The Third Attempt: Banking Agencies Revive Incentive-Based Compensation Rules for Financial Institutions

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The Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Federal Housing Finance Agency (FHFA) and the National Credit Union Administration (NCUA) recently re-proposed rules on incentive-based compensation arrangements at certain financial institutions with at least $1 billion in assets (the Proposed Rule). Among other things, the Proposed Rule would subject certain compensation to recovery for at least seven years after vesting if a "senior executive officer" or "significant risk-taker" (based on their relative level of incentive compensation or ability to expose financial assets to risk) engaged in misconduct that resulted in significant financial or reputational harm to the institution or committed other specified bad acts.

The Proposed Rule revives a proposal first made in 2016 and comes nearly 14 years after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Section 956 of Dodd-Frank requires the FDIC, the OCC, the FHFA, the NCUA, the Board of Governors of the Federal Reserve System (FRB) and the Securities and Exchange Commission (SEC) to jointly prescribe regulations or guidelines covering incentive-based compensation at covered financial institutions.

In 2011, the agencies issued an initial proposal, which they subsequently modified in 2016. The Proposed Rule is the same as that set out in 2016, but it is accompanied by a number of alternatives and questions for public comment, which are addressed below. As with the prior proposal, the Proposed Rule would apply to certain financial institutions with at least $1 billion in assets, with enhanced requirements for larger institutions.

If finalized, the Proposed Rule would complete one of the last remaining pieces of Dodd-Frank. However, the likelihood of adoption of the Proposed Rule remain uncertain, as both the FRB and the SEC declined to join the other agencies in announcing this proposal. Nevertheless, financial institutions should expect greater regulatory scrutiny of executive compensation arrangements.

Challenges to the Near-Term Adoption of the Proposed Rule

Because Section 956 of Dodd-Frank mandates joint rulemaking by six federal financial agencies, the absence of the FRB and the SEC in joining the proposal signals potential interagency misalignment, raising significant doubts as to the likelihood of the Proposed Rule being finalized in its current form. However, according to an FDIC staff memorandum describing the Proposed Rule, the regulators "continue to coordinate to reach consensus."

Key officials from several of the agencies, particularly the FRB, have voiced skepticism over the current structure of the Proposed Rule and noted the need for further study before a rule is finalized. The SEC indicated in its Fall 2023 rulemaking agenda that it is considering re-proposing incentive compensation regulations, but did not commit to action. Furthermore, the scope of the Proposed Rule is uncertain in several aspects and may need refinement. The Proposed Rule may also be delayed due to the 2024 election.

Regulators Divided Over the Proposed Rule

The Proposed Rule elicited divergent views among agency officials. FDIC Chairman Martin J. Gruenberg and Director Rohit Chopra voiced strong support for the Proposed Rule, with Chopra advocating that certain areas be strengthened, including adopting an alternative proposal to require financial institutions to reduce or claw back bonuses (the current rule only requires firms to consider whether to reduce or claw back bonuses) and to expand the prohibition to all compensation arrangements based solely upon revenue or volume targets without regard to performance or risk management.

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In contrast, FDIC Vice Chairman Travis Hill did not support the Proposed Rule, noting that compensation arrangements are "at the core of a well-functioning market economy" and "incentive compensation agreements that were cited by some as a factor in the 2008 financial crisis are far less common today." He also described the Proposed Rule as "too broad and blunt" because it would establish a "highly prescriptive set of requirements," as compared to a "principles-based approach" that was used in 2010 guidance and had an "extraordinarily long lookback" of up to 12 years. Hill further added that "it is extremely odd to issue this proposal without all the relevant agencies participating."

Although supportive of the Proposed Rule, OCC Comptroller Michael Hsu acknowledged that the financial system has changed since the last drafting attempt in 2016, and thus, while the Proposed Rule is a "natural place to start," there will need to be "robust" public engagement regarding a number of alternatives and open questions prior to finalization.

