Incentive Compensation for Financial Institutions: Reproposal
Visual Memorandum
Updated May 12, 2016
This visual memorandum does not cover credit unions, mutual associations, Fannie Mae and Freddie Mac or the Federal Home Loan Banks.

This visual memorandum, originally released as of the morning of May 2, 2016, was updated to reflect the release by the Federal Reserve and the SEC of their versions of the proposed rule.
I. Introduction
Overview

Six Agencies have **jointly** issued a **proposed rule** implementing Dodd-Frank Act Section 956 regarding incentive compensation paid by covered financial institutions. An earlier version of the rule was proposed in 2011.

A joint rule implies that interpretations and supervisory guidance will happen through an interagency working group.

Joint FAQs may develop, as has been the practice with the Volcker Rule, which involves five Agencies (Federal Reserve, FDIC, OCC, SEC and CFTC).

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Davis Polk

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Overview

- 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.
The proposed rule applies **basic requirements** to all covered institutions and **enhanced requirements** to covered institutions with ≥ $50 billion in total average consolidated assets.

**Basic Requirements**
- Prohibition against excessive compensation
- Prohibition against arrangements creating material financial loss
- Board of directors oversight
- Recordkeeping

**Level 1**
Average total consolidated assets ≥ $250 bn

Examples:
- U.S. global systemically important banks (G-SIBs)
- Investment advisors*

**Level 2**
Average total consolidated assets ≥ $50 bn

Examples:
- Regional bank BHCs
- Investment advisors*

**Level 3**
Average total consolidated assets ≥ $1 bn

Examples:
- Community banks
- Small BHCs
- Small broker-dealers
- Investment advisors*

**Enhanced Requirements**
- Downward adjustment and forfeiture
- Mandatory deferral
- Clawback
- Limits on leverage factor
- Mix of equity and cash
- Governance and compliance

Subject to Agency discretion ([page 61](#))

* The SEC estimates that, of covered investment advisors, approximately 18 will be Level 1, 21 will be Level 2 and 630 will be Level 3.
Overview: One-Page Cheat Sheet

### Basic Requirements

**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 (page 55)**. Expanded oversight; must approve incentive compensation arrangements for senior executive officers.

**Recordkeeping (page 60)**. Must be created; retained for 7 years.

### Compensation Structuring

**Deferral (pages 36-40)**. 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 (page 41)**. 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 (pages 42-43)**. 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 (page 50)**. Limits awards in excess of target: 125% of target for senior executive officers; 150% of target for a significant risk-taker.

**Equity compensation (page 40)**. 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 (page 57)**. 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 (page xx) and is commensurate with the size and complexity of the institution’s operations.

**Governance (page 56)**. 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 (page 17)**: Any executive officer, employee, director or principal shareholder who receives incentive compensation.

**Senior executive officer (pages 18-19)**: 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 (pages 20-23)** – 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.
II. Covered Institutions
Covered Institutions
Overview

Covered Institutions are the following with > $1 billion in consolidated assets

<table>
<thead>
<tr>
<th>Agency</th>
<th>Covered Institutions</th>
<th>Subsidiaries Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve</td>
<td>- Bank holding companies (BHCs)</td>
<td>And their subsidiaries*, excluding merchant banking portfolio companies and debt previously contracted (DPC) companies</td>
</tr>
<tr>
<td></td>
<td>- Savings and loan holding companies (SHLCs)</td>
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<td></td>
<td>- State member banks</td>
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<td></td>
<td>- Non-depository member trust companies</td>
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<tr>
<td></td>
<td>- Edge and agreement corporations</td>
<td></td>
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<tr>
<td></td>
<td>- U.S. operations of a foreign banking organization (FBO)</td>
<td>And their U.S. subsidiaries*</td>
</tr>
<tr>
<td></td>
<td>- State-licensed uninsured branch or agency of a foreign bank</td>
<td></td>
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<tr>
<td>FDIC</td>
<td>- State nonmember banks</td>
<td></td>
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<tr>
<td></td>
<td>- State savings associations</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- State insured branches of a foreign bank</td>
<td></td>
</tr>
<tr>
<td>OCC</td>
<td>- National banks</td>
<td>And their subsidiaries*</td>
</tr>
<tr>
<td></td>
<td>- Federal savings associations,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Federal branches or agencies of a foreign bank (insured and uninsured)</td>
<td></td>
</tr>
<tr>
<td>SEC</td>
<td>- Registered broker or dealer</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Investment advisor</td>
<td></td>
</tr>
</tbody>
</table>

* Subsidiaries that are covered institutions under another Agency’s rule will be functionally regulated by that Agency for the purposes of the proposed rule.
Covered Institutions
Overview

- **Consolidation principle.** Covered institutions that are subsidiaries of other covered institutions generally take on the level of their top-tier parent rather than the level that would apply to them based on their own assets.

  - **SEC variant.** The SEC’s proposal will not apply the consolidation principle to covered subsidiaries of covered institutions defined under the SEC’s rules, i.e., subsidiaries of broker-dealers and investment advisors with assets of $1 billion or more.

- **Supervision, examination and enforcement authority.** Each functional regulator will be able to supervise, examine and enforce the covered institutions which it regulates.

  - Subsidiaries of covered institutions that are also covered institutions will be covered under a different Agency’s rule from that of their direct parent or indirect parent, in which case they would be subject to supervision by a different regulator.

