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Dodd-Frank Act, Section 956

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Introduction – Dodd-Frank Act, Section 956

- Section 956 of the Dodd-Frank Act requires U.S. financial regulators to issue rules prohibiting types and features of incentive compensation arrangements that encourage inappropriate risk-taking at Covered Financial Institutions (i) by providing excessive compensation, fees, or benefits or (ii) that could lead to material financial loss
- U.S. Regulators first proposed rules for Section 956 in 2011; the rules have recently been revised and re-proposed to reflect the latest practices of financial institutions and to align with rulemaking by foreign regulators
- Compliance would be required by 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; the proposed rule would not apply to any incentive-based compensation plan with a performance period that begins before the compliance date
- The comment period for the proposed rules ends on July 22, 2016
  - For calendar year institutions, this means the earliest that the new rules could apply would be performance periods beginning January 1, 2019
  - The effect on non-calendar year institutions depends on when the rules are finalized; if the final rules are published at the end of 2016, this would impact awards with performance periods beginning in the second half of 2018 and later

See Appendix for definition of capitalized terms.

Summary of Covered Financial Institutions and Covered Employee Populations

- Under the proposed rules, Covered Financial Institutions are classified according to three levels determined by the institution's average total consolidated assets:
  - **Level 1:** $250 billion or more
  - **Level 2:** $50 billion or more but less than $250 billion
  - **Level 3:** $1 billion or more but less than $50 billion
- Under the proposed rules, **Level 1** and **Level 2** Covered Financial Institutions would be required to subject Qualified Incentive-based Compensation for Senior Executive Officers and Significant Risk-Takers to: deferral of payment, risk of downward adjustment and forfeiture, and clawback
  - Senior Executive Officers include heads of major corporate, risk, and control functions (likely broader than the Section 16 Officer definition for many institutions)
  - Significant Risk-Takers are determined based on compensation and exposure
- **Level 3** Covered Financial Institutions would generally only be subject to a basic set of prohibitions and disclosure requirements
  - Exceptions would apply to **Level 3** institutions where the activities, complexity of operations, risk profile, or compensation practices of the institution are consistent with those of a Level 1 or Level 2 institution
  - In this case, the **Level 3** institution could be required to comply with some or all of the proposed rules for Level 1 and Level 2 institutions
    - Our understanding is that each **Level 3** institution's governing regulatory agency would have the discretion to determine the applicability of the proposed rules

See Appendix for definition of capitalized terms.

Summary of Deferral Requirements
(Applicable to Level 1 and Level 2 Institutions)

- The proposed rules require the deferral of a certain portion of all Incentive-based Compensation awarded to a Senior Executive Officer or Significant Risk-Taker for a specified period of time
- Any variable compensation, fees, or benefits that serve as an incentive or reward for performance is considered Incentive-based Compensation
- Deferral requirements differ for incentive-based compensation awarded under a Long-term Incentive Plan that is based on a performance period of at least 3-yrs

Deferral of Qualifying Incentive-based Compensation

Population	Level 2	Level 1
Senior Executives	3-years at 50%	4-years at 60%
Significant Risk-Takers	3-years at 40%	4-years at 50%

Generally, annual bonus (formulaic or discretionary) and time-based equity

Deferral of Long-term Incentive-based Compensation
(Following completion of a performance period lasting at least 3-yrs)

Population	Level 2	Level 1
Senior Executives	1-year at 50%	2-years at 60%
Significant Risk-Takers	1-year at 40%	2-years at 50%

Generally, shares/ units, options, or cash earned based on performance over a period of 3-yrs or more

Additional prohibitions/ requirements for deferred incentive-based compensation:

- Deferrals may not vest faster than pro-rata (on an annual basis) beginning on the first anniversary of the end of the performance period
- Deferral must include substantial portions of equity-like instruments and cash
- Options may not represent more than 15% of the required deferral
- Required deferral can only accelerate upon Death/ Disability
- Deferred and unvested compensation subject to: Forfeiture (after Performance Period ends) or Downward Adjustment (during Performance Period) for defined Risk Events/ Failures
- Compensation subject to Clawback for a period of 7-yrs from vesting (not Award)

See Appendix for definition of capitalized terms.

