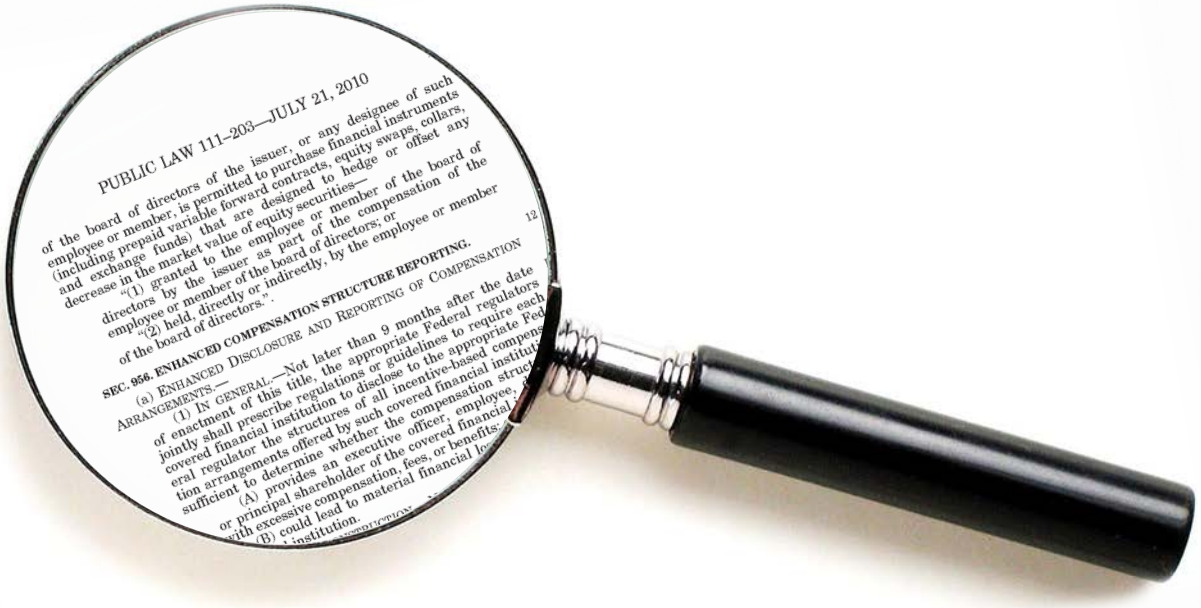
Incentive Compensation for Financial Institutions: Reproposal and Its Impact on Regional Banks

May 25, 2016



Margaret E. Tahyar

Kyoko Takahashi Lin

Jean M. McLoughlin

Davis Polk

Davis Polk & Wardwell LLP

Agenda

Part 1.	Overview
Part 2.	Covered Persons
Part 3.	Structuring Covered Incentive Compensation
Part 4.	Effective Governance and Compliance
Q&A	

Part 1: Overview

- From April 21 to May 6, **six Agencies** released a joint reproposal of Dodd-Frank's mandated rules, which follow the 2011 proposed rules.
- The proposed rule prohibits, for **covered persons** at **covered institutions**, **incentive compensation** that encourages **inappropriate risks** by providing **excessive compensation** or that could lead to **material financial loss**.
- The proposed rule uses a 3-tiered approach with requirements increasing in stringency with the size (**average total assets)** of the covered institution:
  - **Level 1**: ≥ $250 billion; **Level 2**: ≥ $50 and less than $250 billion; **Level 3**: ≥$1 and less than $50 billion.
  - Level 1 and Level 2 institutions must comply with enhanced requirements as to the structure of their incentive compensation for **senior executive officers** and **significant risk-takers**.
- **Existing Compensation Requirements Continue**. The proposed rule does not change the application of other compensation requirements found elsewhere in federal law, including the banking regulators' safety and soundness standards, the OCC's heightened standards or SEC rules regarding disclosure of executive compensation. Mortgage loan originators remain separately subject to CFPB rules restricting compensation.
- **Delayed Effectiveness Date**. The proposed rule will be **effective** on the first day of the calendar quarter 540 days (**18 months**) after the final rule is published in the Federal Register. We estimate that the earliest the rules will apply to compensation programs is 2019.
- **Grandfathering**. The rule will not apply to any incentive compensation plan with a performance period that began before the effective date.
- **Comment deadline:** July 22, 2016.

Overview: One-Page Cheat Sheet

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Basic Requirements Applicable to All Levels

Prohibition on incentive compensation that encourages inappropriate risks by the covered institution (1) by providing covered persons excessive compensation or (2) that could lead to material financial loss.

