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BENEFITS BRIEF

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Mandatory Deferral of Financial Institution Bonuses and Impact on Nonqualified Deferred Compensation Plans

Recently proposed rules could have a major impact on the incentive plans of financial institutions and raise issues under section 409A and other sections of the Internal Revenue Code ("Code"). On May 6, 2016, the Securities and Exchange Commission ("SEC") was the last of six financial regulators to re-propose rules under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") that provide for restrictions on incentive-based compensation arrangements at covered financial institutions with at least $1 billion in assets.[1]

A few highlights of the proposed rules include:

- New design restrictions on short- and long-term incentive plans,
- Mandatory deferrals of up to 60% of incentive-based compensation,
- Potential reductions in award amounts, forfeitures and clawbacks, and
- Significant impact on nonqualified deferred compensation plans.

Comments on these rules are due by July 22, 2016. However, once adopted, the final rules would not be effective until 540 days after publication in the federal register and would only apply to incentive-based compensation arrangements with performance periods beginning on and after the date. For example, assuming these proposed rules are finalized and published in 2016, they would not apply to calendar year incentive-based compensation arrangements until 2019. We summarize below the key provisions of the rules and focus particularly on how the rules may impact nonqualified deferred compensation plans subject to Code section 409A.

Overview

Generally, the proposed rules under Section 956 of the Dodd-Frank Act prohibit covered financial institutions from using any type of incentive-based compensation arrangement that encourages inappropriate risks:

[1] In early 2011, the SEC and five other financial regulators originally proposed these rules, including the Office of Comptroller of Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Federal Housing Finance Agency and National Credit Union Administration.

- by providing a covered person with excessive compensation, fees or benefits; or
- that could lead to material financial loss to the institution.[2]

In addition, these rules require a covered financial institution to create, maintain, and disclose upon the request of a regulator, records of the structure of its incentive-based compensation arrangements sufficient to determine compliance with the above restrictions.

To appropriately balance risk and reward in compliance with the proposed rules, the structure of an incentive-based compensation arrangement must include financial and non-financial performance measures, including considerations of risk-taking relevant for each covered person. And the structure must allow the non-financial measures to override financial performance when appropriate. Further, amounts awarded under an incentive-based compensation arrangement must be subject to downward adjustment to reflect actual losses, inappropriate risks, compliance deficiencies, or other measures or aspects of financial and non-financial performance. The board of directors of a covered financial institution, or a committee of the board, must oversee and approve the incentive-based compensation arrangements for senior executive officers, including the amounts and payouts of all awards and any material exceptions or adjustments to such arrangements.

Covered Financial Institution and Covered Persons

While the proposed rules apply to all covered financial institutions with average total consolidated assets greater than or equal to $1 billion,[3] each covered financial institution will be designated as a Level 1, Level 2 or Level 3 covered institution based on whether its assets equal or exceed $250 billion, $50 billion or $1 billion, respectively. Because specific requirements applicable to Level 3 covered institutions were not addressed in the proposed rules, the remainder of this summary only applies to Level 1 and Level 2 covered institutions.

The proposed rules apply to covered persons and define a "covered person" to include any executive officer, employee, director or principal shareholder who receives incentive-based compensation at a covered institution. However, additional requirements apply to "senior executive officers" and "significant risk-takers" at covered institutions. Senior executive officers include covered persons who hold the title or perform the function of one or more roles specified in the proposed rule (e.g., president, CEO, CFO, COO) or head a major business line or control function. Other than senior executive officers, significant risk- takers include covered persons who:

[2] Incentive-based compensation means any variable compensation, fees, or benefits that serve as an incentive or reward for performance. The proposed rules clarify that compensation, fees, and benefits that are paid for reasons other than to induce performance would not be included. For example, compensation, fees, or benefits that are awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary or a retention award or RSU that is conditioned solely on continued employment) would not be considered incentive-based compensation. Likewise, payments to new employees at the time of hiring (signing or hiring bonuses) that are not conditioned on performance achievement would not be considered incentive-based compensation.