- **Cooperation.** The system is set up in a manner similar to the Volcker Rule and the Agencies have suggested they will cooperate.
Covered Institutions

Example: Broker-Dealers – Unaffiliated with a Bank

Broker-dealers registered under the Exchange Act of 1934 with ≥ $1 billion in total average total consolidated assets are covered institutions.

- **Holding Company** (no bank subsidiaries)
- **Broker-Dealer** ≥ $1bn
- **Service Company** ≥ $1bn
- **Non-Financial Operating Company** ≥ $1bn

Many broker-dealers are subsidiaries of holding companies. These holding companies are not covered by the rule.

Covered Institutions
Not Covered Institutions

Compensation Supervisory Regulator
- Federal Reserve
- FDIC
- SEC
- OCC

Click here to return to table of contents
Investment Advisors ≥ $1 billion in average total consolidated assets (excluding non-proprietary assets*) are covered institutions.

**Example 1**

- **Investment Advisor** ≥ $1bn
  - Non-Controlled Funds
    - Investment Fund/Client
    - Investment Fund/Client

**Example 2**

- **Asset Manager that is exempt from registration but falls within definition of Investment Advisor >$1bn**
  - Investment Fund/Client
  - Investment Fund/Client

**Example 3**

- **Investment Advisor** Balance sheet assets >$1bn
  - Excluding non-proprietary assets (funds that are consolidated with the investment advisor because, e.g. it controls them)
  - Controlled Funds
    - Investment Fund/Client ≥ $1b
    - Investment Fund/Client ≥ $1b

**Example 4**

- **Asset Manager excluded from definition of Investment Advisor ≥ $1bn**
  - Investment Fund/Client
  - Investment Fund/Client

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* The Supplemental Information states that the SEC will take the view that investment advisors should include only proprietary assets in the calculation of total consolidated assets, and that non-proprietary assets, such as client assets under management should not be included, regardless of whether they appear on an investment advisor's balance sheet.

**Covered Institutions**

- Federal Reserve
- FDIC
- SEC
- OCC

**Not Covered Institutions**

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Click here to return to table of contents
BHCs ≥ $1 billion in average total consolidated assets are covered institutions – as are their subsidiaries that are ≥ $1 billion (but, for some subsidiaries, another regulator may have primary supervisory authority under the proposed rule).

Under the consolidation principle, all of the subsidiaries that are covered institutions will be treated at the level of the top-tier holding company.

* This organizational chart does not represent all possible outcomes for a BHC and its subsidiaries. Certain characteristics of how the rule applies to an FBO’s organizational structure may be clarified when the Federal Reserve approves its version of the proposal.
# Calculating Average Total Consolidated Assets

## Existing Regulatory Reports

<table>
<thead>
<tr>
<th>Regulator</th>
<th>Covered Institutions</th>
<th>Regulatory report for determining average of the total consolidated assets for the four most recent consecutive quarters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve</td>
<td>BHCs</td>
<td>Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)</td>
</tr>
<tr>
<td></td>
<td>SHLCs</td>
<td>FR Y-9C, Quarterly Savings and Loan Holding Company Report (FR 2320) or a report of average total consolidated assets filed on a quarterly basis</td>
</tr>
<tr>
<td></td>
<td>State member banks</td>
<td>Reports of Condition and Income (Call Report)</td>
</tr>
<tr>
<td></td>
<td>Edge and agreement corporations</td>
<td>Consolidated Report of Condition and Income for Edge and Agreement Corporations (FR 2886b)</td>
</tr>
<tr>
<td></td>
<td>U.S. operations of an FBO</td>
<td>Capital and Asset Report for Foreign Banking Organizations (FR Y-7Q); Modification of FR Y-7Q to include 2(h)(2) subsidiaries or creation of new report</td>
</tr>
<tr>
<td></td>
<td>State-licensed uninsured branch or agency of a foreign bank, non-depository member trust companies</td>
<td>Unknown</td>
</tr>
<tr>
<td>FDIC</td>
<td>State nonmember banks, state savings associations</td>
<td>Call Report</td>
</tr>
<tr>
<td></td>
<td>State insured branches of a foreign bank</td>
<td>Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002)</td>
</tr>
<tr>
<td>OCC</td>
<td>National banks, Federal savings associations</td>
<td>Call Report</td>
</tr>
<tr>
<td></td>
<td>Federal branches or agencies of a foreign bank</td>
<td>FFIEC 002</td>
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<tr>
<td>SEC</td>
<td>Registered broker or dealer</td>
<td>FOCUS Report</td>
</tr>
<tr>
<td></td>
<td>Investment advisor</td>
<td>Total assets (excluding non-proprietary assets) shown on the balance sheet for the most recent fiscal year end</td>
</tr>
</tbody>
</table>
## Calculating Average Total Consolidated Assets
### Modified or New Regulatory Reports

<table>
<thead>
<tr>
<th>Regulator</th>
<th>Covered Institutions</th>
<th>Modified or new regulatory report for determining average of the total consolidated assets for the most recent quarter or consecutive quarters available</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve</td>
<td>Subsidiaries of BHCs and SHLCs*</td>
<td>A report prepared by the parent, in a form acceptable to the Federal Reserve</td>
</tr>
<tr>
<td></td>
<td>U.S. subsidiaries of FBOs*</td>
<td>A report prepared by the parent, in a form acceptable to the Federal Reserve</td>
</tr>
<tr>
<td>FDIC</td>
<td>Subsidiaries of state nonmember banks, state savings associations or state insured branches of a foreign bank*</td>
<td>Not specified</td>
</tr>
<tr>
<td>OCC</td>
<td>Subsidiaries of national banks, Federal savings associations, or Federal branches or agencies of a foreign bank*</td>
<td>A report prepared by the subsidiary or its parent, in a form acceptable to the OCC</td>
</tr>
</tbody>
</table>