The fact that the FRB did not join the Proposed Rule suggests a lack of clear support by the FRB. Indeed, in a March 6, 2024, hearing before the House Financial Services Committee, when FRB Chair Jerome H. Powell was asked if he supported Section 956, he replied, "I would like to understand the problem we're solving and then I would like to see a proposal that addresses that problem," indicating that further work on the Proposed Rule is likely necessary to satisfy his concerns. In a May 15, 2024 hearing before the House Financial Services Committee, FRB Vice Chair Michael S. Barr explained that additional analysis within the FRB was being conducted in order to determine whether the Proposed Rule was appropriate in its current form, but he supported the need for rulemaking to address excess risk taking "that ends up causing serious harm to the country."

Powell's comment and Hsu's suggestion of a greater need for more engagement may result in further review, which could even take a form similar to the 2009 Horizontal Review in which banking agencies reviewed incentive-based compensation practices at 25 large banking organizations.[1] Further agency review of industry incentive compensation practices would delay the implementation of a final rulemaking.

Highlights of the Proposed Rule

The Proposed Rule consists of the regulatory text of the 2016 proposal with a new preamble that proposes certain alternatives and questions that will be considered for the final rule. Like the 2016 version, the Proposed Rule includes the following key provisions:

Tiered Approach to Applicability

Covered institutions[2] are distinguished by their average total consolidated asset size, with requirements that are more rigorous for larger institutions.[3]

- Level 1 – $250 billion or more
- Level 2 – $50 billion to less than $250 billion
- Level 3 – $1 billion to less than $50 billion

Covered Persons

Covered persons impacted by the rule include any executive officer, employee, director or principal shareholder who received incentive-based compensation at a covered institution. However, the most stringent requirements are imposed on a subset of covered persons at Level 1 and Level 2 institutions referred to as "senior executive officers" (identified by title and function) and "significant risk-takers" (based on their relative level of incentive compensation or ability to expose financial assets to risk).

- **Senior executive officers:** 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 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;

[1] The 2009 Horizontal Review analyzed compensation practices in the areas of trading, mortgage, credit card, sales and commercial lending, as well as senior executive incentive-based compensation awards and payouts. The FRB released its findings in a 2011 report.

[2] The Proposed Rule would apply broadly to "covered institutions." These are institutions that have at least $1 billion in total consolidated assets and fall within one of the following categories: (i) depository institutions; (ii) subsidiaries of depository institutions; (iii) depository institution holding companies; (iv) nonbank subsidiaries of depository institution holding companies; (v) U.S. branches of foreign banks; (vi) non-depository trust companies; (vii) broker-dealers; (viii) investment advisers; and (ix) certain other types of financial institutions such as credit unions, Fannie Mae, and Freddie Mac.

[3] Covered institutions that are subsidiaries of other covered institutions would be subject to the same requirements at the same level as the parent covered institution (and assigned a level based on consolidated assets). Furthermore, the Proposed Rule gives the relevant regulator authority to require a covered institution to comply with more rigorous provisions based on the covered institution's complexity of operations or compensation practices.

- Chief credit officer;
- Chief accounting officer; or
- Head of a major business line or control function.

- Significant risk-takers: Those covered persons (excluding senior executive officers) who receive at least one-third of their total compensation in incentive-based compensation and (i) are among the top 2% of highest compensated individuals (5% for Level 1) or (ii) have the authority to "commit or expose" 0.5% or more of the capital of the covered institution or Section 956 affiliate, regardless of whether the individual is a covered person of the applicable legal entity.

Incentive-Based Compensation

Incentive-based compensation is defined as any variable compensation, fees or benefits that serve as an incentive award for performance. Although similarly named, this definition differs from that used in the SEC's final rule to implement clawback provisions required by section 954 of Dodd-Frank and which refers to any compensation that is granted, earned or vested based on the attainment of a financial reporting measure.

