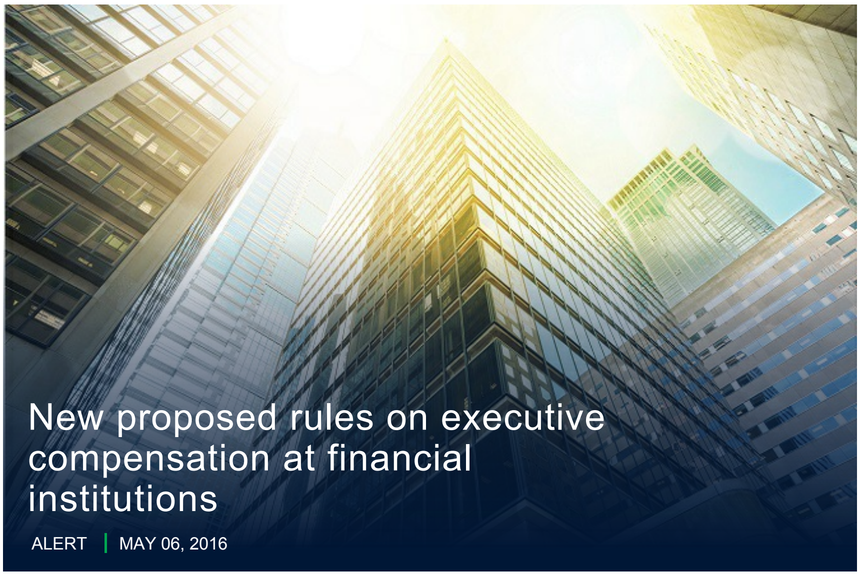

New proposed rules on executive compensation at financial institutions

ALERT | MAY 06, 2016

The National Credit Union Administration (NCUA) recently issued a proposed rule designed to regulate the pay of executives at banks and credit unions around the country. These are the so-called “Wall Street Pay Rules.”

By way of background, these new rules are required to be adopted by Section 956 of the Dodd-Frank Act. If adopted as proposed, the new rules would force many banks to defer pay for longer than they have in the past in an effort to discourage the use of high risk/short-term incentive arrangements and encourage greater accountability.

The new proposed rules amend and restate similar rules proposed in 2011. The 2016 proposed rules are tougher. The new proposal sets forth a tiered approach to executive compensation rules based on total assets of the institution. Financial institutions with $250 billion or more in assets are considered Level 1 (or Tier 1) and subject to the strictest standards; those with between $50 billion and $250 billion are in Level 2 (or Tier 2) and face fewer requirements; and those with assets of $1 billion to $50 billion are in Level 3 (or Tier 3) and face the fewest obligations. The proposal effectively exempts institutions with less than $1 billion of assets from regulation.

HOLDBACKS AND CLAWBACKS

The new regulation would require Tier 1 institutions to hold back at least 60 percent of a senior executive’s incentive pay for four years. Top level employees at Tier 1 institutions who are not senior executives but are nevertheless deemed “significant risk-takers” for the institution would be required to defer 50 percent of their incentive pay for that period. Senior executives would include chief executive officers, chief financial officers, chief accounting officers, and general counsels, among others. Tier 2 financial institutions would be required to defer for three years at least 50 percent of the incentive-based pay of top executives and 40 percent of the incentive-based pay of significant risk-takers.

Under the new proposed pay rules, Tier 1 and Tier 2 institutions would have seven years to recover bonuses from current or former senior executives or traders who “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 executive’s incentive pay.

> Note: This is a distinct rule from the rule that the Securities and Exchange Commission (SEC) proposed in 2015 under Section 954 of the Dodd-Frank Act. Under that Section of the Dodd-Frank Act, companies listed on a national securities exchange will be required to recover from executive officers certain incentive-based compensation that they received during the three fiscal years preceding the date on which a company’s accounting restatement is triggered. This recovery is different in several respects, including the fact that it would be required without regard to whether any misconduct occurred or an executive officer’s responsibility for the erroneous financial statements.

The proposed rules continue to state broad principles for governance of compensation decisions. They would generally prohibit all covered institutions from making incentive-based arrangements that “would encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss.” The proposal states that compensation, fees, and benefits would be considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into account all relevant factors, such as the individual’s compensation history, industry standards and the financial health of the institution. Moreover, per the proposed rules, compensation arrangements that could lead to “material financial loss” are those that do not balance risk and reward, and are not compatible with sound risk management and governance principles.

RECORDKEEPING REQUIREMENTS

Tier 1, Tier 2 and Tier 3 banks would be required to develop and retain for seven years “records documenting the structure of incentive-based compensation arrangements” and ensure oversight “of the institution’s incentive-based compensation arrangements from its board of directors” and disclose such records to the appropriate federal regulator upon request. The proposed rule would require that the records maintained by a covered institution, at a minimum, include copies of all incentive-based compensation plans, a list of who is subject to each plan, and a description of how the covered institution’s incentive-based compensation program is compatible with effective risk management and controls. These records would be the minimum required information to determine whether the structure of the covered institution’s incentive-based compensation arrangements provide covered persons with excessive compensation or could lead to material financial loss to the covered institution. A covered institution would not be required to report the actual amount of compensation, fees, or benefits of individual covered persons as part of this requirement.

The proposal would allow regulators the discretion to require certain Tier 3 banks and credit unions with total assets between $10 and $50 billion to be subject to the restrictions for Tier 1 or Tier 2 institutions, depending on the “complexity of operations or compensation practices.” For example, a Tier 3 covered institution might be involved in particular high-risk business lines, such as lending to distressed borrowers or investing or trading in illiquid assets, and make significant use of incentive-based compensation to reward risk-takers. In such case, the applicable supervising agency may send written notice to the institution to comply with the Tier 1 and Tier 2 rules, as opposed to the Tier 3 rules.

In addition to NCUA, five other agencies must adopt the new plan:

1. Federal Reserve
2. Federal Deposit Insurance Corporation
3. Federal Housing Finance Agency
4. Office of the Comptroller of the Currency
5. SEC

COMMENT PERIOD ENDS JULY 22, 2016

It is not clear at this point whether these other agencies will adopt the new rule as proposed. If they approve of the draft proposal, however, interested parties will have until July 22, 2016 to provide comments. After that, regulators will incorporate feedback into a revised final rule and the completed rule will be adopted by the six agencies. Many commentators suggest that the rules may not be finalized until after President Obama's term expires. In any event, the new compensation practices will become legally binding on the institutions that are covered at the beginning of the first calendar quarter that begins at least 540 days after the final rule is published in the Federal Register.

ILIRJAN PIPA

Read More

MICHAEL RILEY

I have extensive experience helping business owners and executives negotiate compensation and ownership agreements and develop retirement and estate plans. I understand that they do not want problems; they want it done.

Read More

DAVID JOHNSON

Read More