* Not including subsidiaries that have their own functional regulator, in which case the relevant regulatory report is determined under that Agency’s rule.
Determination of Level Transition Rules

- **Upgrading.**
  - **Designation Date:** The date the average of total consolidated assets over the last four quarters equals or exceeds the Level 1 ($250bn), Level 2 ($50bn) or Level 3 ($1bn) thresholds.
  - **Compliance:** Must begin no later than the first day of the first calendar quarter that begins at least 540 days after the designation date (18 months).
  - **Grandfathering:** Covered institutions are not required to comply with the proposed rule with respect to compensation plans with a performance period that began before the designation date.

- **Downgrading.**
  - **De-designation Date:** The date of the regulatory report when total consolidated assets is below the Level 1 ($250bn), Level 2 ($50bn) or Level 3 ($1bn) thresholds for each of four preceding consecutive quarters.
  - **Compliance:** Ends on the de-designation date.

An institution may face upgrading even if total consolidated assets were below the threshold for some quarters, because this test looks at the average.

To be downgraded, total consolidated assets cannot have exceeded the threshold in any of the preceding four quarters.
III. Covered Persons
## Covered Persons

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Covered Persons</th>
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</thead>
<tbody>
<tr>
<td><strong>Basic Requirements</strong> (pages 28-31)</td>
<td>▪ Executive officers&lt;br&gt; ▪ Employees&lt;br&gt; ▪ Directors&lt;br&gt; ▪ Principal shareholders</td>
</tr>
<tr>
<td><strong>Enhanced Requirements</strong> (pages 32-53)</td>
<td>▪ Senior executive officers (pages 18-19)&lt;br&gt; ▪ Significant risk-takers (page 20-23)</td>
</tr>
</tbody>
</table>

- **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.
Covered Persons
Senior Executive Officers

- The enhanced requirements applicable to Level 1 and 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.
Covered Persons
Senior Executive Officers–Dual Hatted Employees

- **Dual-hatted employees.** The proposed rule covers senior executive officers employed by a different entity if they perform the role of a senior executive officer for that covered institution.

**Example 1**
A chief financial officer employed by BHC who performs the function of chief financial officer for the BHC’s subsidiaries would be a covered person for each entity.

**Example 2**
The president of a broker-dealer that is not a covered institution below the asset threshold but that is considered to be a major business line its parent BHC would be a covered person for the BHC.
Enhanced requirements applicable only 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 or 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? *(page 21)*

### 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? *(page 22)*

### 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? *(page 23)*

### 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?

If all conditions are met, the person is a Significant Risk-Taker.

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Covered Persons
Significant Risk-Takers

- **Divide** incentive compensation by total compensation, or the sum of annual base salary and incentive compensation but excluding fringe benefits such as the value of medical insurance or the use of a company car.

- Consider only salary **actually paid** during the calendar year.

  **Example**: The amount actually paid to a manager with an annual salary of $100,000 during the first half of the year and an annual salary of $150,000 during the second half of the year would be $125,000.

- 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, 2021, count compensation as of December 31, 2019.

  

<table>
<thead>
<tr>
<th>Look back to last calendar year</th>
<th>180 days</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/2019</td>
<td>07/05/2020</td>
</tr>
<tr>
<td>07/05/2020</td>
<td>01/01/2021</td>
</tr>
<tr>
<td>01/01/2021</td>
<td>Beginning of Performance Period</td>
</tr>
</tbody>
</table>

Total compensation in the proposed rule differs from total compensation in the Proxy Summary Compensation Table under Item 402 of SEC Regulation S-K.

**Example**: If individual receives salary of $500,000, an annual bonus of $750,000, equity compensation of $750,000, and perks worth $20,000, so that

- Total Comp = $2,000,000 and
- Incentive Comp. = $1,500,000,

Then the one-third threshold is met because:

\[
\frac{1,500,000}{2,000,000} = \frac{3}{4} > \frac{1}{3}
\]
Covered Persons
Significant Risk-Takers

Relative Compensation Test

- Rank all covered persons who are not senior executive officers by compensation.
- The ranking would include all persons at the covered institution and covered affiliates but would not include persons at an affiliate that is not a covered affiliate.
- For Level 1 institutions, the top 5% of highest compensated persons on that list will be considered significant risk-takers.
  - The Agencies have the discretion to, in certain circumstances, limit the size of this pool to the top 2 percent of highest compensated persons (page 61).
- For Level 2 institutions, the top 2% of highest compensated persons on that list will be considered significant risk-takers.

As an alternative to the relative compensation test, the Agencies invite comment on a dollar threshold test, under which covered persons whose total compensation exceeds a specific dollar threshold would be considered significant risk-takers. Total compensation under this alternative would be calculated in the same manner as it is calculated under the proposed rule for purposes of determining whether incentive compensation equals or exceeds one-third of total compensation.

The EU remuneration rules include a threshold amount of €500,000 as part of the determination as to whether an individual is a material risk-taker. Whether a relative compensation test is preferable to a dollar threshold test may depend on the covered institution’s tier.
Covered Persons
Significant Risk-Takers

Exposure Test

- A covered person who has the authority to commit or expose \(0.5\%\) or more of the capital of the covered institution or a covered affiliate. This test includes a covered person who is a voting member of a committee with such authority.