- **Basic prohibition.** All covered institutions must prohibit incentive-based compensation arrangements that encourage inappropriate risks (i) by providing covered persons with "excessive compensation" or (ii) that could lead to a "material financial loss."
  - *Excessive compensation.* Compensation, fees, and benefits are considered excessive when the amounts paid are "unreasonable or disproportionate to the value of the services performed by a covered person" after consideration of all relevant factors including (but not limited to):
    i. the total value of all compensation, fees, or benefits provided to the covered person;
    ii. the compensation history of the covered person and other individuals at the institution with comparable expertise;
    iii. the institution's financial condition;
    iv. compensation practices at comparable institutions (based upon asset size, location, and complexity of operations and assets, among other factors);
    v. the projected total costs and benefits for post-employment benefits; and
    vi. the covered person's connection with "any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered institution."
  - *Material financial loss.* "An incentive-based compensation arrangement at a covered institution encourages inappropriate risks that could lead to material financial loss to the covered institution, unless the arrangement: (i) appropriately balances risk and reward; (ii) is compatible with effective risk management and controls; and (iii) is supported by effective governance."

    In order to appropriately balance risk and reward: (i) arrangements must include both financial and non-financial performance criteria, allowing the non-financial criteria to override the financial criteria when appropriate; (ii) criteria must include an appropriately weighted consideration of risk-taking that is applicable to the individual's role and type of business at the institution; and (iii) amounts must be subject to adjustment to reflect "actual losses, inappropriate risks taken, compliance deficiencies, or other measures of financial and non-financial performance."

- **Mandatory deferrals.** The Proposed Rule requires covered institutions to subject incentive-based compensation to continued risk of forfeiture through certain mandatory deferral (*i.e.*, minimum vesting) periods.
  - Depending on the level of the covered institution (Level 1 or Level 2) and the type of incentive-based compensation arrangement ("short-term" or "long-term"), covered institutions must defer 50% to 60% of incentive-based compensation for senior executive officers and 40% to 50% for significant risk-takers. The required deferral period (measured from the end of the performance period through the last vesting date) is (i) one to two years for compensation arrangements with a long-term performance period (at least three years) or (ii) three to four years for compensation arrangements with a short-term performance period (less than three years).
  - During a deferral period, incentive-based compensation cannot vest faster than on a pro-rata annual basis, and in no case earlier than the first anniversary of the end of the applicable performance period. No accelerated vesting is permitted except upon death or disability of the covered person.
  - The use of stock options to satisfy these minimum deferral requirements is limited to no more than 15% of the total incentive-based compensation awarded in a performance period.

- **Award limits and performance measures.** The Proposed Rule limits the amount of incentive compensation that can be awarded to senior executive officers (125% of target amount) and significant risk-takers (150% of target amount) but does not prescribe limits on setting the target amount. Performance measures for Level 1 and Level 2 institutions may not be based solely on (i) relative industry peer performance comparisons or (ii) transaction revenue or volume without regard to "transaction quality" (undefined) or compliance with risk management.

- **Downward adjustment and forfeiture.** All incentive-based compensation awarded to senior executive officers and significant risk-takers must be subject to consideration for downward

adjustment and forfeiture due to: (i) poor financial performance attributable to a significant deviation from risk parameters; (ii) inappropriate risk-taking; (iii) material risk management or control failures; (iv) non-compliance with statutory, regulatory or supervisory standards resulting in enforcement or legal action by a regulator or that results in a financial restatement; or (v) other poor performance or misconduct.

- **Clawback.** A Level 1 or Level 2 institution must incorporate clawback provisions that permit the institution to recover incentive-based compensation paid to senior executive officers and significant risk-takers for seven years after vesting if the covered institution determines that the individual engaged in (i) misconduct resulting in significant financial or reputational harm to the institution; (ii) fraud; or (iii) intentional misrepresentation of information used to determine the applicable incentive-based compensation.[4]
- **Risk management, governance and recordkeeping.** Level 1 and Level 2 institutions would be required to have a risk management framework for its incentive-based compensation programs that is appropriate for the size and complexity of the institution's operations and such institutions would also be required to establish an independent compensation committee and obtain input from the institution's risk and audit committees to oversee the incentive-based compensation programs. All covered institutions would need to have their board (or board committee) approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under those arrangements, and approve any material exceptions or adjustments. In addition, all covered institutions would be required to create and maintain, for at least seven years, annual records that document the covered institution's compliance with the rule.
- **Grandfathering; effectiveness.** The Proposed Rule would grandfather incentive-based compensation arrangements with a performance period that began before the effective date of the final rule. If adopted and approved, the final rule would become effective on the first day of the calendar quarter that is 540 days after the final rule is published in the Federal Register, although a shorter effectiveness date is under consideration.

