The Consumer Finance Podcast: Revisiting Financial Institution Incentive Compensation Rules Under _Dodd-Frank_
Host: Chris Willis
Guests: Sheri Adler and Jina Davidovich
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Chris Willis:

Welcome to _The Consumer Finance Podcast_. I'm Chris Willis, the co-leader of Troutman Pepper's consumer financial services regulatory practice. And today, we're going to be talking about a very interesting blast from the past because a bunch of financial services federal regulators are now revisiting one of the hottest issues that was around at the time Dodd-Frank was passed, and that is incentive compensation. But before we jump into that, let me remind you to visit and subscribe to our blogs, TroutmanPepperFinancialServices.com and ConsumerFinancialServicesLawMonitor.com. And don't forget about all of our other podcasts. We have _FCRA Focus_ all about credit reporting, _The Crypto Exchange_, which of course is all about crypto. We have _Unauthorized Access_, which is our privacy and data security podcast. And finally, _Payments Pros_, which is all about the payments industry. All those podcasts are available on all popular podcast platforms.

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So to talk about this subject, I've got two of my colleagues from our executive compensation and employee benefits group. Sheri Adler, who you all know as one of our very frequent guests on the podcast, but also Jina Davidovich, who's also a member of that group. So Sheri, Jina, thanks very much for being on the podcast today.

Sheri Adler:

Thanks so much for having us, Chris.

Jina Davidovich:

Thanks, Chris. Excited to be here.

Chris Willis:

So Dodd-Frank, as many of our listeners are very familiar with, was enacted in 2010 in the wake of the financial crisis and had 2,000 pages worth of provisions aimed at safeguarding the American public from various business practices that were perceived to have contributed to that crisis. One of those, and was on the lips of everybody at the time Dodd-Frank was passed, was incentive pay at financial institutions that was believed to have encouraged inappropriate risk taking. So Sheri, can you tell us at a high level how Dodd-Frank sought to address executive compensation practices at financial institutions?

Sheri Adler:

Absolutely, Chris. There are a handful of Dodd-Frank provisions that sought to place guardrails around exec comp that, no doubt, our public company listeners are very acquainted with. One example is the requirement for public companies to have robust disclosures around the linkage between pay and performance and to conduct say on pay votes, where shareholders can weigh in on a company's executive compensation practices. And of course, the mandatory clawback rules that went into effect last year and are fresh on everyone's minds. The most recent effort to ran an incentive comp at financial institutions, which is what we'll be focusing on today, is a proposed rule-making under Section 956 of Dodd-Frank. Section 956 is about reducing risky behavior by employees of a financial institution by prohibiting incentive pay practices that are viewed as excessive or that are designed in a way that could lead to material financial losses to the institution. I'll turn it over to Jina now to give our listeners some background on the rule-making process under Section 956.

Jina Davidovich:

Thanks Sheri. Under Section 956, there are six financial institution regulators that are tasked with jointly prescribing regulations under this section. It's the Federal Deposit Insurance Corporation, the FDIC, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency, National Credit Union Association, the SEC and the Fed. And in addition to coming up with rules that prohibit the grant of excess incentive-based compensation that encourages risk-taking, as Sheri mentioned, the regulators are also required under 956 to put enhanced disclosure and reporting frameworks for this type of incentive-based compensation into place. To give us a little bit of a history lesson on this, the regulations under 956 were originally proposed jointly by these agencies in 2011, and at the time they received more than 10,000 comments. So clearly a lot of people feel really strongly about how 956 should go. Updated regulations were then proposed jointly by the regulators in 2016, and they sat idly essentially since then.

And then on May 6th of this year, an updated notice of proposed rulemaking came out. It includes the same rule text that was proposed in 2016, but also explores potential alternatives to certain provisions in the rule, and it also requests comments on virtually the entirety of the proposal. That's given the amount of time that's passed since 2016 and industry developments in the meantime, and also some international developments such as in the UK and EU with respect to financial institutions and how they regulate incentive comp.

Chris Willis:

Jina, do we have any indication as to where the six agencies currently stand with respect to the notice of proposed rulemaking? Do we know what they're going to do?