- **Commit or expose:** Ability to put the capital at risk of loss due to market risk or credit risk, regardless of whether or not such exposures or commitments are realized.

- **Authority:** Measured over the course of the calendar year, even if such authority is not provided in any single transaction or time period.
  - Daily maximum exposures would be multiplied by the number of days in the year such exposures could be realized.

  **Example:** \[ \text{Daily Exposure Limit} \times \text{Trading Days} = \text{Yearly Exposure} \]

  - If there is no specific maximum exposure allowed for the year, and the covered person’s exposure is subject to approval on a rolling basis, such person is assumed to have such authority in excess of \(0.5\%\).

- A covered person may be a significant risk-taker with respect to a covered institution even if not directly employed by such covered institution but instead employed by an affiliate. The exposure test could thus apply to an individual who is employed by an affiliate that is not itself a covered institution.

  This test relates solely to a covered person’s ability to subject such capital to **credit risk** or **market risk** and does not cover other types of risk, such as compliance risk, which may be difficult to measure or quantify.
III. Covered Compensation
Covered Compensation

Compensation

- Compensation, fees or benefits, or all direct and indirect payments, both cash and non-cash, awarded to, granted to or earned by or for the benefit of, any covered person in exchange for services rendered to the covered institution, regardless of form of payment. The Agencies in the preamble note that compensation:
  - Includes payments or benefits pursuant to an employment contract, compensation, pension or benefit agreements, fee arrangements, perquisites, options, post-employment benefits and other compensatory arrangements.
  - Excludes reimbursement for reasonable and proper costs incurred by persons in carrying out the covered institution’s business.

Incentive Compensation

- Any variable compensation, fees or benefits that serve as incentive or reward for performance, whether in the form of cash, equity-like instruments or any other form of payment. The Agencies in the preamble note that incentive compensation:
  - Includes incentive plans, annual bonuses and discretionary awards.
  - Excludes compensation paid for reasons other than to induce performance, including:
    - Salary or retention awards conditioned solely on continued employment
    - Signing or hiring bonuses not conditioned on performance
    - Payments for achieving or maintaining a professional certification or higher level of education
    - Employer contributions to a 401(k) retirement savings plan
    - Dividends paid and appreciation realized on stock or other equity-like instruments owned outright (although stock or equity-like instruments awarded would not be considered owned outright while subject to any vesting or deferral)
Covered Compensation: 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.
V. Compensation Structuring
A. Basic Requirements Applicable to All Covered Institutions
### 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**

<table>
<thead>
<tr>
<th>Excessive Compensation</th>
<th>Material Financial Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amounts paid that are <strong>unreasonable</strong> or <strong>disproportionate</strong> to the value of the services performed by the covered person.</td>
<td>An incentive compensation arrangement at a covered institution will be deemed to encourage inappropriate risks that could lead to a <strong>material financial loss</strong> unless the arrangement:</td>
</tr>
<tr>
<td>Determination based on all relevant factors, including:</td>
<td>• Appropriately balances risk and reward</td>
</tr>
<tr>
<td>• Combined value of all compensation, fees, or benefits provided to the covered person</td>
<td>• Is compatible with effective risk management and controls and</td>
</tr>
<tr>
<td>• Compensation history of the covered person and other individuals with comparable expertise at the covered institution</td>
<td>• Is supported by effective governance</td>
</tr>
<tr>
<td>• Financial condition of the covered institution</td>
<td></td>
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<tr>
<td>• Compensation practices at comparable covered institutions based on asset size, geographic location and complexity of the covered institution’s operations and assets</td>
<td></td>
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<tr>
<td>• For post-employment benefits, the projected total cost and benefit to the covered institution and</td>
<td></td>
</tr>
<tr>
<td>• 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.</td>
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</tr>
</tbody>
</table>

This framework is little-changed from the 2011 proposed rule.
Incentive compensation arrangement will not be considered to appropriately balance risk and reward, unless performance goals incorporate the following concepts:

- Arrangement includes financial and non-financial measures of performance, including considerations of risk-taking relevant to a covered person’s role within a covered institution and to the type of business in which the covered person is engaged and are appropriately weighted to reflect risk-taking.

  - **Financial measures:**
    - Tied to the attainment of strategic financial objectives
    - Contributions by covered persons towards the attainment of strategic financial objectives, such as measures related to corporate sales, profit or revenue targets

  - **Non-financial measures:**
    - Assessments of a covered person’s risk-taking or compliance with limits on risk-taking
    - Assessments of compliance with the policies and procedures
    - Adherence to the risk framework and conduct standards
    - Compliance with applicable laws
    - Considerations of risk-taking that are relevant to the covered person’s role and the type of business in which the covered person is engaged

- **Non-financial measures of performance** may override financial measures of performance when appropriate in determining incentive compensation 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.

May lead to scorecard approach for performance metrics. This is contrary to shareholder activism trend which focuses exclusively on financial measures, such as TSR.

The use of performance measures that are closely tied to short-term revenue or profit, without adjustments for the longer-term risks, could encourage inappropriate risk-taking.

