Davis Polk

Some, but not all, required regulators re-propose incentive compensation rule under Dodd-Frank

May 9, 2024 | Client Update | 10-minute read

The Officer of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the Federal Housing Finance Agency (FHFA) have re-proposed the same rule from 2016 to implement Section 956 of the Dodd-Frank Act, which deals with incentive compensation arrangements at covered financial institutions.

The text of the proposed rule (the Proposed Rule) is the same as what was proposed in June 2016 (the 2016 Proposed Rule). In an unusual move, however, the preamble has changed and now provides clues as to what some regulators may want, citing to "additional supervisory experience, changes in industry practice, and other developments" since that time. Since the text of the rule is the same, we link to our still accurate client update from 2016 explaining what the Proposed Rule would do.

This rule is required to be issued jointly by six regulators, the three listed above plus the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC) and the Federal Reserve. The NCUA and the SEC are expected to soon release their own identical versions. However, unless the Federal Reserve joins them, the release of the Proposed Rule at this time has no legal import. So far, Chair Jerome Powell is on record as saying, "I would like to understand the problem we're solving and then I would like to see a proposal that addresses that problem."[1]

Summary of the Proposed Rule

Below, we address some key questions about the Proposed Rule.

1. What does Section 956 of the Dodd-Frank Act provide?

Section 956 requires that the six regulators jointly issue regulations or guidelines: (1) prohibiting incentive compensation arrangements at covered financial institutions that encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss; and (2) requiring those covered institutions to disclose information concerning incentive compensation arrangements to the appropriate Federal regulator.

2. What rulemaking have the regulators engaged in so far?

In April 2011, the six regulators proposed a rule to implement Section 956 which received more than 10,000 comments. After a delay of five years, in June 2016, the six regulators proposed a different version of the rule and received more than 100 comments. Agency staff members have also held several meetings with different stakeholders to obtain supplementary information, but there has been no official action since 2016.

Copyright 2024 Davis Polk & Wardwell LLP

In June 2010, before the enactment of the Dodd-Frank Act, the OCC, the FDIC, the Federal Reserve and the now-defunct Office of Thrift Supervision separately adopted "Guidance on Sound Incentive Compensation Policies."[2] They relied upon Section 30 of the Federal Deposit Insurance Act (FDIA), which covers safety and soundness. This interagency guidance has remained in effect.

3. How does the Proposed Rule compare to the 2016 Proposed Rule?

The text of the rule is the same in both versions. See our summary of the 2016 Proposed Rule.

The preamble, however, is different, and provides clues as to changes that some regulators may want to make.

4. What are the highlights of the Proposed Rule?

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.

3-tiered approach: 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

The Proposed Rule applies basic requirements to all covered institutions.

Enhanced requirements (for Level 1 and Level 2 institutions): 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:

- **Downward adjustment and forfeiture**: Requirements to reduce, due to various adverse outcomes (e.g., poor financial performance): (1) incentive compensation that has not yet been awarded during the performance period and (2) deferred incentive compensation during the deferral period.
- **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 a minimum 3-year performance 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.
- **Limits on leverage factor**: Limits awards in excess of target – 125% of target for senior executive officers; 150% of target for significant risk-takers.
- **Additional limits on compensation**: Prohibitions on (1) use of performance measures that are based solely on industry peer performance comparison and (2) incentive compensation based solely on transaction revenue or volume without regard to transaction quality or compliance with sound risk management.
- **Mix of equity and cash**: 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.
- **Risk management and controls**: Must have a 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 financial institution's operations. In addition, must provide the individuals in control functions with appropriate authority to influence the risk-taking of the business areas they monitor, and must provide for independent monitoring of (1) incentive compensation plans to identify whether the plans appropriately balance risk and reward, (2) events and decisions related to forfeiture and downward adjustment and (3) compliance of the incentive compensation program with the institutions policies and procedures.

