Labor and Employment Alert: Major Changes Proposed for Incentive Compensation – Limited to Financial Institutions or Preview of Coming Attractions for Other Types of Employers?

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On June 10, 2016, six agencies that regulate financial institutions (FDIC, SEC, OCC, Federal Reserve Board, National Credit Union Administration, and Federal Housing Finance Agency) jointly proposed regulations regarding incentive compensation for financial institutions. You can access a copy of the proposed rule here. The proposed regulations would require deferral of a significant portion of incentive compensation after the end of the performance period before the award is "vested" and would also require the vested amount to be subject to substantial forfeiture and clawback risks.

Before employers outside of the financial industry get too comfortable, this proposed rule could be a hint of the future for all employers. The concepts in the proposals are likely to be extended to publicly traded employers, tax exempt entities, federal contractors, and other employers either by mandate or as emerging best practices. Therefore, you may want to look into the crystal ball to see your possible future...

What is incentive compensation?

Incentive compensation is defined broadly as any variable compensation, fee, or benefit that serves as an incentive or award for performance. The form of payment (cash, equity-like instrument, or something else) is irrelevant. If adopted as proposed, this rule would have broad impact on compensation programs.

Does the proposed rule apply equally to all financial institutions?

No. The proposed rule applies differently depending on the size of the institution's average total consolidated assets, the length of the performance period, and the employee's role within the institution. Financial institutions would be divided into four levels based on the total consolidated assets within the controlled group.

Institution Category

Average Total Consolidated Assets

Level 1

Greater than or equal to $250 billion

Level 2

Greater than or equal to $50 billion but less than $250 billion

Level 3

- Greater than or equal to $10 billion but less than $50 billion (could be regulated as if a Level 1 or 2)
- Greater than or equal to $1 billion but less than $10 billion

Not described

Less than $1 billion

An institution that increases in asset size would immediately become subject to the rules for new incentive awards, but outstanding awards that had been granted in compliance with the standards at the lower level would be grandfathered. In contrast, an institution that shrinks in size would remain subject to restriction for four more calendar quarters as if it remained the size of the larger institution.

Although Level 3 institutions are not explicitly subject to most of these rules, the proposed rule would allow the regulators to impose some or all of the proposed rule's requirements on the smaller institution if the regulators determine that the institution's complexity of operations, risk profile, and compensation practices justify that oversight.

Which proposed rules apply to all financial institutions?

All financial institutions of any size would need to evaluate their incentive compensation structures to confirm:

The total compensation package is not excessive, considering:

1. The value of the employee's total compensation package considering compensation, fees and benefits;
2. The relative compensation of other employees within the institution with comparable expertise;
3. The financial condition of the institution;
4. Compensation paid by comparable institutions (based on asset size, geographic location, complexity of operations and assets);
5. A cost/benefit analysis of post-employment benefits; and

6. Any bad actions by the employee (fraud, breach of trust, breach of fiduciary duty, insider abuse).

Compensation package appropriately balances risk/reward

1. Is compatible with effective risk management and controls;
2. Is supported by effective governance;
3. Must include both financial and non-financial performance measures;
4. Must contain risk adjustments;
5. Recommend specific activity performance measures and risk adjustments.

Each institution would be required to document an annual evaluation of its incentive compensation practices and to retain documentation regarding that evaluation for 7 years.

Are there limits on performance goals?

If these regulations are finalized as proposed, several common incentive practices would be prohibited:

Prohibited Practice

Examples of Banned Practices

Ban on setting incentives based on relative performance measures

Goals measured as performance in comparison to performance by peer companies like relative net earnings or relative TSR (so that the employees are not rewarded for objectively poor performance just because they performed better than peers)

Ban on volume driven incentive measures (unless the measure includes a transaction quality adjustment component)

Loan origination quota goals, unless accompanied by an adjustment for default rate (so that the goal encourages risk appropriate loan origination practices).

Ban on providing incentives with a payout in excess of 125% of the target amount for senior executive officers (150% for significant risk takers)

Can a person be entitled to a bonus just because the performance goals have been met?

No. Financial institutions would be required to analyze all incentives and determine whether the bonus that would be payable based on the established performance goal is appropriate in the circumstances, or whether the bonus should be reduced. The financial institution would be required to consider the factors described below and defend any decision to pay the full bonus. The reduction is called different things, depending on when within the incentive process the decision is made.

Applicable definitions for the reductions

1. “Downward adjustment” during the performance period (before the award);
2. “Forfeiture” during the deferral period (after the end of the performance period but before vesting);
3. “Clawback” for 7 years after the vesting.

Situations where forfeiture or downward reduction of the whole incentive must be considered

1. Poor financial performance attributable to a significant deviation from established risk parameters;
2. Inappropriate risk taking – ***regardless of outcome***;
3. Material failures of risk management or control measures;
4. Noncompliance with standards that result in (a) regulatory enforcement against the institution, (b) legal actions against the institution, or (c) financial restatement;
5. Any other conduct or poor performance identified by the institution.

Situations where clawbacks of previously paid incentives required

1. The employee’s misconduct resulted in significant financial or reputational harm to the institution;
2. Any fraud by the employee (even if no significant financial or reputational harm);
3. Any intentional misrepresentation of information by the employee.

Process

1. Must establish substantive and procedural criteria for the analysis of downward adjustments, forfeitures and clawbacks.
2. Identify who has authority to decide downward adjustment, forfeiture and clawback decisions.