Board of directors. Expanded oversight; must approve incentive compensation arrangements for senior executive officers.

Recordkeeping. Must be created; retained for 7 years.

Enhanced Requirements Applicable to Level 1 and 2 Institutions

Compensation Structuring

Deferral. Mandatory deferral of incentive compensation 50-60% for senior executive officer and 40-50% for significant risk-taker, for 4 years (Level 1) or 3 years (Level 2) from the last day of the performance period for short-term arrangements and 2 years (Level 1) or 1 year (Level 2) for long-term arrangements (those with minimum 3 year performance period).

Downward adjustment and forfeiture. Requirements to reduce, due to various adverse outcomes (e.g., poor financial performance), for senior executives and significant risk-takers: (1) incentive compensation that has not yet been awarded during the performance period and (2) deferred incentive compensation during the deferral period.

Clawback. Minimum of 7 years from end of vesting, based on (1) misconduct resulting in significant financial or reputational harm to the financial institution; (2) fraud; or (3) intentional misrepresentation of information used to determine applicable incentive compensation.

Leverage factor. Limits awards in excess of target: 125% of target for senior executive officers; 150% of target for a significant risk-taker.

Equity compensation. Incentive compensation required to be deferred must include portions of both deferred cash and equity-like instruments. Options used to meet the minimum amount cannot exceed 15% of the amount of a senior executive officer's or significant risk-taker's total incentive compensation.

Effective Governance and Compliance

Risk management and controls. Must have risk management framework for incentive compensation that is independent of any line 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 institution's operations.

Governance. Must have a compensation committee composed solely of directors who are not senior executive officers, which must obtain input from risk and audit committees and risk management function. Both management and the risk function must submit to the committee an annual or more frequent assessment of the effectiveness of the institution's incentive compensation program and related compliance and control processes.

Who is Covered?

Covered person : Any executive officer, employee, director or principal shareholder who receives incentive compensation.

Who is Covered?

Senior executive officer: Title of or acts as president, CEO, executive chairman, COO, CFO, 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 head of a major business line or control function.

Significant risk-taker – e.g., loan officer, underwriter: A covered person whose compensation is 1/3rd incentive-based and meets one or both of these tests (excluding senior executive officers):

- **Relative compensation test**: among top 5% (for Level 1) and 2% (for Level 2) of highest compensated covered persons in the entire consolidated organization, including covered affiliates; **OR**
- **Exposure test**: has authority to commit or expose 0.5% or more of the capital of the institution.

Part 2: Covered Persons

Requirements	Covered Persons
Basic Requirements	▪ Executive officers ▪ Employees ▪ Directors ▪ Principal shareholders
Enhanced Requirements	▪ Senior executive officers ▪ Significant risk-takers

Executive officers includes senior executive officers and other executive officers designated by the covered institution.

Directors includes a member of the board of directors of a covered institution. Any member of a covered institution's governing body would be included within this definition, **including directors of subsidiaries** that are covered institutions.

Principal shareholders includes **natural persons** who, directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote **10 percent or more of any class of voting securities** of the covered institution.

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Covered Persons

Senior Executive Officers

- The **enhanced requirements** applicable to Level 1 and Level 2 institutions apply to incentive compensation paid to **senior executive officers**, which includes covered persons who **hold the title**, **or**, without regard to title, salary or compensation, **perform 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
  - head of a major business line
  - head of a control function
- If a covered institution does not have any covered persons who hold the titles or performs the function of a senior executive officer, **the proposed rule would not require the covered institution to designate a covered person** to fill such a position.

The Agencies invite comment on whether **chief technology officers**, chief information security officers or similar titles should be included in the definition of senior executive officer.

The Agencies invite comment on whether the term **major business line** provides enough information to identify covered persons and if the proposed rule should instead refer to **core business line** as defined in FDIC and Federal Reserve rules relating to resolution planning; **principal business unit, division or function** as defined by the SEC definitions of executive officer; or to business lines that contribute **greater than a specified amount to the covered institutions total annual revenues or profit**.

Control function means a compliance, risk management, internal audit, legal, human resources, accounting, financial reporting or finance role responsible for identifying, measuring, monitoring or controlling risk-taking.

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Covered Persons

Significant Risk-Takers

- **Enhanced requirements** applicable to Level 1 and Level 2 institutions apply to incentive compensation paid to **significant risk-takers** who are deemed to be in a **position to put a Level 1 and Level 2 institution at risk of material financial loss**.
- Significant risk-takers do not include senior executive officers and are determined by the **relative compensation test**, the **exposure test** or by **designation**.

One-Third Threshold Is incentive compensation at least **one-third** of their total compensation?