Copyright 2024 Davis Polk & Wardwell LLP

– **Governance**: Must have a compensation committee composed solely of directors who are not senior executive officers, and which must obtain input from risk and audit committees and the 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. In addition, has enhanced disclosure and recordkeeping requirements.

Relationship with existing law and regulation: 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 the SEC's rules regarding disclosure of executive compensation. Mortgage loan originators remain separately subject to CFPB rules restricting compensation.

Effectiveness: If it becomes effective, it would be on the first day of the calendar quarter 540 days (18 months) after the final rule is published in the Federal Register.

Grandfathering: The Proposed Rule will not apply to any incentive compensation plan with a performance period that begins before the effective date.

5. What kind of changes, as compared to the Proposed Rule, might the regulators make when they finalize the rule?

Based on the questions that the regulators have posed for comment, the following are key potential changes that the regulators may be considering:

– **Changes to enhanced requirements**
  - Requiring mandatory forfeiture or downward adjustment of incentive compensation for specified adverse outcomes, rather than at the discretion of the financial institution
  - Requiring mandatory clawback of vested incentive compensation under specified circumstances, rather than at the discretion of the financial institution
  - Expanding the prohibition on volume-driven incentive compensation to *all* incentive compensation based on transaction revenue or volume, rather than limited just to such compensation based *solely* on transaction revenue or volume, and/or adding additional requirements to address the "unbalanced use" of incentive compensation based on transaction revenue or volume
  - Reducing the cap on options from 15% to 10% of senior executive officer's or significant risk-taker's total incentive compensation
  - Expanding the prohibition on hedging to also require contracts with employees banning personal hedging
  - Requiring that the financial institution consider the risk management and controls assessments from the independent risk and control functions when setting incentive compensation for senior executive officers and significant risk-takers

– **Applying certain enhanced requirements to Level 3 institutions**: Applying the following enhanced requirements (in whatever form finally adopted) to Level 3 institutions: (1) limits on leverage; (2) prohibition on use of relative performance measures; (3) prohibition on volume-driven incentive compensation; and (iv) prohibitions on hedging

– **Performance measures (all covered institutions)**: Requiring covered institutions to establish performance measures and targets before the beginning of a performance period, and prohibiting any changes to any pre-established targets used to pay out incentive compensation without documentation and approval of such actions from appropriate personnel

– **Adopting a two-tiered approach**: Adopting a two-tiered approach, rather than a three-tiered approach, with the same enhanced requirements applying to all covered institutions with average consolidated assets of more than $50 billion, and using a single deferral percentage of 60% and a deferral period of 4 years for the senior executive officers and significant risk takers at such institutions with average total consolidated assets or more than $50 billion

– **Earlier effective date**: Changing the effective date from 540 days to the first quarter that begins at least 365 days after the final rule is published in the Federal Register

6. What are some other questions that the regulators have asked?

Copyright 2024 Davis Polk & Wardwell LLP

Other questions of interest include:

- What implications do the minimum deferral requirements have on “level playing fields” between covered institutions and non-covered institutions? This is an opportunity for commenters to discuss the competition for talent that financial institutions may be losing, because of increasingly stringent regulations with respect to incentive compensation.
- Are the proposed deferral, forfeiture, downward adjustment and clawback requirements consistent with, more lenient or more stringent than current practices at Level 1 and Level 2 covered institutions? This is an opportunity for commenters to discuss current market practice regarding risk management and mitigants that are built into existing compensation programs.
- Various questions regarding downward adjustment, forfeiture and clawbacks invite commenters to discuss whether the clawback rule should be modified to prevent duplicate recovery, whether the forfeiture and downward adjustment rule should be harmonized with the clawback requirement under Section 954 of the Dodd-Frank Act (relating to accounting statements), whether there are practical or other considerations that would make application of the clawback rule challenging or unduly burdensome, etc. This is an opportunity for commenters to reiterate the challenges posed by forfeitures, downward adjustments and clawbacks.
- The regulators are requesting data regarding the characteristics of voluntarily adopted clawback policies, as well as data regarding compensation structures that are used by covered institutions, and whether the voluntary adoption of clawback provisions has resulted in a decline in inappropriate risks by covered institutions, or a decline in excessive compensation, fees or benefits. This is an opportunity for commenters to discuss current market practice around clawback policies.
- The regulators are considering modifying the “significant risk-taker” test, which, under the Proposed Rule, has a relative compensation test and an exposure test, to a more “flexible risk-based approach.” This is an opportunity for commenters to endorse an approach that may be less prescriptive.