Similarly, if there is no mechanism for factoring risk outcomes over a longer period of time into compensation decisions, traders who have incentive compensation plans with performance periods which close at the end of the year, could be incentivized to take large risks toward the end of the calendar year to either make up for underperformance earlier in the performance period or to maximize their year-end profit.
Incentive compensation arrangements generally would have to take account of the full range of current and potential risks that a covered person’s activities could pose for a covered institution.

Performance and risk measures generally should align with the broader risk management objectives of the covered institution and could be incorporated through the use of a formula or through the exercise of judgment.

Performance and risk measures may play a role in setting amounts of bonus pools, in allocating pools to individuals and incentive compensation or both.

Relevant risks may vary by covered institution, but could include:
- Credit
- Market (including interest rate and price)
- Liquidity
- Operational
- Legal
- Strategic
- Compliance

Relevant risks should be tailored to the size, complexity, business strategy and risk tolerance of each covered institution.

Incentive compensation programs should be supported by effective governance and compliance (pages 54-60).
B. Enhanced Requirements Applicable to Level 1 and 2 Institutions
Enhanced Requirements
Level 1 and Level 2 Institutions

- Proposed rule would impose **stricter** requirements for compensation structuring on larger financial institutions, including Level 1 and Level 2 institutions.
  - Downward adjustment
  - Deferral
  - Forfeiture
  - Clawback
  - Substantial portion of deferred cash and equity-like instruments
  - Limitations on options
  - Maximum incentive compensation opportunity limit
  - Limitations on relative performance measures
  - Limitation on volume-driven compensation
  - Anti-hedging requirement
**Downward Adjustment, Deferral, Forfeiture and Clawback**

**Award**
Under the proposed rule, to **award** refers to a final determination about incentive compensation based on a performance period, communicated to the covered person. This differs from the common use of the term award, which generally means to grant equity compensation prior to or shortly after the commencement of a performance period.

**Downward adjustment**
This term refers to a reduction of the amount of a covered person's incentive compensation for any performance period that has already begun but before such incentive compensation has been **awarded**.

**Vesting**
Under the proposed rule, **vesting** of incentive compensation occurs after it has been **awarded** and means the transfer of ownership of such compensation to the covered person where such person’s right to receive the incentive compensation is no longer contingent on the occurrence of any event. After it has been **awarded**, a certain percentage of the incentive compensation must be subject to a deferral period, while the remainder can vest immediately. The proposed rule’s use of the term **vest** differs from the way in which the term is commonly used. Vesting is generally said to occur at the end of a service period for a time-based award and a performance period for a performance-based award, without regard to a subsequent deferral period.

**Forfeiture**
This refers to a reduction of the amount of incentive compensation that has been **awarded** and **deferred** but which has not yet **vested**.

**Clawback**
This refers to a mechanism by which a covered institution can recover incentive compensation that has already **vested** if certain events occur.

---

**Performance Period**
- Award Date
- Incentive Compensation may be Subject to Downward Adjustment

**Deferral Period**
- Vesting Date
- Award may be Subject to Forfeiture Before Vesting

**Clawback Period**
- Vested Award may be Subject to Clawback

**Click here to return to table of contents**
Downward Adjustment

Pre-Award—Subject to Downward Adjustment

- Period of time before final award is determined.
  - This period relates to the time that the incentive compensation is subject to a performance period and performance criteria.
- During this time, 100% of incentive compensation will be subject to downward adjustment review based on certain triggering events.
- Upon the conclusion of the performance period, incentive compensation awarded will either immediately vest or will be subject to a post-award deferral period based on the deferral requirements (pages 36 - 41).

Example: For a senior executive officer at a Level 1 institution, 60% of the amount awarded under a short-term award will be deferred for a minimum period of 4 years with pro-rata vesting each year, while the remaining amount will vest immediately (page 44).
Deferral

- Deferral is the period of time after the incentive compensation has been awarded to the covered person but before vesting occurs.

- Factors affecting minimum required deferral amount and minimum required deferral period:
  - Size of the covered institution – Level 1 or Level 2.
  - Type of covered person – senior executive officer or significant risk-taker.
  - Type of incentive compensation – qualifying incentive compensation (i.e., short-term award) or awarded under a long-term incentive plan.

- Graduated vesting from deferral period permitted with a minimum one year vesting period.

- 100% of incentive compensation required to be deferred will be subject to forfeiture during the post-award deferral period based on certain triggering events.
# Deferral

## Performance Period → Deferral Period → Clawback Period

<table>
<thead>
<tr>
<th>Level 1</th>
<th>Level 2</th>
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<tbody>
<tr>
<td>Minimum Deferral</td>
<td>Minimum Time Period</td>
</tr>
<tr>
<td><strong>Senior Executive Officer</strong></td>
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<tr>
<td>60%</td>
<td>Short-Term Award</td>
</tr>
<tr>
<td></td>
<td>Long Term Award</td>
</tr>
<tr>
<td><strong>Significant Risk-Taker</strong></td>
<td></td>
</tr>
<tr>
<td>50%</td>
<td>Short Term Award</td>
</tr>
<tr>
<td></td>
<td>Long Term Award</td>
</tr>
</tbody>
</table>
Deferral

- Deferral of incentive compensation of senior executive officers and significant risk-takers would also be required to meet the following requirements:
  - Deferred amounts may **not** be increased during the deferral period
  - For covered institutions that issue equity, **substantial portions** of deferred incentive compensation must be paid in the form of **deferred cash** and **equity-like instruments**
  - All deferrals will be limited in the amount of stock options that can be used to meet the deferral requirement
  - All deferrals must be subject to a **forfeiture review**.
- Covered institutions would be required to consider reducing some or all of a senior executive officer’s or significant risk-taker’s incentive compensation when the covered institution becomes aware of **inappropriate risk-taking** or other aspects of behavior that could lead to **material financial loss**.
- Amounts reduced would depend upon the **severity** of the event, the **impact** of the event on the covered institution, and the **actions** of the senior executive officer or significant risk-taker in the event.
Deferral
Example: Qualifying Incentive Compensation (i.e. Short-Term Award)

- 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 (page 49)**.