[3] These covered financial institutions include, among others, the following types of entities: banks, savings associations, bank holding companies, savings and loan companies, U.S. operations of foreign banks that are treated as bank holding companies, state- and federally licensed U.S. branches and agencies of foreign banks, credit unions, broker-dealers, investment advisers, Fannie Mae, and Freddie Mac.

- receive at least one-third of their total compensation (i.e., annual base salary and incentive-based compensation) in the form of incentive-based compensation, and
- are either: (a) among the highest compensated in the covered institution (i.e., top 5% for Level 1 covered institutions and top 2% for Level 2 covered institutions); or (b) may commit or expose 0.5% or more of the covered institution's capital.

As described in more detail below, these additional requirements include:

- mandatory deferrals,
- downward adjustments, forfeitures and clawbacks,
- restrictions on plan design, and
- other corporate governance and documentation requirements.

Mandatory Deferral of Incentive-Based Compensation

Percentages and Periods. The proposed rules require covered institutions to defer a percentage of the senior executive officers' and significant risk-takers' "qualifying incentive-based compensation" and incentive-based compensation from a "long-term incentive plan" for a set period of time following the end of the applicable performance period. We include below a chart reflecting the minimum required deferral percentages and periods based on the type of covered institution, the type of incentive-based compensation, and the position of the covered person.[4]

Type of Incentive-Based Compensation	Level 1 Covered Institution		Level 2 Covered Institution	
	Senior Executive Officer	Significant Risk-Taker	Senior Executive Officer	Significant Risk-Taker
Qualifying Incentive-Based Compensation	60% for 4 years	50% for 4 years	50% for 3 years	40% for 3 years
Long-Term Incentive Plan Compensation	60% for 2 years	50% for 2 years	50% for 1 year	40% for 1 year

During the deferral period, the deferred incentive-based compensation may not be:

- paid out faster than on a pro rata annual basis beginning no earlier than the first anniversary of the end of the applicable performance period.[5]
- subject to accelerated payment, except in the event of death or disability, and
- increased, except based solely on a change in share value or interest rates, or the payment of interest established at the time of the award.

[4] A long-term incentive plan is any plan that provides for incentive-based compensation that is based on a performance period of at least three years, and qualifying incentive-based compensation is any incentive-based compensation awarded for a performance period of less than three years.
[5] For purposes of the proposed rules, "vesting" of incentive-based compensation means the transfer of ownership of the incentive based compensation to the covered person to whom such compensation was awarded (i.e., payment).

Further, to the extent a covered institution or one of its affiliates issues incentive-based compensation in the form of equity, the deferred awards must include a substantial portion of both deferred cash and deferred equity-like instruments.

Downward Adjustment, Forfeiture and Clawback. Generally, upon the occurrence of certain adverse events at a covered institution, all of the unpaid deferred incentive-based compensation (including under a long-term incentive plan) must be subject to forfeiture and all of the incentive-based compensation (including under a long-term incentive plan) not yet awarded to a senior executive officer and a significant risk-taker for the current performance period must be subject to a downward adjustment (i.e., a reduction of the amount of incentive-based compensation under a current performance period).[6]

In addition, the incentive-based compensation arrangements must include clawback provisions that allow the covered institution to recover all or part of the incentive-based compensation paid to current or former senior executive officers and significant risk-takers for seven years after payment, if the covered institution determines that the person engaged in:

- misconduct that resulted in significant financial or reputational harm;
- fraud; or
- intentional misrepresentation of information used to determine the incentive-based compensation.

Restrictions on Design. The proposed rules provide several additional prohibitions on the design of incentive-based compensation arrangements at covered institutions, including:

- Covered institution must not award incentive-based compensation in excess of 125% of target for a senior executive officer or 150% of target for a significant risk-taker.
- Covered institution must not use performance measures based solely on industry peer performance comparisons (e.g., relative TSR).
- Covered institution must not provide incentive-based compensation based solely on transaction revenue or volume without regard to transaction quality or compliance with sound risk management.
- Covered institution must not purchase a hedging instrument or similar instrument to hedge or offset any decrease in value of the incentive-based compensation.