180-day look-back: Count compensation from the **last calendar year that ended at least 180 days** before the beginning of the performance period when significant risk-taker is identified.

Example: For a performance period beginning January 1, 2019, count compensation as of December 31, 2017.

Yes

AND

Relative Compensation Test Is the person among the **top 5%** (if a Level 1 institution) or **top 2%** (if a Level 2 institution) of highest compensated covered persons in the entire consolidated organization, including covered affiliates?

OR

Exposure Test Does the person have the authority **to commit or expose 0.5% or more of** the capital of the covered institution or a covered affiliate?

Yes

Designation Was the person designated as a significant risk-taker because of that person's ability to expose the covered institution to risks that could lead to material financial loss, in accordance with procedures established by the Agency or by the covered institution?

Yes

Significant Risk-Taker

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Part 3: Structuring Covered Incentive Compensation

- For Level 1 and Level 2 institutions, compensation structuring requirements will apply to qualifying incentive compensation and long-term incentive compensation.

Incentive Compensation

Qualifying Incentive Compensation: Short-Term Awards

- The proposed rule refers to **qualifying incentive compensation** as the amount of incentive compensation awarded to a covered person for a particular performance period.
  - Excludes amounts awarded to such covered person for that particular performance period under a long-term incentive plan.
- Performance period is **less than 3 years**.
- With the exception of long-term incentive plans, all forms of compensation, fees and benefits that qualify as incentive compensation, including **annual bonuses**, would be included in the amount of qualifying incentive compensation.
- A portion of amounts (ranging from 40-60%) considered to be qualifying incentive compensation will be subject to further restrictions, including deferral and forfeiture for 3-4 years.

Amounts Awarded under Long-Term Incentive Plans

- **Long-term incentive plans** are forward-looking plans designed to reward employees for performance over a multi-year period.
- A long-term incentive plan based on a **performance period** of at least **three years**.
- These awards generally provide an award of cash or equity at the end of a performance period if the employee meets certain individual or institution-wide performance measures.
- Any incentive compensation awarded to a covered person for a performance period of less than 3 years would not be awarded under a long-term incentive plan, but instead would be considered qualifying incentive compensation.
- A portion of amounts (ranging from 40-60%) considered to be awarded under a long-term incentive plan will be subject to further restrictions, including deferral and forfeiture for 1-2 years.

Compensation Structuring

General Prohibitions

- Prohibition on incentive compensation arrangements that would encourage inappropriate risks by providing **excessive compensation** or that could lead to a **material financial loss**

Excessive Compensation	Material Financial Loss
Amounts paid that are **unreasonable** or **disproportionate** to the value of the services performed by the covered person. Determination based on all relevant factors, including: • Combined value of all compensation, fees, or benefits provided to the covered person • Compensation history of the covered person and other individuals with comparable expertise at the covered institution • Financial condition of the covered institution • Compensation practices at comparable covered institutions based on asset size, geographic location and complexity of the covered institution's operations and assets • 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 omissions, breach of trust or fiduciary duty, or insider abuse with regard to the covered institution.	An incentive compensation arrangement at a covered institution will be deemed to encourage inappropriate risks that could lead to a **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.

This framework is little-changed from the 2011 proposed rule.