- **Example**: Level 1 senior executive officer is awarded an annual bonus of $300,000. He or she can receive 40% (i.e., $120,000) immediately, but must defer 60% (i.e., $180,000) for 4 years. Permissible vesting schedule (i.e., actual payment schedule):

<table>
<thead>
<tr>
<th>Performance Period</th>
<th>Deferral Period</th>
<th>Clawback Period</th>
</tr>
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<tbody>
<tr>
<td>$45,000 each year over 4 years</td>
<td>$90,000 each year over 2 years</td>
<td></td>
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<tr>
<td>20% in year 2 and 40% in each of years 3 and 4</td>
<td>40% in year 1 and 30% in each of years 2 and 3</td>
<td></td>
</tr>
<tr>
<td>50% in year 2 and 50% in year 4</td>
<td>50% in year 1 and 50% in year 3</td>
<td></td>
</tr>
<tr>
<td>100% in year 4</td>
<td>100% in year 3</td>
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</tbody>
</table>
Mandatory 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**

<table>
<thead>
<tr>
<th>Performance Period</th>
<th>Deferral Period</th>
<th>Clawback Period</th>
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</thead>
<tbody>
<tr>
<td>Level 1 and Level 2 institutions must consider <strong>downward adjustment</strong> and <strong>forfeiture</strong> upon the occurrence of certain <strong>triggering events:</strong></td>
<td>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:</td>
<td></td>
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<tr>
<td>▪ Poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered institution’s policies and procedures</td>
<td>▪ <strong>Intent</strong> 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</td>
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</tr>
<tr>
<td>▪ Inappropriate risk-taking, regardless of the impact on financial performance</td>
<td>▪ Senior executive officer’s or significant risk-taker’s level of participation in, awareness of, and responsibility for, the events triggering the review</td>
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</tr>
<tr>
<td>▪ Material risk management or control failures and</td>
<td>▪ Any actions the senior executive officer or significant risk-taker took or could have taken to prevent the events triggering review</td>
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</tr>
<tr>
<td>▪ 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</td>
<td>▪ The financial 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</td>
<td></td>
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<tr>
<td>▪ Additional triggers defined by the covered institution</td>
<td>▪ The causes of the events triggering the review, including any decision-making by other individuals and</td>
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</tr>
<tr>
<td>▪ 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.</td>
<td>▪ Any other relevant information, including past behavior and risk outcomes attributable to the senior executive officer or significant risk-taker.</td>
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</table>
Clawback

- **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

- 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.

- Covered institutions may include other circumstances or outcomes that would trigger additional use of such provisions.

- Whether a covered institution seeks recovery from a senior executive officer or significant risk-taker would be based on all relevant information.

- The proposed rule does not require covered institutions to exercise the clawback provision nor dictate the process that covered institutions should use to recover vested incentive compensation.
Qualifying Incentive Compensation – Level 1
Senior Executive Officer – 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 4**: 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 **11-year at-risk period** following award.
Long-Term Arrangement - Level 1

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

- Year 1 through Year 3: 3-year performance-based RSU.
- Year 4 through Year 5: 2-year deferral period.
  - **Tranche 1**: 50% vests at the end of Year 1 of the deferral period.
    - Subject to **7-year clawback** through year 11.
  - **Tranche 2**: Remaining 50% vests at the end of Year 2 of the deferral period.
    - Subject to **7-year clawback** through Year 12.
- **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 up to **12-year at-risk period** following grant.
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.

**Tranche 1**
- 3-year Deferral Period for 40% of award amount
- 7-year clawback period – Tranche 3
- 7-year clawback period – Tranche 2
- 7-year clawback period – Tranche 1
- 7-year clawback period – amount not subject to deferral

**Award Date**: Jan. 1 of Year 1

**10-Year At-Risk Period**
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.

11-year At-Risk Period

Award Date: Jan. 1 of Year 1

3-year Performance Period

1-year Deferral Period for 50% of award amount

Restricted Stock Unit Award

7-year clawback period – deferred amounts

7-year clawback period – amount not subject to deferral
## Existing Clawback Provisions in Other Laws

<table>
<thead>
<tr>
<th>Federal Regulation</th>
<th>Applicable Clawback Provision</th>
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<tbody>
<tr>
<td><strong>Section 304 of Sarbanes-Oxley</strong></td>
<td><strong>Financial Restatement; Fault; CEO and CFO:</strong> If an issuer is required to restate its financial statements due to a material noncompliance of the issuer as a result of misconduct with any financial reporting requirements under the securities laws, the CEO and CFO must reimburse the issuer for (1) any bonus or other incentive compensation or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC of the financial document embodying such financial reporting requirement and (2) any profits realized from the sale of securities of the issuer during the 12-month period.</td>
</tr>
<tr>
<td><strong>Section 954 of Dodd-Frank (Section 10D of the Securities Exchange Act of 1934)</strong></td>
<td><strong>Financial Restatement; No Fault:</strong> If an issuer is required to restate its financial statements, the issuer will recover from any of the issuer’s current or former executive officers who received incentive compensation during the previous three years.</td>
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* Pending. The SEC has proposed a rule, as required under the Dodd-Frank Act, but it has yet to be finalized. After it is finalized, the national securities exchanges will be required to propose and finalize implementing listing standards.*
Prohibition on Acceleration of Vesting

- The proposed rule would only allow acceleration of vesting due to death or disability of the covered person.