Alternative Provisions Under Consideration

The preamble to the Proposed Rule states that the agencies are also considering, and seeking public comments on, several alternative provisions that could be included in a final rule. These provisions are generally more rigorous than the corresponding provisions in the Proposed Rule and would require covered institutions to take additional measures in setting and administering incentive-based compensation. The following is a summary of the alternative provisions under consideration by the agencies:

- **Two-tiered asset threshold.** Replacing the three-level structure with two tiers, in which case the general requirements of the Proposed Rule would continue to apply to all covered institutions, but the additional, more stringent requirements would apply to institutions with more than $50 billion average consolidated assets.
- **Simplifying the "significant risk-taker" definition.** Replacing the two tests for determining significant risk-takers (*i.e.*, relative level of incentive compensation or ability to expose financial assets to risk) with a requirement that a covered institution identify its significant risk-takers and submit notice of its identification methodology to its primary federal regulator. A variation of this alternative would be for an institution to identify significant risk-takers based on its own methodology but maintain the relative compensation test as a component of that methodology.
- **Specific compensation-related alternatives:**
  - Requiring covered institutions to establish performance measures and targets before the beginning of the applicable performance period.
  - Reducing the proposed limit on stock option usage from 15% to no more than 10% of the amount of total incentive-based compensation awarded to senior executive officers or significant risk-takers at Level 1 or Level 2 institutions for a performance period.
  - Requiring Level 1 and Level 2 institutions to (rather than merely requiring them to consider whether to):
    i. (seek recovery of incentive-based compensation by forfeiture and downward adjustment of incentive-based compensation for certain adverse events listed in the Proposed Rule (including material risk management or control failures, inappropriate risk-taking and poor financial performance attributable to significant deviation in applicable risk parameters); and
    ii. except in limited circumstances, claw back any vested incentive-based compensation from current and former senior executive officers or significant risk-takers under the same circumstances as identified in the Proposed Rule.
  - Prohibiting Level 1 and Level 2 institutions from:
    i. designing an incentive-based compensation arrangement that permits a covered person to purchase a hedging or

[4] This clawback would be in addition to the SEC-approved Dodd-Frank clawback rules adopted in 2022, implementing Section 10D of the Securities Exchange Act of 1934. For more information about the SEC clawback rules and related disclosure requirements, see our November 22, 2022, client alert, "SEC Adopts Final Clawback Rules and Disclosure Requirements."

similar instrument that has the effect of offsetting any decreases in incentive-based compensation caused by application of the Proposed Rule; and

ii. providing incentive-based compensation based (solely or in part) on transaction revenue or volume.

- **Additional risk management and controls requirement.** Adding a requirement for Level 1 and Level 2 institutions to include, as part of their risk management frameworks, "that a risk management and controls assessment from the independent risk and control functions be considered when setting incentive-based compensation for senior executive officers and significant risk-takers."
- **Accelerated compliance date.** Reducing from 540 days to 365 days the timeline for covered institutions to comply with the final rule after it is published in the Federal Register.

Looking Ahead

The Proposed Rule is the latest attempt at finalizing a rule under Section 956 to address incentive compensation practices at financial institutions. The previous proposals generated thousands of comment letters, and we expect significant industry interest in, and opposition to, the Proposed Rule. However, even if the Proposed Rule is not adopted, financial institutions should expect greater scrutiny of executive compensation arrangements through the supervisory process.[5]

[5] Following the failure of Silicon Valley Bank, for example, some regulators cited poorly structured incentive-based compensation arrangements as an area of supervisory concern. See, *e.g.*, Board of Governors, Federal Reserve System, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank" (April 28, 2023) at 75 ("Stronger or more specific supervisory guidance or rules on incentive compensation for firms of SVBFG's size, complexity, and risk profile — or more rigorous enforcement of existing guidance and rules — may have mitigated these risks.").

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