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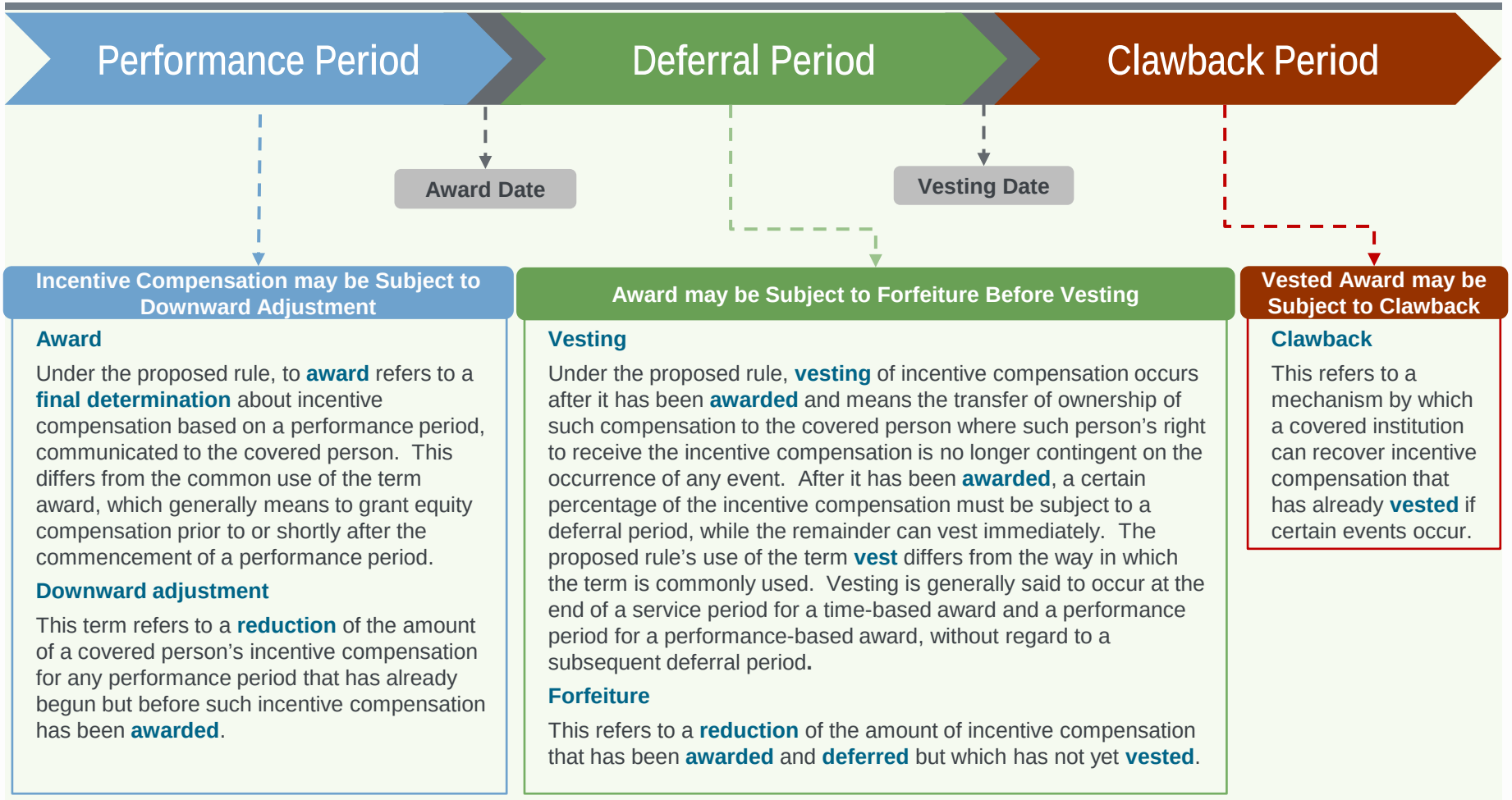
Level 1 and Level 2: Downward Adjustment, Deferral, Forfeiture and Clawback



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Required Deferral Period

Performance Period → **Deferral Period** → Clawback Period

	Level 1			Level 2		
	Minimum Deferral	Minimum Time Period		Minimum Deferral	Minimum Time Period	
Senior Executive Officer	60%	Short-Term Award	4 years	50%	Short-Term Award	3 years
		Long Term-Award	2 years		Long Term-Award	1 year
Significant Risk-Taker	50%	Short Term-Award	4 years	40%	Short Term-Award	3 years
		Long Term-Award	2 years		Long Term-Award	1 year

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Deferral

Example: Qualifying Incentive Compensation (i.e., Short-Term Award)

Performance Period → **Deferral Period** → Clawback Period

- Amounts deferred under the proposed rule:
  - Awards must not vest faster than on a **pro rata annual basis** and
  - Vesting of awards cannot begin earlier than on the **first anniversary** of the end of the performance period for which the compensation was awarded.
  - Accelerated vesting of award prohibited other than following **death** or **disability.**
  - No acceleration for **government service**.
- **Example**: Level 2 senior executive officer is awarded an annual bonus of $300,000. He or she can receive 50% (i.e., $150,000) immediately, but must defer 50% (i.e., $150,000) for 3 years. Permissible vesting schedule (i.e., actual payment schedule):

Permissible	Not Permissible
$50,000 each year over 3 years	$75,000 each year over 2 years
20% in year 1 and 40% in each of years 2 and 3	40% in year 1 and 30% in each of years 2 and 3
50% in year 2 and 50% in year 3	50% in year 1 and 50% in year 3
100% in year 3	100% in year 2

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Composition of Deferred Awards

Performance Period → **Deferral Period** → Clawback Period

- Mandatorily deferred incentive compensation must meet certain **composition requirements** - i.e., **substantial amounts** of both **deferred cash** and **equity-like instruments**.
  - Under the proposed rule, **equity-like instruments** include:
    - Equity in the covered institution or of an affiliate or
    - A form of compensation either payable at least in part based on the price of the shares or other equity instruments of the covered institution or of any affiliate of the covered institution; or that requires, or may require, settlement in the shares of the covered institution or any affiliate of the covered institution.
  - Agencies prescribe that incentive compensation must be balanced between cash and equity-like instruments.
  - The proposed rule discusses aligning the interests of senior executive officers and significant risk-takers with the **interests of shareholders** and other **stakeholders**, which the Agencies believe will be accomplished through the necessary composition requirements of the deferred incentive compensation.
  - The amount of **options** used to meet the minimum required deferred compensation amounts may **not** exceed **15%** of the amount of total incentive compensation awarded for that **performance period**.