Additional Prohibitions/ Requirements (Applicable to Level 1 and Level 2 Institutions)

- **Hedging.** Covered institutions and Covered Persons cannot hedge deferrals
- **Maximum Incentive-based Compensation opportunity.** Covered institutions are prohibited from awarding Incentive-based Compensation (including long-term compensation) to a Senior Executive Officer in excess of 125% of target (150% of target for a Significant Risk-Taker); the proposed rules do not define "target" and do not discuss how discretionary incentive plans would be treated under this maximum
- **Performance measures.** Incentive-based Compensation arrangements at all covered institutions (including Level 3 institutions) must: (1) include financial and non-financial measures; (2) allow non-financial measures of performance to override financial measures when appropriate; and (3) be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance
  - We believe institutions can choose to utilize non-financial measures as a gating mechanism for the respective incentive plan
- **Relative performance measures.** Incentives granted to Covered Persons cannot rely solely on relative measures
- **Volume-driven measures.** Incentives granted to Covered Persons cannot rely solely on transaction or revenue volume measures without regard to transaction quality or the compliance of the Covered Person with sound risk management
- **Risk management/ compliance systems.** Covered institutions would be required to:
  - Have a systematic approach to designing and implementing their compensation programs supported by independent risk management frameworks with written policies and procedures and developed systems; and
  - Develop, as part of broader risk management framework, an independent compliance program for Incentive-based Compensation
- **Independent compensation committee.** Covered institutions must establish a compensation committee, composed solely of directors who are not Senior Executive Officers, to assist the board in carrying out its responsibilities related to Incentive-based Compensation; the independent committee also must obtain:
  - Input and assessments from various parties, e.g., risk and audit committees of the board or groups performing similar functions; and
  - A written assessment from management, on an annual or more frequent basis, of the covered institution's compensation program and related compliance and control processes

Note: the above represents a summary of the proposed prohibitions and requirements for Level 1 and Level 2 Institutions and is not exhaustive. See Appendix for definition of capitalized terms.

Appendix

Appendix:
Definition of Capitalized Terms

- **Covered Financial Institution.** Includes any of the following types of institutions that have $1 billion or more in assets: (A) a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); (B) a broker-dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o); (C) a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; (D) an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)); (E) the Federal National Mortgage Association (Fannie Mae); (F) the Federal Home Loan Mortgage Corporation (Freddie Mac); and (G) any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for these purposes
- **Covered Person.** Any executive officer, employee, director, or principal shareholder who receives Incentive-based Compensation at a Covered Financial Institution. Included in the class of Covered Persons are Senior Executive Officers and Significant Risk-Takers. The term "executive officer" would include individuals who are Senior Executive Officers, as defined in the proposed rule, as well as other individuals designated as executive officers by the covered institution
- **Senior Executive Officer.** 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 (CEO), 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. The definition of "senior executive officer" also includes a covered person who performs the function of a senior executive officer for a covered institution, even if the covered person's formal title does not reflect that role or the covered person is employed by a different entity
- **Significant Risk-Taker.** Individuals who are not senior executive officers but are in the position to put a Level 1 or Level 2 covered institution at risk of material financial who received annual base salary and incentive-based compensation of which at least one-third is incentive-based compensation during the last calendar year prior to the relevant performance period. An individual would be determined to be a "significant risk-taker" if the individual is either:
  - Among the top 5% (Level 1) or 2% (Level 2) highest compensated covered persons (including executive officers, employees, directors, or principal shareholders who receives incentive-based compensation at a covered institution) in the consolidated organization, or
  - Has the authority to commit or expose 0.5% or more of the capital of the covered institution or an affiliate that is itself a covered institution
- **Performance Period.** The period during which the performance of a covered person is assessed for purposes of determining incentive-based compensation. The Agencies intend for the proposed rule to provide covered institutions with flexibility in determining the length and the start and end dates of their employees' performance periods