Jina Davidovich:

Yeah, it's a great question. There's actually a three-three split. So the notice of proposed rulemaking that came out on May 6th, as I mentioned, was actually only formally approved by three of the agencies, the FDIC, the Office of the Comptroller of the Currency and the Federal Housing Finance Agency. It did include the National Credit Union Association, but technically that agency hasn't formally approved it yet, but they're expected to take action on it in the near future. Back in 2023, the SEC had the rule on its rulemaking agenda for 2024, but it did drop off. Practitioners anticipate that the SEC will look to take action on the proposed rule in light of the other agency's actions, though.

The Fed is really the wild card here and we're not sure how that's going to go. We did get some insight into the Fed's current view at the House Financial Services Committee meeting that was held on March 6th of this year. Chairman Jerome Powell was asked whether the Fed would commit to helping finalize the Section 956 rules, and he said in a quote that's been cited a lot recently, that he'd like to better understand the problem we're solving and then see a proposal that addresses that problem. That language seems to suggest that the Fed isn't totally on board with the proposed rule just yet, so we're not really clear on what they'll do.

Chris Willis:

Okay, so what happens if some of the agencies propose a rule and the others don't join it?

Jina Davidovich:

The proposed rule can't progress to the official rulemaking process unless and until it's proposed by all six regulators. So until we have the official notice of proposed rulemaking from the National Credit Union Association, until the SEC acts and the Fed decides which approach they want to take, we're still in a holding pattern. But I'll note that the other agencies that I mentioned are still soliciting comments on an individual basis until the rule appears in the Federal Register.

Chris Willis:

So even if the rule stalls for a while because all six of them haven't aligned their orbits quite yet, I still think it's important for you and Sheri to be here on the podcast today to give our listeners some insight into what the proposed rule says and what the impact might be on financial institutions if it goes into effect. So Sheri, let me go back to you and start with some basics. First of all, what kind of financial institutions would be impacted by the regulations if they go through as proposed?

Sheri Adler:

Chris, under the statute it would be depository institutions and their holding companies, broker dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac, and then other financial institutions that the regulators decide to include in their discretion, but only if the institutions have at least a billion dollars in assets. Institutions with less than a billion dollars in assets are excluded from these regs. The proposed reg goes on further to break down the covered institutions into three tiers based on the value of the entity's assets. Level three is the lowest tier, and those are for entities that have more than a billion dollars in assets. Level twos have $50 billion or more, and level ones have $250 billion or more. And this will be important as we continue talking because you'll see that more stringent requirements apply to those entities that have $50 billion in assets or more, so the level one and twos.

Chris Willis:

Okay, so we know which financial institutions are covered by the proposed rule, but Jina, which individuals associated with these institutions would be impacted by the new rules?

Jina Davidovich:

It's pretty all-inclusive. It basically covers all individuals who receive incentive compensation. The regulation uses the term "covered person", which includes executive officers, employees, directors, and principal shareholders. There are more detailed and stringent requirements that apply to specific categories of individuals at those level one and two institutions. Those are senior executive officers and significant risk-takers. And we'll get into more detail on exactly which requirements apply to those individuals a little bit later on.

Chris Willis:

It's amazing that the new rules would apply to any employee of a financial institution, even all the way down to customer service and collections, which do frequently have incentive compensation programs. So that's highly relevant to our audience. Jina, if you're an employee or someone else who's covered by the proposed rule, what are the rules that apply to your incentive pay?

Jina Davidovich:

Taking a step back really quickly thinking about what kind of incentive-based compensation is covered here, it's a really broad definition. It's defined in the regulation as any variable compensation, fees or benefits that serve as an incentive or reward for performance. So we're not talking about base salary here, but there are a broad array of incentive-based compensation arrangements that are probably covered here. And we're looking at two elements of incentive-based compensation. We want to ensure that it's not excessive and that it doesn't encourage significant risk-taking. So when we think about what is and isn't excessive incentive-based compensation, we're trying to see if there's an imbalance in the value of the services that are performed and the value of the compensation package that's offered. And if we're determining if something is or isn't excessive, we're looking at a number of different factors.