7. When will the official comment period start?

The official comment period cannot begin until all six agencies re-propose the rule because the Federal Register will not publish a “joint” proposed rulemaking without all six agencies. In his statement accompanying the re-proposal, Acting Comptroller of the Currency Michael J. Hsu acknowledged this fact, noting “[t]o be clear, this [notice of proposed rulemaking] has not been adopted by all six agencies so we are not requesting publication in the Federal Register.”[3] As a result, the agencies are requesting informal comments.

8. Can the Proposed Rule go into effect?

The Proposed Rule cannot become legally binding unless all six agencies participate in the re-proposal, and we believe that the Federal Reserve is unlikely to do so. It is an open question whether the three banking agencies might use comments received to revise the enforceable guidelines that “each” agency is permitted to pass under Section 39 of the FDIA as amended under the Federal Deposit Insurance Corporation Improvement Act of 1991.[4] This statute does not apply to the SEC, the FHFA or the NCUA, but the three banking agencies have existing guidelines with respect to compensation which must be linked to safety and soundness. It is unclear whether the scope of the authority in the FDIA would permit the level of prescriptive requirements in the Proposed Rule without relying on Section 956 of the Dodd-Frank Act.

Next steps

Covered financial institutions should consider the following next steps:

- Refresh yourselves on how the Proposed Rule would work and, for Level 1 and Level 2 financial institutions, determine who would qualify as your senior executive officers and significant-risk takers, as well as consider ways in which incentive compensation program might need to be changed for those individuals.
- Discuss the Proposed Rule and its implications with your senior management, board and compensation committee.
- Consider commenting on the Proposed Rule or working with a trade organization to do so, especially in the areas noted above. If there is no comment, the regulators may take the view that financial institutions have tacitly accepted the rule and its various requirements.

Copyright 2024 Davis Polk & Wardwell LLP

We will continue to monitor these developments.

Copyright 2024 Davis Polk & Wardwell LLP

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Dana Seesel Bayersdorfer
+1 212 450 3423
dana.bayersdorfer@davispolk.com

Jennifer S. Conway
+1 212 450 3055
jennifer.conway@davispolk.com

Luigi L. De Ghenghi
+1 212 450 4296
luigi.deghenghi@davispolk.com

Adam Kaminsky
+1 202 962 7180
adam.kaminsky@davispolk.com

Kyoko Takahashi Lin
+1 212 450 4706
kyoko.lin@davispolk.com

Eric McLaughlin
+1 212 450 4897
eric.mclaughlin@davispolk.com

David L. Portilla
+1 212 450 3116
+1 202 962 7155
david.portilla@davispolk.com

Margaret E. Tahyar
+1 212 450 4379
margaret.tahyar@davispolk.com

Travis Triano
+1 212 450 3096
travis.triano@davispolk.com

Veronica M. Wissel
+1 212 450 4794
veronica.wissel@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.

[1] Jerome H. Powell, *The Federal Reserve's Semi-Annual Monetary Policy Report Hearing Before the H. Comm. on Financial Services*, 118th Congress (March 6, 2024).

[2] 75 Fed. Reg. 36396 (June 25, 2010).

[3] Michael J. Hsu, "Acting Comptroller Issues Statement on Notice of Proposed Rulemaking on Incentive Compensation," (May 6, 2024).

[4] 12 U.S.C. § 1831p-1.

Copyright 2024 Davis Polk & Wardwell LLP