 1 covered institution could also choose to make different amounts available for vesting at different times during the deferral period, as long as: the total amount that is made eligible for vesting on the first anniversary is not more than \$25,000; the total amount that has been made eligible for vesting by the second anniversary is not more than \$50,000; and the total amount that has been made eligible for vesting by the third anniversary is not more than \$75,000. For example, the Level 1 covered institution would be permitted to make eligible for vesting \$10,000 on the first anniversary, \$30,000 on the second anniversary (bringing the total for the first and second anniversaries to \$40,000), \$30,000 on the third anniversary (bringing the total for the first, second, and third anniversaries to \$70,000) and \$30,000 on the fourth anniversary.

Must Defer Same Percentage of LTIP and Qualifying Incentive-Based Compensation. A Level 2 covered institution that awards a senior executive officer \$50,000 of qualifying incentive-based compensation and \$20,000 under an LTIP would be required to defer at least \$25,000 of the qualifying incentive-based compensation and at least \$10,000 of the amounts awarded under the LTIP. The Level 2 covered institution would not be permitted to defer, for example, \$35,000 of qualifying incentive-based compensation and no amounts awarded under the LTIP, even though that would result in the deferral of 50% of the senior executive officer's total incentive-based compensation.

15% Limit Applicable to Options. A Level 1 covered institution might award a significant risk-taker \$100,000 in incentive-based compensation at the end of a performance period: \$80,000 in qualifying incentive-based compensation, of which \$25,000 is in options, and \$20,000 under an LTIP, all of which is delivered in cash. The Level 1 covered institution would be required to defer at least \$40,000 of the qualifying incentive-based compensation and at least \$10,000 of the amount awarded under the LTIP. Under the proposed rule, the Level 1 covered institution could count \$15,000 in options (15% of the \$100,000 total amount of incentive-based compensation awarded) toward the requirement to defer \$40,000 of qualifying incentive-based compensation.

Forfeiture and Downward Adjustment

The proposed rule would require a Level 1 or Level 2 covered institution to consider reducing some or all of the incentive-based compensation of a senior executive officer or significant risk-taker when the covered institution becomes aware of inappropriate risk-taking or other behavior that could lead to a material financial loss.

Relevant Definitions

- **Forfeiture:** A reduction of the amount of deferred incentive-based compensation awarded to a covered person that has not vested.
- **Downward adjustment:** A reduction of the amount of a covered person's incentive-based compensation not yet awarded for any performance period that has already begun.

The proposed rule would require a Level 1 or Level 2 covered institution to make subject to forfeiture all unvested deferred incentive-based compensation of any senior executive officer or significant risk-taker, including unvested deferred amounts awarded under LTIPs. This forfeiture requirement would apply to all unvested, deferred incentive-based compensation for those persons, regardless of whether the deferral was required by the proposed rule.

Furthermore, the proposed rule would require Level 1 and Level 2 covered institutions to adjust deferred compensation to reflect actual losses incurred, or performance measures realized, by the institution during the deferral period. Specifically, a Level 1 or Level 2 covered institution would be required to make subject to downward adjustment all incentive-based compensation amounts not yet awarded to any senior executive officer or significant risk-taker for the current performance period, including amounts payable under LTIPs.

A Level 1 or Level 2 covered institution would be required to consider forfeiture or downward adjustment of incentive-based compensation in any of the following circumstances (or additional triggers the covered institution may define based on conduct or poor performance):

- Poor financial performance attributable to a significant deviation from the covered institution's risk parameters set forth in the covered 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 brought by a federal or state regulator or agency, or a requirement that the covered institution report a restatement of a financial statement to correct a material error; and
- Other aspects of conduct or poor performance as defined by the covered institution.

The proposed rule sets forth six minimum factors that would have to be considered when determining the amount of incentive-based compensation to be reduced, including the covered person's level of participation in the triggering circumstances and their financial and reputational impact, the covered person's intent to operate outside of the applicable risk management policies and any preventative actions the covered person could have taken. Any forfeiture or downward adjustment would have to be administered under a formal documented policy and procedure.

