

MEMO# 29869

April 26, 2016

Federal Agencies Re-Propose Rules on Incentive-Based Compensation Arrangements

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TO: CHIEF RISK OFFICER COMMITTEE No. 11-16
CLOSED-END INVESTMENT COMPANY MEMBERS No. 5-16
COMPLIANCE MEMBERS No. 11-16
INVESTMENT ADVISER MEMBERS No. 6-16
RISK ADVISORY COMMITTEE No. 2-16
SEC RULES MEMBERS No. 18-16 RE: FEDERAL AGENCIES RE-PROPOSE RULES ON
INCENTIVE-BASED COMPENSATION ARRANGEMENTS

Last week, the National Credit Union Administration (NCUA) board approved issuing the preamble and NCUA's portion of proposed interagency rules relating to incentive-based compensation practices at certain covered financial institutions, including investment advisers. [\[1\]](#) The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires NCUA to issue this rule jointly with five other agencies—the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission. The other agencies have not issued a re-proposal as of yet, and the preamble and proposed rule will not be published in the Federal Register until they have done so. According to the Release, the final version may differ from what the NCUA has published.

Background

Dodd-Frank Section 956 requires seven financial regulators jointly to prescribe requirements with respect to incentive-based compensation arrangements at covered financial institutions. The statute requires these agencies to prohibit incentive-based payment arrangements, or any feature of any such arrangement, that the agencies determine encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss. The statute also requires covered financial institutions [\[2\]](#) to disclose to their appropriate regulator the structure of their incentive-based arrangements.

The agencies originally issued a proposal regarding incentive-based compensation arrangements at covered financial institutions in 2011, on which ICI filed extensive comments. [3] The 2011 proposed rule would have 1) prohibited incentive-based compensation arrangements that encourage inappropriate risks; 2) required covered financial institutions to make annual non-public reports to their primary regulators describing their incentive-based compensation arrangements; and 3) required the institutions to implement related policies and procedures. The 2011 proposal included additional requirements for covered institutions with assets of \$50 billion or more.

Although the re-proposal includes the same prohibitions as the 2011 proposal, it also incorporates certain practices that financial institutions and foreign regulators have adopted in the last few years to address deficiencies in incentive-based compensation practices. In addition, it distinguishes covered financial institutions by asset size, applying less prescriptive incentive-based compensation requirements to the smallest covered financial institutions and progressively more rigorous requirements to larger covered financial institutions. [4] Significantly and consistent with ICI's comments on the proposal, investment advisers would determine asset size by total assets shown on the balance sheet for the adviser's most recent fiscal year end, excluding non-proprietary assets. According to the Release, the SEC estimates that approximately 669 investment advisers would be covered institutions under the re-proposed rule, with 630 of those investment advisers falling within the lowest asset size tier. [5]

Key Elements of the Re-proposed Rule

Prohibitions. [6] Similar to the 2011 proposal, the re-proposal would prohibit incentive-based compensation arrangements that encourage inappropriate risk by providing excessive compensation or that could lead to material financial loss.

Risk Management and Controls. [7] The re-proposal's risk management and controls requirements for large covered institutions generally are more extensive than the requirements in the 2011 proposed rule.

Board Oversight. [8] In addition to requiring a covered institution's board to oversee its incentive-based compensation program, the re-proposal would require the board to approve specifically the amounts and vested payouts of any incentive-based compensation arrangements for senior executive officers.

Policies and Procedures. [9] The re-proposal would require covered financial institutions to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based compensation. These requirements are more detailed than those of the 2011 proposed rule.

Recordkeeping. [10] The re-proposal would require covered institutions to document the structure of any incentive-based compensation arrangements. This recordkeeping requirement replaces the annual reporting requirement set forth in the 2011 proposal.

Each of these areas of the re-proposal are explained in more detail below.

Key Definitions

There are a number of defined terms in the re-proposal, including:

"Covered person." Only incentive-based compensation paid to "covered persons" would be

subject to the requirements of the re-proposed rule. A “covered person” is any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution.

“Incentive-based compensation.” The re-proposed rule defines “incentive-based compensation” as any variable compensation, fees, or benefits that serve as an incentive or reward for performance.

“Senior executive officer.” The re-proposed rule defines “senior executive officer” as a covered person who holds the title of or functions as president, executive chairman, Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, Chief Investment Officer, Chief Compliance Officer, or various other senior positions.

“Significant risk-taker.” According to the Release, significant risk-takers are individuals who are not senior executive officers but who may have the ability to expose a covered institution to significant risk. [\[11\]](#) Most of the re-proposal’s requirements relating to senior executive officers also would apply to significant risk-takers to some degree.

Prohibitions relating to Excessive Compensation and Risk of Material Loss

The re-proposed rule expressly would prohibit incentive-based compensation arrangements that encourage inappropriate risk by providing excessive compensation. Consistent with the 2011 proposed rule, the re-proposed rule provides that the regulator would consider compensation excessive when amounts paid are unreasonable or disproportionate to the value of the services that a covered person performs. In making this determination, the SEC would consider six specific factors, including the total compensation package, financial condition of the covered institution, and compensation practices at comparable covered institutions. Consistent with ICI’s comments on the 2011 proposal, the re-proposal clarifies that the list of factors would not be exclusive and that all relevant factors would be taken into consideration.

The re-proposed rule also would prohibit incentive-based compensation arrangements that encourage inappropriate risk that could lead to material financial loss. In making this determination, the re-proposed rule would require an incentive-based compensation arrangement to: 1) appropriately balance risk and reward; 2) be compatible with effective risk management and controls; and 3) be supported by effective governance. This is consistent with the requirements in the 2011 proposed rule. In determining whether an incentive-based compensation appropriately balances risk and reward, however, the re-proposed rule additionally would require that the arrangement 1) include financial and non-financial measures of performance; 2) be designed to allow non-financial measures of performance to override financial measures of performance, when appropriate; and 3) be subject to adjustment.