It's a non-exhaustive list, but the regulations specifically suggest that you should look at the employee's total compensation, their compensation history, the compensation history of colleagues of theirs with similar expertise, compensation practices at peer entities, the institution's overall financial condition, and potential bad acts by the covered individual like fraud or breach of some kind of fiduciary duty to the institution. And when we're thinking about encouraging inappropriate risks, we're looking at risks that could lead to material financial loss for the institution. And that incentive-based compensation has to appropriately balance risk and reward. It has to be compatible with effective risk management and also supported by good governance. So when we're looking at that balance between risk and reward, the regulations specifically state that these kind of incentive-based compensation arrangements need to include both financial and non-financial performance measures.

So for example, if you have an award that's tied purely to corporate sales or profit or revenue, that wouldn't be sufficient. You also have to have non-financial measures included in that award, such as compliance with the institution's policies or rules on risk-taking or strategic leadership through a challenging merger. Both have to be included in the design. In addition to that, the award has to have a mechanism where the non-financial measures can actually override the financial measures where it's appropriate. And finally, the award has to allow for adjustments in the case of losses, inappropriate risk-taking and compliance failures that occur during the performance period. Importantly, we do want to note that there is a grandfathering provision so you don't have to run out and change all of your incentive-based compensation programs right away. This would only apply to those arrangements whose performance periods begin after this rule goes into effect.

Chris Willis:

You mentioned that there are some additional requirements that apply to certain categories of upper level employees or people at level one and level two institutions. So who are those individuals that have heightened requirements applicable to them?

Jina Davidovich:

There are two categories, as I mentioned, senior executive officers and significant risk-takers. So senior executive officers at those level one and two institutions covers your C-suite, your CEO, your CFO, your COO. Also bound up in there would be your chief compliance, audit, risk, credit and lending officers, as well as individuals who head up major business lines or control functions. And then significant risk-takers at these institutions are going to bring in those who are not senior executives, but have a significant portion of their pay tied up as incentive compensation. It has to be at least one-third of their pay, and they have to either be in the top two to 5% of the most highly paid individuals other than those senior executive officers. The two to 5% just depends if you're at a level one or two institution. Or they have to be someone who can commit or expose at least 0.5% of the institution's capital.

There's also some additional discretion for the regulators to lump in other people who don't fit into those categorizations as significant risk-takers as well. The basic idea is that these are people who, in addition to top management, have the ability to expose the institution to significant risk because of the design of their incentive pay or their control over the institution's capital.

Chris Willis:

Jina, I feel like it would be kind of a cool badge of honor to put on your LinkedIn profile that you're a significant risk-taker, don't you?

Jina Davidovich:

100%. It might come with some additional requirements under 956, but it could be worth it.

Chris Willis:

Okay. So Sheri, let me turn back to you. What are some examples of the additional requirements that apply to incentive compensation for the senior executives and significant risk-takers at the level one and two institutions under the proposed rule?

Sheri Adler:

First of all, there's a cap on incentive comp payouts. Let's just say you have a performance-based restricted stock unit award, so a PRSU award, and it provides for payout at the end of a three-year performance period based on the achievement of performance metrics. And the payout can range anywhere from 0% to 200% of a target level. Under these proposed rules, that wouldn't work for these categories of individuals because the payout would have to be capped at 125% of target for senior executives and 150% of target for significant risk-takers. Now, there's no requirement mandating that target payout be set at a specified amount of money, but still, there are many awards out there right now that range from zero to 200%, so this would certainly be a change.

Chris Willis:

Are there also limits on the types of performance measures that can be used in senior executive officers and significant risk-takers incentives at the same level one and two institutions?

Sheri Adler:

You can't use purely relative measures for incentive pay. So meaning, a performance measure that tracks performance based solely on a bank's performance relative to a peer group or a market index like a relative total shareholder return, RTS, PRSU, or one that looks on relative return on average assets. You would also need an absolute performance metric within that award, meaning you have to look also at whether the company is meeting its own internal metrics, not just tied to the market performance. And the truth is we do see a lot of awards that have both components to some degree. One common design we'll see for PRSU awards is an award that's based on the achievement of relative TSR, so compared to the market. But then the award will also say that nonetheless, no greater than 100% of the award can be earned if the absolute TSR is a negative measure.