Triggering Events
Downward Adjustment and Forfeiture

Performance Period → **Deferral Period** → **Clawback Period**

- Level 1 and Level 2 institutions must consider **downward adjustment** and **forfeiture** upon the occurrence of certain **triggering events**:
  - **Poor financial performance** attributable to a **significant deviation** from the **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 and
  - **Non-compliance** with statutory, regulatory or supervisory standards that results in enforcement or legal action or a requirement that the covered institution report a financial restatement to correct a material error and
  - Additional triggers defined by the covered institution
- Once a review is triggered, the covered institution will need to identify the senior executive officer or significant risk-taker responsible for the triggering event.

- In addition, the Level 1 and Level 2 institutions would be required, at a minimum, to consider the following non-exhaustive list of factors in determining the amount of incentive compensation to adjust downward or forfeit:
  - **Intent** of the senior executive officer or significant risk-taker to operate outside the **risk governance framework** approved by the covered institution's board of directors or to depart from the covered institution's **policies and procedures**
  - Senior executive officer's or significant risk-taker's **level of participation** in, **awareness** of, and **responsibility** for, the events triggering the review
  - Any actions the senior executive officer or significant risk-taker took or could have taken to **prevent** the events triggering review
  - The **financia**l and **reputational** impact of the events triggering events, the line or subline of business and individuals involved, including the **magnitude** of any financial loss and the cost of known or potential subsequent **fines**, **settlements** and **litigation**
  - The causes of the events triggering the review, including any decision-making by other individuals and
  - Any other relevant information, including **past behavior** and **risk outcomes** attributable to the senior executive officer or significant risk-taker.

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Clawback

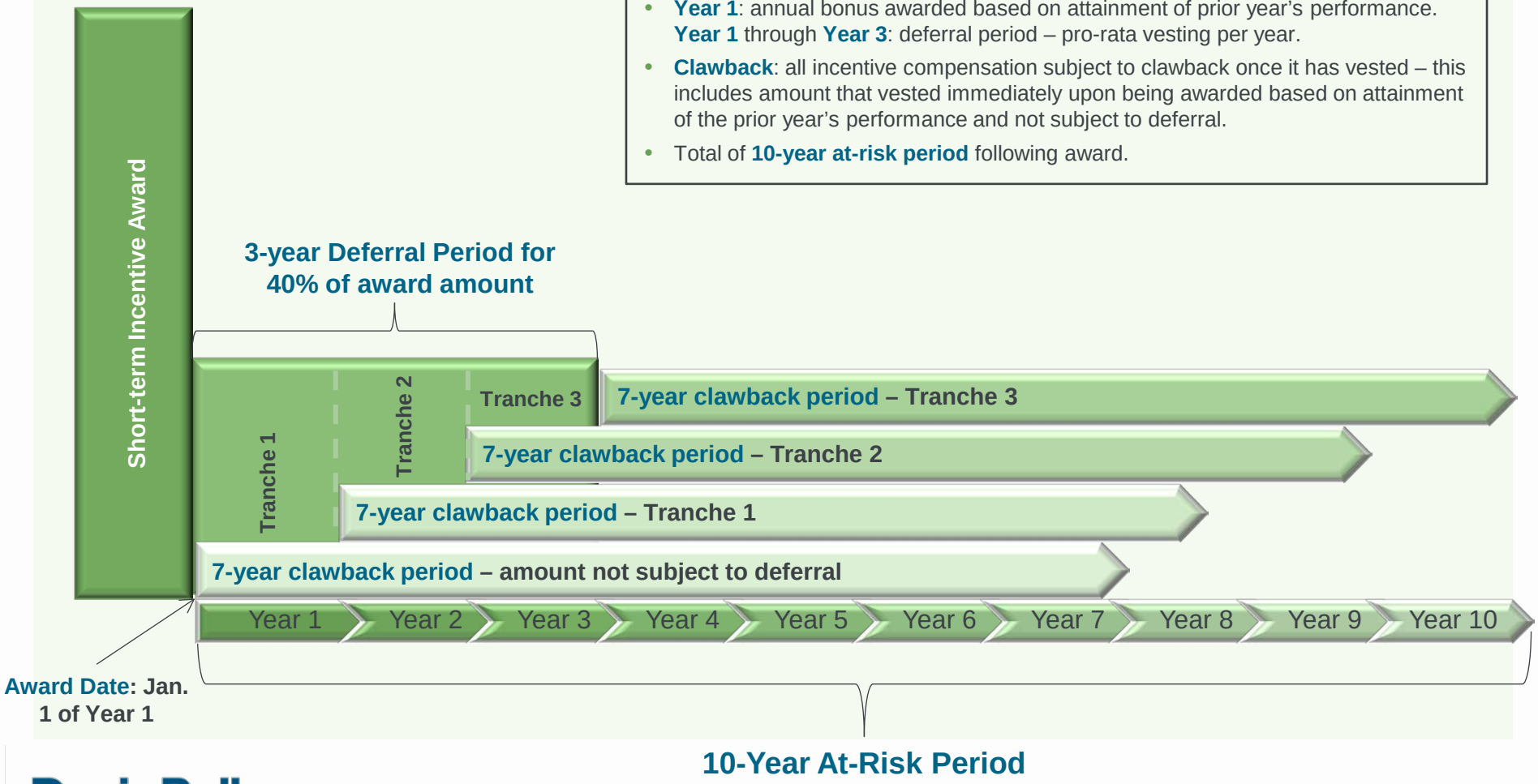
Performance Period → Deferral Period → **Clawback Period**