Are there special limits on Level 1 and Level 2 (and some level 3) institutions?

Level 1 and 2 institutions would need to establish (if they haven’t already) a risk management framework for internal controls, testing, monitoring, and training on written policies and procedures. This must be independent of any line of business. Specifically, the compensation of the individuals in control functions must be independent of the performance of the business areas they monitor. Individuals in control functions must have appropriate authority to influence the risk taking of the business areas that they monitor.

Each year, Level 1 and 2 institutions would need to prepare a list of all “senior executive officers” and “significant risk takers” including the individual’s name, employer, job function, organizational chart hierarchy, and line of business. For each identified person, the institution needs to: (1) list their incentive compensation arrangements; (2) for each incentive program, describe the review and decisions regarding forfeitures, downward reductions or clawbacks; and (3) describe any material changes to the incentive programs from the prior year. These records must be sufficient to audit and verify all incentive compensation decisions and must be retained for at least 7 years.

The “senior executive officers” include people with the title or functional responsibility of: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief audit executive, chief credit officer, chief accounting officer, and any head of a major business line or control function.

A “significant risk taker” is any person (other than a senior executive officer) who has:

Authority to commit or expose 0.5% or more of the net worth or total capital of the institution, if:

- Incentive based compensation is 1/3 (or more) of the total compensation package; and
- Total compensation is in the highest 5% (level 1) or 2% (level 2) for the institution (excluding the SEOs); and

Without regard to the compensation package mix, if the person has authority to expose the institution to risks that could lead to material financial loss in relation to the institution’s size, capital or overall risk tolerance.

A portion of all incentive compensation for Level 1 and 2 institutions would be required to be deferred. Accelerated payment of the deferred amount would only be permitted in the event of the employee’s death or disability, or at the time of income taxation on deferred amounts. This means that change in control acceleration provisions would no longer be permissible.

Below is a sample timeline for incentive compensation awards where the performance period starts on January 1, 2018 (assuming that the rules are effective then):

Length of performance measurement period

Now Called

Award Date (last date of the performance period)

Deferral Period

Vesting Date

Clawback Period

Annual Incentive (or any other performance period less than 3 years)

“Qualifying Incentive Based Compensation”

12/31/2018

Level 1: 4 years

Level 1: 12/31/2022

7 years

Level 2: 3 years

Level 2: 12/31/2021

Any Incentive with a performance period greater than or equal to 3 years)

“Long-Term Incentive Based Compensation”

12/31/2020

Level 1: 2 years

Level 1: 12/31/2022

7 years

Level 2: 1 years

Level 2: 12/31/2021

Title/Institution Size

Type of Incentive

Deferral Percentage

Deferral Period

Senior Executive Officer / Level 1

Incentive Based Compensation

60%

4 years

LTIP

60%

2 years

Senior Executive Officer / Level 2

Incentive Based Compensation

50%

3 years

LTIP

50%

1 year

Significant Risk Taker / Level 1

Incentive Based Compensation

50%

4 years

LTIP

50%

2 years

Significant Risk Taker / Level 2

Incentive Based Compensation

40%

3 years

LTIP

40%

1 year

For example, the compensation committee sets two performance awards for the CEO of a Level 2 institution: (1) an annual cash-based award with a bonus opportunity of $100,000 if the annual performance goals are satisfied; and (2) a performance share award on 10,000 shares if 3-year performance goals are satisfied. Assuming that the committee determines that no downward adjustments or forfeitures are appropriate, the employee would be paid as follows:

12/31/2018

12/31/2019

12/31/2020

12/31/2021

$100,000 cash incentive

$100,000 cash award “awarded”

$50,000 paid (subject to clawback until 12/31/2025)

$16,667 of deferred cash award paid (subject to clawback until 12/31/2026)

$16,667 of deferred cash award paid (subject to clawback until 12/31/2027).

Remaining $16,666 of deferred cash award paid (subject to clawback until 12/31/2028).

10,000 performance share

During performance period

During performance period

10,000 performance shares “awarded”

5,000 performance shares settled immediately (subject to clawback until 12/31/2027)

5,000 deferred performance shares settled (subject to clawback until 12/31/2028).

Where the employee receives a split of cash and equity based incentives, a substantial amount of both types of compensation would have to be deferred. A financial institution would not be permitted to pay cash immediately and defer a larger percentage of the equity award.

The institution may credit and pay interest on the deferred incentive if the terms of the interest accrual are specified in the plan at the time the performance goals are established.

Can employees take steps to protect their incentives?

No. The proposed rules contain a blanket prohibition against methods by which an employee could hedge their incentives.

When would this take effect?

Compliance with these rules would not be required until the first calendar quarter beginning at least 540 days after a final rule is published in the federal register. Any incentive whose performance period started before that compliance date would be exempt from the new rules. This means that the rule is unlikely to apply to performance periods starting before 2019.

Note that a financial institution is unable to circumvent these proposed rules by using a third-party staffing model. Institutions that provide staffing to financial institutions must design compensation programs that would comply with these requirements as if the worker had been employed directly by the financial institution.

Next steps?

Think about how these proposed rules would impact your compensation practices.

- Who are your senior executive officers and significant risk takers?
- What compensation do they receive?
- What changes would need to be made to your current incentive compensation programs to comply?
- How disruptive to employee relations would those changes be?

Depending on your answers, you may want to comment on the proposed rules. Comments are due July 22, 2016. Contact your Vorys lawyer if you have questions about these proposed regulations and their potential impact on your operations.