The re-proposed rule provides more detailed requirements and prohibitions than the 2011 proposed rule with respect to the measurement, composition, and acceleration of deferred incentive-based compensation; the manner of vesting; increases to the amount; and the amount that can be in the form of options. For example, the re-proposed rule would require that incentive-based compensation arrangements for certain covered persons include deferral of payments, [\[12\]](#) risk of downward adjustment and forfeiture, and clawback [\[13\]](#) with the aim of appropriately balancing risk and reward.

Risk Management and Controls

The re-proposed rule would establish certain minimum requirements for a risk management framework at a Level 1 or Level 2 covered institution. The framework would need to 1) be independent of any lines of business, 2) include an independent compliance program, 3) and be commensurate with the size and complexity of the covered institution's operations. The re-proposed rule would require these institutions to provide for independent monitoring of 1) incentive-based compensation plans to identify whether those plans appropriately balance risk and reward; 2) events and decisions relating to forfeiture and downward adjustment reviews; and 3) the incentive-based compensation program's compliance with the covered institution's policies and procedures.

Board Oversight

As in the 2011 proposed rule, the re-proposed rule would require a board of a covered financial institution to approve and oversee the institution's incentive-based compensation program, including any material exceptions or adjustments. The re-proposed rule also would require each Level 1 or Level 2 institution to establish a compensation committee composed solely of directors who are not senior executive officers. In addition to general oversight, the board would be required to approve specifically the amounts and vested payouts of any incentive-based compensation arrangements for senior executive officers.

Policies and Procedures

The re-proposed rule would require a Level 1 or Level 2 covered institution to develop policies and procedures for its incentive-based compensation program that, among other requirements:

1. Are consistent with the requirements and prohibitions of the proposed rule;
2. Specify the substantive and procedural criteria for the application of forfeiture and clawback;
3. Document final forfeiture, downward adjustment, and clawback decisions;
4. Specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person;
5. Identify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions, including when discretion is authorized;
6. Describe how discretion is exercised to achieve balance;
7. Require that the covered institution maintain documentation of its processes for the establishment, implementation, modification, and monitoring of incentive-based compensation arrangements;
8. Describe how incentive-based compensation arrangements will be monitored;
9. Specify the substantive and procedural requirements of the independent compliance program; and
10. Ensure appropriate roles for risk management, risk oversight, and other control personnel in the covered institution's processes for designing incentive-based compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback, and vesting and assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.

Recordkeeping Requirements

Under the re-proposed rule, a covered institution would be required to create and maintain

for at least seven years 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 risks and controls.

The re-proposed rule additionally would require Level 1 and Level 2 covered institutions to create annually and maintain records that document:

1. The covered institution's senior executive officers and significant risk-takers;
2. Incentive-based compensation arrangements for senior executive officers and significant risk-takers;
3. Any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and
4. Any material changes to the covered institution's incentive-based compensation arrangements and policies.

The re-proposed rule would require covered institutions to disclose these records to the appropriate federal regulator upon request.

Next Steps; Proposed Compliance Date

When all of the federal agencies involved in the rulemaking approve their version of the proposed incentive-based compensation rule for public comment, the proposed rule will be published in the Federal Register. Regardless of the date of publication in the Federal Register, the deadline for comments is July 22, 2016.

The agencies propose the compliance date to be no later than the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register.

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endnotes

[1] The release can be found on the National Credit Union Administration's website at <https://www.ncua.gov/About/Documents/Agenda%20Items/AG20160421Item2b.pdf> ("Release").

[2] "Covered financial institutions" include, among others, broker-dealers and investment advisers with more than \$1 billion in average total consolidated assets. An investment adviser that is a subsidiary of a depository institution holding company would be subject to the same requirements, and defined to be the same asset level, as the parent covered institution.

[3] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, Securities and Exchange Commission, dated May 31, 2011, available at <https://www.ici.org/pdf/25232.pdf>.

[4] The re-proposed rule divides covered financial institutions into three tiers, with "Level 1" institutions defined as those with assets equal to or greater than \$250 billion, "Level 2" institutions with assets between \$50 billion and \$250 billion, and "Level 3" institutions with

assets between \$1 billion and \$50 billion. Consistent with ICI's comments on the proposal, the re-proposal imparts some flexibility for firms that cross one of these asset thresholds.

[5] The SEC estimates that approximately 18 investment advisers will be Level 1 covered institutions, and approximately 21 will be Level 2 covered institutions.

[6] The Release discusses this aspect at pgs. 115-127 and 138-195.

[7] The Release discusses this aspect at pgs. 195-201.

[8] The Release discusses this aspect at pgs. 127-129 and 201-206.

[9] The Release discusses this aspect at pgs. 206-209.

[10] The Release discusses this aspect at pgs. 129-135.

[11] The re-proposed rule defines a covered person as a significant risk-taker if at least one-third of the person's compensation is incentive-based, that incentive-based compensation is substantial enough to influence the person's risk-taking behavior, and the person meets either a "relative compensation test" or an "exposure test."

[12] The re-proposed rule would apply deferral requirements to significant risk-takers as well as senior executive officers and would require 40, 50, or 60 percent deferral depending on the size of the covered institution.

[13] Level 1 and Level 2 covered institutions would need to include clawback provisions in incentive-based compensation arrangements for senior executive officers and significant risk-takers.

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