Practice Pointer - Compensation to Consider for Forfeiture or Downward Adjustment

A significant risk-taker of a Level 1 covered institution might engage in misconduct in June 2025, but the Level 1 covered institution might not become aware of the misconduct until September 2028. The Level 1 covered institution would be required to consider forfeiture of any amounts that are deferred, but not yet vested, as of September 2028 (e.g., amounts that were awarded for a performance period that ran from January 1, 2026 to December 31, 2026 and that have been deferred and do not vest until December 31, 2030). The Level 1 covered institution would also be required to consider downward adjustment of any amounts available under any of the significant risk-taker's incentive-based compensation plans with performance periods that are still in progress as of September 2028 (e.g., an annual plan with a performance period that runs from January 1, 2028 to December 31, 2028 or an LTIP with a performance period that runs from January 1, 2027 to December 31, 2030).

Clawback of Incentive-Based Compensation

Unlike the 2011 proposed rule, which did not contemplate a clawback provision, the proposed rule would require Level 1 and Level 2 covered institutions to include clawback provisions in the incentive-based compensation arrangements for senior executive officers and significant risk-takers that would enable the institutions to recover vested incentive-based compensation from such persons if certain events occur. At a minimum, such provisions would have to allow the covered institution to recover incentive-based compensation from a current or former senior executive officer or significant risk-taker for seven years following the date on which such compensation vests, if the covered institution determines that the person engaged in (i) misconduct that resulted in significant financial or reputational harm to the covered institution, (ii) fraud or (iii) intentional misrepresentation of information used to determine the person's incentive-based compensation. When combined with the applicable performance period and required deferral period, in some cases the clawback requirement would cause incentive-based compensation to be at risk for at least 12 years from the beginning of the performance period.

Additional Prohibitions

The proposed rule contains several additional prohibitions applicable to Level 1 and Level 2 covered institutions not contemplated by the 2011 proposed rule as described below.

Hedging Prohibition

The proposed rule would prohibit a Level 1 and Level 2 covered institution from purchasing hedging or similar instruments on behalf of a covered person to hedge or offset any decrease in the person's incentive-based compensation.

Maximum Incentive-Based Compensation Opportunity (Leverage)

The proposed rule would limit maximum payouts of incentive-based compensation under each applicable plan to 125% of the pre-established target amount for senior executive officers and 150% of the pre-established target amount for significant risk-takers.

Practice Pointer – Calculating Maximum Incentive-Based Compensation Opportunity

A Level 1 covered institution might provide an incentive-based compensation plan for its senior executive officers that links the amount awarded to a senior executive officer to the covered institution's four-year average return on assets (ROA). The plan could establish a target award amount of \$100,000 and a target four-year average ROA of 75 basis points (i.e., if the covered institution's four-year average ROA was 75 basis points, a senior executive officer would receive \$100,000). The plan could also provide that senior executive officers would earn nothing (0% of target) under the plan if ROA was less than 50 basis points; \$60,000 (60% of target) if ROA was 65 basis points; and \$125,000 (125% of target) if ROA was 100 basis points. Under the proposed rule, the plan would not be permitted to provide, for example, \$130,000 (130% of target) if ROA was 100 basis points or \$150,000 (150% of target) if ROA was 110 basis points.

Relative Performance Measures and Volume-Driven Incentive-Based Compensation

The proposed rule would prohibit a Level 1 and Level 2 covered institution from using incentive-based compensation performance measures based solely on industry peer performance comparisons (e.g., a metric comparing a covered institution's performance to "peer institutions" or an industry average). Relative performance measures may only be used if in combination with absolute performance measures (e.g., absolute total shareholder return (TSR) rather than relative TSR compared to the covered institution's peer group). The proposed rule would also prohibit Level 1 and Level 2 covered institutions from using transaction or revenue volume as a sole performance measure goal without regard to transaction quality or compliance with risk management requirements.