- **7-Year Clawback Period**
  - After awards have vested, incentive compensation provided to senior executive officers and significant risk-takers would be subject to a **7-year clawback period** from the vesting date.
  - All vested incentive compensation, whether paid out immediately upon award or subject to the post-award deferral period, would be subject to the 7-year clawback period.
- Clawback would be exercised where a senior executive officer or significant risk-taker engaged in:
  - **Misconduct** that resulted in **significant financial** or **reputational** harm to the covered institution
  - **Fraud** or
  - **Intentional misrepresentation** of information used to determine the senior executive officer's or significant risk-taker's incentive compensation.
- This is in addition to Sarbanes-Oxley clawback and Dodd-Frank's other proposed clawback, each of which tie to financial restatements.

Qualifying Incentive Compensation – Level 2

Significant Risk-Taker – Annual Bonus
Based on Prior Year's Performance

- **Year 1**: annual bonus awarded based on attainment of prior year's performance. **Year 1** through **Year 3**: deferral period – pro-rata vesting per year.
- **Clawback**: all incentive compensation subject to clawback once it has vested – this includes amount that vested immediately upon being awarded based on attainment of the prior year's performance and not subject to deferral.
- Total of **10-year at-risk period** following award.



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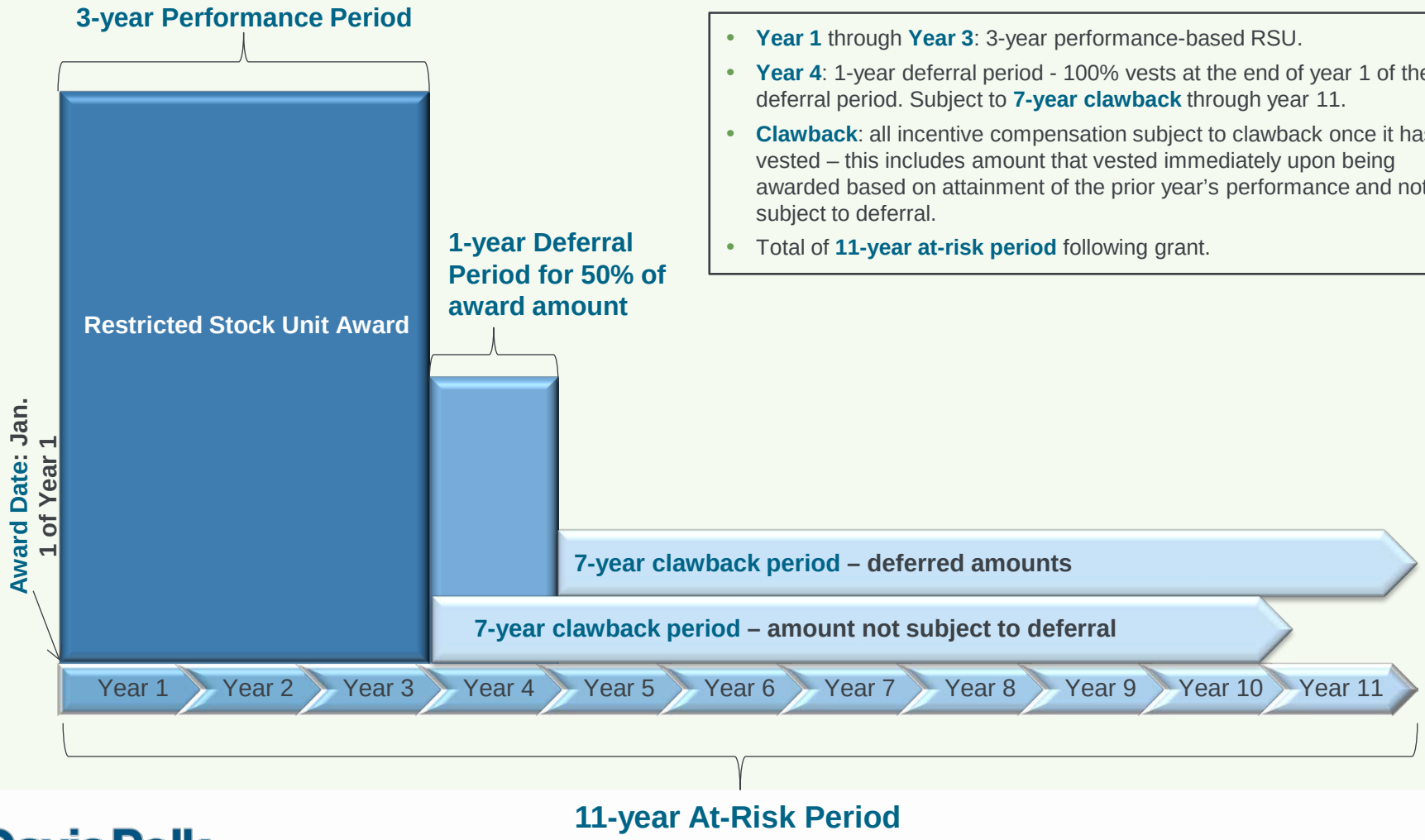
Long-Term Arrangement - Level 2

Senior Executive Officer – Long-Term Award
Based on 3-Year Performance Period

- **Year 1** through **Year 3**: 3-year performance-based RSU.
- **Year 4**: 1-year deferral period - 100% vests at the end of year 1 of the deferral period. Subject to **7-year clawback** through year 11.
- **Clawback**: all incentive compensation subject to clawback once it has vested – this includes amount that vested immediately upon being awarded based on attainment of the prior year's performance and not subject to deferral.
- Total of **11-year at-risk period** following grant.



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Other Enhanced Requirements