So in other words, even if the company is outperforming their peers, the executive can't earn maximum unless the company's also hitting certain internal targets. So we do already see a bit

of an interplay between relative and absolute measures in award designs, but I think with these proposed rules, we'd really need to do a deep dive and a more intensive analysis to see just how much the absolute metric needs to be factored into the award design if these rules do get approved.

Chris Willis:

So I understand there are also deferral requirements for at least a portion of pay for the same group of individuals that we've been talking about. What is that all about?

Sheri Adler:

There's a mandatory deferral period for between 40 to 60% of a senior executive officer's or a significant risk-taker's incentive pay depending on the role and level of the institution. This isn't how a lot of exec comp lawyers will think of deferral periods as 409A compliant deferrals. You've earned the amounts, you're vested into the amounts and you defer it and want it to pay out later for tax structuring reasons. That's not what we're talking about here. What we're talking about is minimum vesting conditions. So after performance conditions are fulfilled, the proposed reg says that compensation that goes into this 40% to 60% needs to be subjected to additional minimum vesting requirements. That subsequent minimum vesting period can range from one to four years. It just depends on the type of incentive, how long the performance period is and what institution you're at, your title, etc.

And the agencies believe that this is necessary because there are certain risks and outcomes that won't become clear until a certain amount of time has passed after the conclusion of a performance period. So you can't make a longer performance period and have these vesting requirements run concurrently. They always have to happen after the culmination of the performance period for the percentage of pay, which is subject to these deferral requirements. As an example, let's say you are a senior executive at a level one institution. You have a typical PRSU with a three-year performance period. The period ends, the comp committee determines how many shares you earned, and let's just say it's 100. Now though, those shares are subject to a two-year subsequent minimum vesting period. And the fastest rate at which they're allowed to vest is over tranches in equal installments starting a year later. So you can vest into 50 of those shares after one year after the performance ends, and then the other 52 years after the performance ends.

In other words, you won't fully vest into that grant until five years after the grant was made. Also, the vesting can't be accelerated except for death or disabilities. And in fact, one of the questions that's raised in the notice of rulemaking and requests for comments is whether there should be an exception for a termination without cause too. As we know, that's quite common that executives get some kind of accelerated vesting if there is an involuntary termination.

Chris Willis:

Okay. So as to the composition of that 40 to 60% of incentive pay that's subject to the deferral rules that you just mentioned, are there additional rules about what can go into that?

Sheri Adler:

Well, it needs to be a mix of cash and equity-based instruments, and also incentive-based options or stock appreciation rights can only represent up to 15% of the deferred amount.

Chris Willis:

Now I understand there also need to be mechanisms to reduce incentive pay for the senior executives and significant risk-takers at level one and two institutions. Can you describe those?

Sheri Adler:

Right. So there needs to be mechanisms to reduce the incentive pay basically at each stage. Whether the performance period is still open, whether it's closed, then the awards are in the minimum vesting stage, or whether they've already vested. And based on the different stages, there are different terms used. So forfeiture, downward adjustment, clawback. While a performance period remains open or during the subsequent minimum vesting period, financial institutions will need to consider a whether reduction is appropriate, whereas senior executive or significant risk-taker had some responsibility for adverse outcomes that happened. For example, poor financial performance at the institution or a failure to comply with certain rules that led to an enforcement action. It also includes an analysis of the individual's intent and their role in the problematic event.

And then I know you're all sick of hearing from me on clawbacks, but section 956 also has a clawback requirement. And yep, it's in addition to the other clawback policies that all the public companies that are listening put into place last year under section 954 of Dodd-Frank, those separate ones mandate a clawback in the event of a restatement of financials, whether or not the executive engaged in misconduct. This one, the focus of the section 956 clawback is different because it is more focused on misconduct. So if the senior executive officer or significant risk-taker engages in certain bad acts, say they had some misconduct that really harms the institution, whether financially or reputationally, the institution will need to consider whether clawback is appropriate. There's a focus here under section 956 on the individual's behavior and really the individual's misbehavior.