- The proposed rule would thus preclude acceleration following a change of control or under a severance agreement.
  - Entering into government service will no longer be an acceptable triggering event for acceleration of an award.

- Agencies believe acceleration of deferred compensation under most circumstances has the potential to undermine risk-balancing mechanisms.

- The prohibition, however, would not apply to compensation that the employee or employer elects to defer in excess of the amounts required under the proposed rule or for time periods that exceed the required deferral periods or in certain other limited circumstances.

Under the proposed rule, accelerated vesting in connection with a change of control will not be permitted. This could create issues for all-stock deals where equity awards cannot be rolled over.
Limitation on Leverage

- Prohibits a Level 1 or Level 2 institution from awarding incentive compensation above targets established at the beginning of the performance period:
  - **senior executive officer**: cannot award compensation >125% of target
  - **significant risk-taker**: cannot award compensation >150% of target

- This limitation would apply on a **plan-by-plan basis**, and therefore, would apply to long-term incentive plans separately from other incentive compensation plans.

- The Agencies' view is that high levels of upside (e.g., 200% to 300% above target amounts) could lead to senior executive officers or significant risk-takers taking inappropriate risks to maximize the opportunity to double or triple their incentive compensation.

- The Agencies emphasized that the proposed limitations on the maximum incentive compensation award opportunities would not equate to a **ceiling** on overall incentive compensation, only a limit on the percentage by which incentive compensation could exceed the target amount.

- Increases in the amount of awarded incentive compensation due to changes in share value, changes in interest rates or the payment of reasonable interest or a reasonable rate of return would not be counted as increases in the target award amount.
Limitation on Relative Performance Measures

- Prohibition on incentive compensation arrangements based solely on industry peer performance comparisons (e.g., relative performance metrics).
  - Applies to all covered persons at Level 1 and Level 2 institutions, not only senior executive officers and significant risk-takers.

- Level 1 and Level 2 institutions would be permitted to use relative performance measures in combination with absolute performance measures such as total shareholder return, but not in isolation.
  - Institution-specific performance measures (e.g., earnings per share, return on tangible common equity) along with relative total shareholder return would be permissible.
Limitation on Volume-Driven Compensation

- Prohibition on incentive compensation that is based **solely** on **transaction** or **revenue volume** without regard to **transaction quality** or the **compliance** of the covered person with **sound risk management**.
  - Applies to **all covered persons** at Level 1 and Level 2 institutions, not only senior executive officers and significant risk-takers.

- Transaction or revenue volume could be a factor in incentive compensation arrangements, but only in combination with other factors designed to cause the covered person to account for the risks of their activities.
Anti-Hedging Requirement

- Prohibition on purchasing **hedging** or **similar instruments** on behalf of covered persons to hedge or offset any decrease in the value of the covered person’s incentive compensation.
  - Applies to **all covered persons** at Level 1 and Level 2 institutions, not only senior executive officers and significant risk-takers.
- The Agencies’ view is that hedging strategies may undermine the effect of risk-balancing mechanisms such as downward adjustment, deferral and forfeiture, or may otherwise negatively affect the goals of the risk-balancing mechanisms and their overall efficacy in inhibiting inappropriate risk-taking.
VII. Effective Governance and Compliance
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.
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

<table>
<thead>
<tr>
<th>Ongoing</th>
<th>Periodic</th>
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<tbody>
<tr>
<td><strong>Assist the Board</strong></td>
<td><strong>Written Assessment</strong></td>
</tr>
</tbody>
</table>
| - 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 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** |

| | **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 |

| | **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.
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

**Independent Compliance Program**

**Controls** (page 58)

**Training** (page 58)

**Policies and Procedures** (page 59)

**Monitoring and Testing** (page 58)
Risk Management Framework
Controls and Training

Controls

- Individuals engaged in control functions must have the authority to influence the risk-taking of the business areas they monitor
- Covered persons engaged in control functions must not be compensated in accordance with the performance of the business areas they monitor, and should instead be compensated in accordance with the achievement of performance objectives linked to their control functions
- To be considered independent, individuals engaged in control functions should have a reporting line to senior management or the board that is separate from the covered persons whom the group or person is responsible for monitoring

Monitoring and Testing

- Periodic review of all incentive compensation plans to assess whether those plans provide incentives that appropriately balance risk and reward, aided by systems and processes to collect information and adjust compensation arrangements
- Regular monitoring of events that could trigger a forfeiture and downward adjustment review and any related decisions
- Monitoring of compliance with the covered institution’s policies and procedures
- Monitoring may be done by internal audit

Training

- Communications to employees about compliance risk management standards and policies and procedures
- Communications to managers on expectations regarding risk adjustment and documentation
Policies and procedures must, at minimum