Level 1 and Level 2 Institutions

- Recap: In addition to the requirements discussed above the proposed rule would impose the following compensation structuring requirements on Level 1 and Level 2 financial institutions:
  - Maximum incentive compensation opportunity limit
    - 125% of target for senior executive officers
    - 150% of target for significant risk-takers
  - Limitations on relative performance measures
  - Limitation on volume-driven compensation
  - Anti-hedging requirement

Part 4: Effective Governance

Requirements for All Covered Institutions

- The **board of directors** of a covered institution or a **designated committee** will be required to maintain oversight of the covered institution's incentive compensation program. Oversight should:
  - Provide sufficient detail to enable senior management to translate the incentive compensation program into **objectives**, **plans** and **arrangements** for each line of business and control function.
  - Include overall goals and purposes.
  - Oversee senior management in the development of an incentive compensation program that incentivizes behaviors consistent with the long-term health of the covered institution.
  - Generally should include holding senior management **accountable** for effectively **executing** the covered institution's incentive compensation program and for **communicating** expectations regarding acceptable behaviors and business practices to covered persons.
  - Approve incentive compensation arrangements for senior executive officers, including the amounts of all awards.
  - At the time of vesting, approve payouts under the incentive compensation arrangement.
  - Approve any **material exceptions** or **adjustments** to incentive compensation policies or arrangements for **senior executive officers**.
- **Recordkeeping** and **disclosure**.

Effective Governance

Requirements for Levels 1 and 2

- Stricter governance standards are prescribed for **Level 1** and **Level 2** institutions, which must **establish** a compensation committee composed **solely** of directors who are **not** senior executive officers and that has certain **ongoing** and **periodic** responsibilities.