There's also differences in terms of it being mandatory under those other clawback policies and here more discretionary. But in any event, important to know that there are overlapping regimes here for public companies. And the other thing I wanted to mention is that potential clawback under section 956, it's also potentially a much longer period than the clawback policies that were put into place at public companies last year, because the clawback could occur for seven years after vesting. So if you think about it, if you have an award that was granted, it had a three-year performance period, then it had a two-year vesting period, and then it's subject to clawback for another seven years. We're talking about 12 years after grant. That's a lot longer than the mandatory clawbacks put into place under section 954 last year, which looks at awards that had closed performance periods in the three completed years right before the clawback was triggered.

Chris Willis:

That is a lot of rules and a lot of potential changes to compensation design, but that's not all, right? You mentioned that Section 956 also imposes documentary and governance guidelines on the covered financial institutions. So Jina, could you tell us a little bit about those?

Jina Davidovich:

The covered institutions have to maintain detailed records regarding incentive based compensation for seven years and be ready to provide those records to the appropriate federal regulator upon request. The 2011 proposed rules that I mentioned actually contemplated an annual reporting requirement, but this was replaced by the record keeping and disclosure upon request requirement that I just mentioned. So a little bit easier, but could still be onerous for some institutions. I do note that there's no disclosure required of specific people and their compensation amounts like the proxy statement here. So that's a little bit easier, but could still be a lot for some institutions. In addition, there is enhanced disclosure compliance and record keeping obligations for level one and level two institutions. Not surprising given what else the rule does for level one and two institutions, as we discussed earlier.

Just as a few examples, you have to keep a list of senior executive officers and significant risk-takers, details on all of their incentive compensation arrangements, details on any reduction that's based on forfeiture, downward adjustment or clawback under the rules, and material changes to incentive compensation policies generally. This has to be maintained in such a way that it can be audited by a third party that is independent from the covered institution. And then from a governance perspective, there has to be a compensation committee that monitors this incentive based compensation, which as many of you know is the norm at public companies with respect to executive officer pay arrangements. So you may already have some of that in place.

In addition to that committee, management members are required to report to this committee about the effect of incentive compensation programs on the institution's broader financial health and how those relate to the risk management strategy. And the internal risk and audit committees also have to submit a report to this compensation committee, at least on an annual basis, about what the institution's incentive based compensation programs look like. So like I said, there's a lot of additional work that these institutions, especially those level one and level twos with more than 50 billion in assets, are required to do to comply with these regulations.

Chris Willis:

So now that we've gone through some of the increased burdens and compliance obligations and compensation design changes that the proposed rule would bring about, could you answer for me, what's the likelihood in your view that these rules will actually go into effect anytime soon?

Jina Davidovich:

Would that I had a crystal ball, Chris. That's a great question. The rule appears to have a lot of aspects open. The participating regulators included questions for public consideration on almost every single aspect of the rule, and they also offered a number of alternatives to the proposed rule's current language. Those alternatives include whether we should collapse level one and two institutions into a single category, if the appropriate definition is used for significant risk-takers, if the forfeiture and downward adjustments that Sheri was mentioning earlier should be mandatory or discretionary, and if there should be additional risk management requirements that are imposed. Given that, we're not really sure where the rule stands.

Sheri Adler:

Yeah, I agree, Jina, there's a lot that seems to be open to comment and review here, and we don't even have buy-in yet from all the agencies. Chris, there's a lot of uncertainty right now about the impact that the reproposed rule will have, and then add to that the general climate of uncertainty in an election year. We'll stay tuned and continue to monitor the landscape for updates, and we'll be happy to come back on the podcast if there are any.

Chris Willis:

Well, I'll be happy to have you on, just as I was very happy to have you on today. Although I have to note for our audience that I think that the drafters of Dodd-Frank have ruined the number 956 for me because there was a famous Porsche race car called the Porsche 956 in the eighties, and I grew up watching it race, and now every time I hear 956, I'm going to think about this confounded proposed rule that we've just been talking about. But nevertheless, it's a very important thing for our clients and for the financial services industry to know about. So Sheri and Jina, thank you very much for being on the podcast today. And thanks to our audience for tuning in today as well.

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