- Be **consistent** with the requirements and prohibitions under the proposed rule
- Specify the substantive and procedural **criteria** for the **application of forfeiture and clawback**, including
  - Process for determining the **amount** clawed back
  - **Notice** to covered persons of the circumstances that would lead to forfeiture and clawback
  - **Clear triggers** that result in consideration of downward adjustment, forfeiture and clawback
  - Which **individuals** or **committees** are **responsible** for identifying, escalating and resolving such cases
  - Contribution of input and **participation by control functions** in any such decisions
  - Clear processes for **determination of responsibility**
  - Contribution of **input from covered employees** under consideration for forfeiture and clawback
- Require the maintenance of **documentation** of downward adjustment, forfeiture and clawback decisions
- Specify the substantive and procedural **criteria for acceleration of payments**, including how a disability would be evaluated
- Identify and describe the role of employees, committees or groups **authorized to make** compensation decisions, including when such **discretion is authorized** and how discretion is expected to be exercised
- Require maintenance of **documentation** of the establishment, implementation, modification and monitoring of incentive compensation arrangements
- Describe how incentive compensation arrangements will be **monitored**
- Specify the substantive and procedural requirements of the **independent compliance program**
- Address the appropriate **roles** for risk management, risk oversight and other control function personnel **in designing compensation arrangements** and **assessing the effectiveness** of those arrangements in restraining inappropriate risk-taking

Covered institutions with international operations might choose to adopt **enterprise-wide policies** and procedures that **may need to be modified** when used by various subsidiary institutions to reflect local regulation and the requirements of home country regulators.
# Recordkeeping and Disclosure

<table>
<thead>
<tr>
<th>Recordkeeping</th>
<th>Disclosure</th>
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</table>
| **All Covered Institutions** | | Create **annually** and maintain for at least **7 years** records that document the structure of all incentive compensation arrangements.  
- At a minimum, these records must include:  
  - **Copies** of **all** incentive compensation **plans**  
  - A **record** of **who is subject to each plan** and  
  - A **description** of how the incentive compensation program is compatible with effective risk management and controls. | Covered institutions must be able to **disclose** these records to their primary regulators **upon request**.  
- Covered institutions are **not** required to report the actual amount of compensation, fees or benefits of individual covered persons as part of this requirement. |

| **Level 1 and Level 2 Institutions** | | Create **annually** and maintain for at least **7 years** records that document:  
- The covered institutions **senior executive officers** and **significant risk-takers**, listed by legal entity, job function, organizational hierarchy and line of business  
- The **incentive compensation arrangements** for senior executive officers and significant risk-takers, including information on percentage of incentive compensation deferred and form of award  
- Any **downward adjustment**, **forfeiture** or **clawback reviews** and **decisions** for senior executive officers and significant risk-takers and  
- Any material changes to the covered institution’s incentive compensation arrangements and policies.  
- Records must be created and maintained in a way that allows for an **independent audit** of incentive compensation arrangements, policies and procedures. | Level 1 and Level 2 institutions must **disclose** these records to their primary regulators in such form and with such frequency as requested by their primary regulator.  
- Covered institutions are **not** required to report the actual amount of compensation, fees or benefits of individual covered persons as part of this requirement. |
VIII. Broad Agency Discretion
Reservation of Authority to Regulators

Discretion to Reduce Number of Covered Persons at Level 1 Institutions
An Agency may reduce the pool of covered persons by applying a 2%, rather than 5%, threshold under the relative compensation test, if:
- Agency determines that the Level 1 institution’s activities, complexity of operations, risk profile and compensation practices are similar to those of a Level 2 institution.

Factors to consider
In accordance with procedures established by the Agency:
- Activities
- Complexity of operations
- Risk profile
- Compensation practices and
- Any other relevant factors.

Discretion to Impose Stricter Level 1 or 2 Standards to Level 3
An Agency may require a Level 3 institution to comply with some or all of the provisions applicable to Level 2 or Level 1, if:
- Average total consolidated assets ≥ $10 bn and
- Agency determines that the Level 3 institution’s complexity of operations or compensation practices are consistent with those of a Level 1 or Level 2 institution.
If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Federal Deposit Insurance Act Sec. 39(c)  
Required the Federal Reserve, OCC, FDIC and OTS to prescribe standards for all depository institutions prohibiting unsafe and unsound compensatory arrangements that would provide excessive compensation or could lead to material financial distress.

Emergency Economic Stabilization Act  
Imposed compensation restrictions on TARP recipients.

Dodd-Frank Sec. 956  
Required seven federal Agencies to propose an interagency rule subjecting covered financial institutions to prohibitions, deferrals, disclosures and reporting.

2011 Proposal  
PRA’s and FCA’s remuneration rules became effective on June 25, 2015.

2016 Reproposal  
The Agencies repropose Sec. 956 interagency rule, which takes into account changed incentive compensation practices in the financial services industry, supervisory experiences of the Federal Reserve, OCC and FDIC, the FHFA’s experiences in applying compensation related rules and foreign jurisdictions’ compensation rules.

FSB Principles  
The FSB released standards for G-20 member nations to implement principles of sound compensation practices that the FSB had issued earlier that year.

Agencies’ Guidance  
The Federal Reserve, OCC, FDIC and OTS jointly issued guidance intended to ensure incentive compensation paid by a covered banking organization does not encourage risk-taking that could threaten the organization’s safety and soundness.

EU CRD IV Directive 2013/36  
 Came into effect on Jan. 1, 2014, providing incentive-based compensation remuneration codes.

UK Remuneration Code  
PRA’s and FCA’s remuneration rules became effective on June 25, 2015.