Compensation Committee Responsibilities

Ongoing

Assist the Board

- Assist the board with
  - Its **oversight** of the incentive compensation program
  - **Approval** of incentive compensation for senior executive officers and
  - Approval of any **material exceptions** or adjustments to incentive policies or arrangements for senior executive officers

Obtain Input

- Obtain input on the effectiveness of risk measures and adjustments used to balance risk and reward from
  - **Risk committee**
  - **Audit committee** and
  - **Risk management** function

Periodic

Written Assessment

- Obtain a written assessment on the effectiveness of the incentive compensation program and related compliance and control processes **by management** with **input** from
  - **Risk** and **audit committees** and
  - **Risk management** and **audit functions**

Independent Written Assessment

- Obtain a written assessment on the effectiveness of the incentive compensation program and related compliance and control processes **by** the **internal audit** or **risk management function independent** of the covered institution's management

Many covered institutions already make use of compensation committees at the parent level. The required standards are a significant expansion of the role of the compensation committee as to the number of covered individuals.

While covered institutions that are subsidiaries of other covered institutions may rely on their parent's effective governance, the regulators responsible for examination and enforcement of such subsidiaries still require corrective action to ensure compliance.

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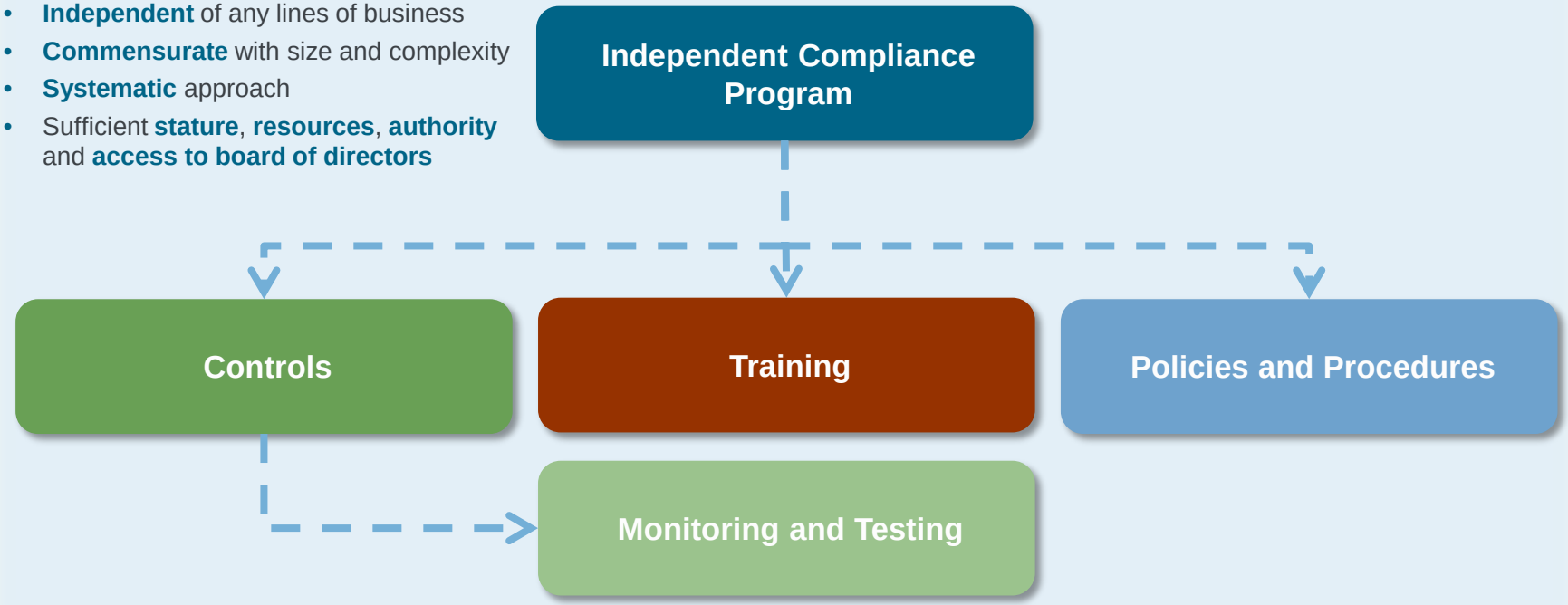
Level 1 and Level 2 Risk Management Framework

- The proposed rule requires that incentive compensation arrangements be compatible with **effective risk management and controls**.
- **Level 1 and Level 2** institutions are required to establish a **risk management framework** that includes an **independent compliance program** consisting of controls, including monitoring and testing, training and policies and procedures.

Risk Management Framework

- **Independent** of any lines of business
- **Commensurate** with size and complexity
- **Systematic** approach
- Sufficient **stature**, **resources**, **authority** and **access to board of directors**



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