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- **Incentive-based Compensation.** Any variable compensation, fees, or benefits that serve as an incentive or reward for performance. The Agencies propose a broad definition to provide flexibility as forms of compensation evolve. Compensation earned under an incentive plan, annual bonuses, and discretionary awards are all examples of compensation that could be incentive-based compensation. The form of payment, whether cash, an equity-like instrument, or any other thing of value, would not affect whether compensation, fees, or benefits meet the definition of "incentive-based compensation." The proposed definition clarifies that compensation, fees, and benefits that are paid for reasons other than to induce performance would not be included, e.g., salary or retention awards conditioned solely on continued employment, signing or hiring bonuses, employer contributions to 401(k), and dividends paid/ appreciation realized on stock owned outright
- **Long-term Incentive Plan.** A plan to provide incentive-based compensation that is based on a performance period of at least three years. Any incentive-based compensation awarded to a covered person for a performance period of less than three years would not be awarded under a long-term incentive plan, but instead would be considered "qualifying incentive-based compensation"
- **Qualifying Incentive-based Compensation.** The amount of incentive-based compensation awarded to a covered person for a particular performance period, excluding amounts awarded to such covered person for that particular performance period under a long-term incentive plan. With the exception of long-term incentive plans, all forms of compensation, fees, and benefits that qualify as "incentive-based compensation," including annual bonuses, would be included in the amount of qualifying incentive-based compensation
- **Deferral.** The delay of vesting of incentive-based compensation beyond the date on which the incentive-based compensation is awarded. The Agencies would not consider compensation that has vested, but that the covered person then chooses to defer, e.g., for tax reasons, to be deferred incentive-based compensation for purposes of the proposed rule because it would not be subject to forfeiture. The Agencies note that the deferral period under the proposed rule would not include any portion of the performance period, even for incentive-based compensation plans that have longer performance periods. Deferral involves a "look-back" period that is intended as a stand-alone interval that follows the performance period and allows time for ramifications (such as losses or other adverse consequences) of, and other information about, risk-taking decisions made during the performance period to become apparent. If incentive-based compensation is paid in the form of options, the period of time between when an option vests and when the option can be exercised would not be considered deferral under the proposed rule
- **Vesting.** "Vesting" of incentive-based compensation means the transfer of ownership of the incentive-based compensation to the covered person to whom the incentive-based compensation was awarded, such that the covered person's right to the incentive-based compensation is no longer contingent on the occurrence of any event

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- **Control Function.** A compliance, risk management, internal audit, legal, human resources, accounting, financial reporting, or finance role responsible for identifying, measuring, monitoring, or controlling risk-taking
- **Risk Events/ Failures.** Events that would be required to trigger a forfeiture and downward adjustment review include: (1) poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered institution's policies and procedures; (2) inappropriate risk-taking, regardless of the impact on financial performance; (3) material risk management or control failures; and (4) non-compliance with statutory, regulatory, or supervisory standards that results in: (i) enforcement or legal action against the covered institution brought by a Federal or state regulator or agency; or (ii) a requirement that the covered institution report a restatement of a financial statement to correct a material error. Covered institutions would be permitted to define additional triggers based on conduct or poor performance. The proposed enumerated adverse outcomes are a set of minimum standards
- **Downward Adjustment.** A reduction of the amount of a covered person's incentive-based compensation not yet awarded for any performance period that has already begun, including amounts payable under long-term incentive plans, in accordance with a forfeiture and downward adjustment review under the proposed rule. Downward adjustment is distinct from clawback and forfeiture because downward adjustment affects incentive-based compensation that has not yet been awarded. It is also distinct from performance-based adjustments that covered institutions might make in determining the amount of incentive-based compensation to award to a covered person, absent, or separate from a forfeiture or downward adjustment review
- **Forfeiture.** A reduction of the amount of deferred incentive-based compensation awarded to a covered person that has not vested
- **Clawback.** Refers specifically to a mechanism that allows a covered institution to recover from a Senior Executive Officer or Significant Risk-Taker Incentive-based Compensation that has vested if the covered institution determines that the Senior Executive Officer or Significant Risk-Taker has engaged in: (1) misconduct that resulted in significant financial or reputational harm to the covered institution; (2) fraud; or (3) intentional misrepresentation of information used to determine the Senior Executive Officer's or Significant Risk-Taker's Incentive-based Compensation. Covered institutions would retain flexibility to include other circumstances or outcomes that would trigger additional use of such provisions. A covered institution could require Clawback irrespective of whether the Senior Executive Officer or Significant Risk-Taker was currently employed by the covered institution. Unlike the Dodd-Frank Section 954 clawback, which will be part of stock exchange listing requirements, covered institutions would not be required to exercise their Section 956 clawback rights

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