Risk Management and Controls

The proposed rule would require Level 1 and Level 2 covered institutions to have a risk management and control framework for their incentive-based compensation programs that:

- Is independent of any lines of business;
- Includes an independent compliance program that provides for internal controls, testing, monitoring and training with written policies and procedures; and
- Is commensurate with the size and complexity of the covered institution's operations.

The proposed rule would also require Level 1 and Level 2 covered institutions to:

- Provide persons in control functions with appropriate authority to influence the risk-taking of the business
 areas they monitor and ensure covered persons engaged in control functions are compensated independently
 of the performance of the business areas they monitor; and
- Provide for independent monitoring of: (i) incentive-based compensation plans to identify whether the plans
 appropriately balance risk and reward; (ii) events related to forfeiture and downward adjustment and
 decisions of forfeiture and downward adjustment reviews to determine consistency with the proposed rules;
 and (iii) compliance of the incentive-based compensation program with the covered institution's policies and
 procedures.

To be considered independent under the proposed rule, the person at the covered institution responsible for monitoring the areas described above generally should have a reporting line to senior management or the covered institution's board of directors that is separate from the covered persons whom the person is responsible for monitoring.

Governance

The proposed rule would require each Level 1 or Level 2 covered institution to establish a compensation committee composed solely of directors who are not senior executive officers to assist the board of directors in carrying out its responsibilities under the proposed rule. The compensation committee would be required to obtain input from the covered institution's risk and audit committees, or groups performing similar functions, and risk management function on the effectiveness of risk measures and adjustments used to balance incentive-based compensation arrangements.

Management would be required to submit to the compensation committee at least annually a written assessment of the effectiveness of the covered institution's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the risk profile of the covered institution. The compensation committee would be required to obtain at least annually a written assessment on the same subject from the internal audit or risk management function of the covered institution developed independently of management's assessment.

A compensation committee that is already in existence at a covered institution may be used for this purpose, although modifications to its committee charter may be necessary or advisable.

Policies and Procedures

The proposed rule would require all Level 1 and Level 2 covered institutions to develop and maintain policies and procedures that, among other requirements:

- Are consistent with the requirements and prohibitions of the proposed rule;
- Specify the substantive and procedural criteria for forfeiture and clawback, including the process for determining the amount of incentive-based compensation to be clawed back;
- Document final forfeiture, downward adjustment and clawback decisions;
- Specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person (e.g., upon death or disability);
- Identify and describe the role of any employees, committees or groups authorized to make incentive-based compensation decisions, including when discretion is authorized;
- Describe how discretion is expected to be exercised to appropriately balance risk and reward;
- Require that the covered institution maintain documentation of the establishment, implementation, modification and monitoring of incentive-based compensation arrangements;
- Describe how incentive-based compensation arrangements will be monitored;
- Specify the substantive and procedural requirements of the independent compliance program; and
- Ensure appropriate roles for risk management, risk oversight and other control personnel in the covered
 institution's processes for (i) designing incentive-based compensation arrangements and determining
 awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback and vesting and
 (ii) assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate
 risk-taking.

Next Steps

The public comment period for the joint proposed rule will end on July 22, 2016. The compliance date of the proposed rule would be no later than the beginning of the first calendar quarter that begins at least 540 days (approximately 18 months) after a final rule is published in the Federal Register.

Even though the proposed rule will not be effective for some time, financial institutions that would be subject to the rule should review their incentive-based compensation arrangements and policies and procedures in light of the proposed rule and consider what changes and actions will be required. It is possible that some of the compensation practices developed by financial institutions to comply with the final rule could spread to other large public companies outside of the financial services industry or be considered by institutional shareholders or their advisers, such as Institutional Shareholder Services, to be preferred compensation practices.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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