



Insights

Agencies to Release Proposed Rule On Executive Compensation

April 24, 2016

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Financial Institutions with less than \$1 Billion in Assets Exempt; Financial Institutions with less than \$50 Billion in Assets Subject to Less Restrictive Provisions

The National Credit Union Association (the "NCUA"), recently released a draft of their Proposed Rule (the "Proposed Rule") on Incentive-Based Compensation Arrangements pursuant to the requirements established by Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act"). The Dodd-Frank Act requires the NCUA to issue this rule jointly with five other agencies – The Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve Board (the "Board"), the Federal Deposit Insurance Company (the "FDIC"), the National Credit Union Association (the "NCUA"), the Federal Housing Finance Authority (the "FHFA"), and the Securities and Exchange Commission (the "SEC") (collectively the "Agencies"). The Agencies will all have to individually issue the Proposed Rule before it is published in the Federal Register, and the official notice and comment period begins. While it is possible the individual agencies could choose to amend the Proposed Rule from the version released by the NCUA, given the coordination required to bring the proposal to this point, it is unlikely.

This Client Alert details the requirements of the Proposed Rule for institutions with less than \$50 Billion in assets. For analysis of the impact of the Proposed Rule for financial institutions with over \$50 Billion in assets, we will be issuing a future Client Alert.

Financial institutions with less than \$50 Billion in assets will be spared from the most restrictive parts of the Proposed Rule. The Proposed Rule applies to three different levels of "covered financial institutions" with average total consolidated assets of one billion dollars (\$1B) or more. Level one covered financial institutions have average total consolidated assets of greater than \$250 billion. Level two covered financial institutions have average consolidated assets between \$50 billion and \$250 billion. Level three covered financial institutions have average consolidated assets between \$1 billion and \$50 billion.

Covered Financial Institutions

Covered Financial Institutions include:



- Depository institutions;
- Depository institution holding companies;
- Registered broker-dealers;
- Credit unions;
- Investment advisers;
- The Federal National Mortgage Association;
- The Federal Home Loan Mortgage Corporation; and
- Any other institution the Agencies determine should be treated as a covered financial institution.

Covered Persons

Covered Persons include:

- Any Executive Officer, Employee, Principal Shareholder, or Director who receives incentive-based compensation at a covered financial institution.
 - Executive Officer includes anyone considered a "Senior Executive Officer" ("SEO"), defined as a covered person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions at a covered institution for any period of time in the relevant performance period:
 - President;
 - Chief Executive Office;
 - Executive Chairman;
 - Chief Operating Officer;
 - Chief Financial Officer;
 - Chief Investment Officer;
 - Chief Legal Officer;
 - Chief Lending Officer;
 - Chief Risk Officer;
 - Chief Compliance Officer;
 - Chief Audit Executive;
 - Chief Credit Officer;
 - Chief Accounting Officer; or
 - Head of a major business line or control function.



- Principal Shareholder includes any natural person who, directly or indirectly, or acting through or in concert with one or more persons, owns, controls or has the power to vote ten percent (10%) or more of any class of voting securities of a covered financial institution.
- Director includes any member of a governing board of a covered financial institution

Incentive-Based Compensation

Incentive-Based Compensation includes any variable compensation, fees or benefits that serve as an incentive or reward for performance.

Requirements for Level 3 Covered Financial Institutions

- Level 3 covered financial institutions will be required to annually create, and maintain for a period of seven (7) years, records that document the structure of all incentive based compensation arrangements and demonstrate compliance with the requirements of the Proposed Rule. These records must include at a minimum copies of all incentive-based compensation plans, a record of who is subject to each plan, and a description of how the incentive-based compensation plan is compatible with effective risk management and controls;
- Level 3 covered financial institution's Board of Directors, or a committee they establish, must:
 - Conduct oversight of the incentive-based compensation plan;
 - Approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and
 - Approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.
- Level 3 covered financial institutions are prohibited from establishing or maintaining any type of incentive-based compensation arrangement that encourages inappropriate risks by providing a covered person with excessive compensation, fees or benefits, or that could lead to a material financial loss.

What is considered excessive compensation?

Compensation, fees and benefits are considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into consideration all relevant factors, including, but not limited to:

- The combined value of all compensation, fees, or benefits to the covered person;
- The compensation history of the covered person;
- The financial condition of the covered financial institution;



- Compensation practices at comparable covered institutions based on factors such as asset size, geographic location and the complexity of the covered institutions 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 omission, breach of trust or fiduciary duty, or insider abuse with respect to the covered institution.

As mandated by the Dodd-Frank Act, the factors for determining excessive compensation are comparable to the standards contained in the Federal Agency Safety and Soundness Guidelines implementing Section 39 of the Federal Deposit Insurance Act.

What is considered an inappropriate risk?

An incentive-based compensation arrangement encourages inappropriate risks that could lead to a material financial loss unless the arrangement:

- Appropriately balances risk and reward. An incentive-based compensation arrangement will not be considered to appropriately balance risk and reward unless it:
 - Includes financial and non-financial measures of performance, including considerations of risk-taking, that are relevant to a person's role within the covered institution and to the type of business in which the person is engaged and that are appropriately weighted to reflect risk taking;
 - Is designed to allow non-financial measures of performance to override financial measures of performance when appropriate in determining incentive based compensation; and
 - Any amounts to be awarded under the arrangement are subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial or non-financial performance.
- Is compatible with effective risk management and controls; and
- Is supported by effective governance.

While many of the requirements in the Proposed Rule have already been incorporated into existing executive compensation plans by virtue of compliance with earlier regulatory guidance, there are some additional provisions that will require covered financial institutions to further adjust their compensation policies. Once adopted by each of the Agencies, the Proposed Rule will be published in the Federal Register for comment. All comments on the Proposed Rule must be made by July 22, 2016, and covered financial institutions will have to comply with the new requirements five hundred and forty (540) days after publication of the Final Rule in the Federal Register.

¹ Exec. Comp. Proposed Rule 2016

² Average total consolidated assets for all institutions with the exception of Investment Advisers are calculated based on an institutions regulatory reports for the four most recent consecutive quarters. Average total consolidated assets for Investment Advisers are calculated based on the advisers total assets shown on the balance sheet for the most recent fiscal year end.



³ Included among those additional financial institutions the Agencies intends to designate by rule as covered institutions are:

⁴ Principal Shareholders are not included within the scope of the NCUA Proposed Rule given the ownership structure of credit unions.

⁵ See Section 956 (c) of the Act, referring to 12 U.S.C. 1831(p)