<u>Other Corporate Governance and Documentation Requirements</u>

The proposed rules require covered institutions to, among other things:

- have a risk management framework for its incentive-based compensation program,
- provide for independent monitoring,
- establish a compensation committee composed solely of directors who are not senior executive officers,
- create and maintain extensive records that would allow for an independent audit of compliance, and
- develop and implement certain policies and procedures with respect to its incentive-based compensation program to ensure compliance with the proposed rules.

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[6] The adverse events triggering a forfeiture or downward adjustment include, without limitation, poor financial performance resulting from a significant deviation from risk parameters, inappropriate risk taking, regardless of the impact on financial performance, material risk management or control failures, non-compliance with statutory, regulatory, or supervisory standards that results in enforcement or legal action or a financial restatement.

Impact on Nonqualified Deferred Compensation Plans

For reasons described below, these proposed rules may require a covered institution to revisit and potentially revise the design of its nonqualified deferred compensation plans (absent further guidance).

No Substantial Risk of Forfeiture. Although the deferred portion of an incentive-based compensation award remains subject to forfeiture and clawback, as described above, these contingencies alone should not constitute a "substantial risk of forfeiture" under section 409A of the Internal Revenue Code ("Section 409A").[7] As a result of the required delay in payment under the proposed rules well beyond the date the substantial risk of forfeiture lapses, most of the mandatorily deferred awards will be subject to Section 409A and must have a compliant time and form of payment.

409A Compliant Payment Timing. Payments under Code section 409A may only be made upon a specified date or upon one of five permissible "trigger" events: (1) a separation from service, (2) death, (3) disability, (4) change in control, or (5) unforeseeable emergency. A nonqualified deferred compensation plan may provide for distributions upon the earlier of, or the later of, two or more specified permissible events. Based on the accelerated payment restrictions under the proposed rules, the deferred awards may only be paid upon the earlier of: (i) a specified date, (ii) disability (as defined under Code section 409A) or (iii) death. As a result, a nonqualified deferred compensation plan of a covered institution may need to be revised to incorporate the above payment design with respect to these deferred awards (i.e., no payment of these deferred awards upon retirement or involuntary termination and use of a 409A-compliant definition of disability).

Increase in Share Value or Pre-established Interest. The proposed rules require that any increase in the deferred incentive-based compensation during the deferral period must be solely due to an increase in share value or pre-established interest. Also, to the extent applicable, the proposed rules require the deferral of a substantial portion in equity-like instruments (i.e., a deferred right to receive a share in a future year). Because most nonqualified deferred compensation plans provide for the crediting of earnings on deferred amounts based on notional investments in mutual funds or similar investment vehicles, many nonqualified deferred compensation plans will likely need to be revised to comply with these requirements.

Limitations on Plan Termination. Code section 409A permits a company to terminate and liquidate its nonqualified deferred compensation plans provided certain requirements are met. In the event of a plan termination, the company is required to payout all of the deferred amounts within set periods of time depending on the circumstances (e.g., within 12 months following termination). Due to the restrictions on accelerated payment in the proposed rule, covered institutions will be unable to take advantage of these plan termination rules under Code section 409A.

Clawback and Related Compliance Issues. Covered institutions should be aware of a potential pitfall for the recovery of incentive-based compensation created by Code section 409A. Code section 409A contains strict rules regarding nonqualified plan documentation and operation and imposes severe tax penalties on employees for violations. Among many other restrictions, Code section 409A generally prohibits the settlement of a current employee debt over $5,000 by reducing the amount of deferred compensation the employee is scheduled to be paid in the future, as such an arrangement would be an impermissible "acceleration" of the deferred amount. This prohibition on accelerations means a company should not satisfy its clawback obligation under the proposed rule by

[7] Treas. Reg. §1.409A-1(d).

deducting the amount to be recovered from an executive's nonqualified plan account (or any other amount subject to Section 409A), as such a practice would expose the executive to Code section 409A's tax penalties. There is also a potential problem if the documentation for an arrangement subject to Code section 409A provides for recouping amounts owed by the employee, even if recoupment is to occur at the originally scheduled payment date.

While the proposed rules do not prescribe how to recover incentive-based compensation paid to senior executive officers and significant risk-takers, they require covered institutions to create policies and procedures that specify the substantive and procedural criteria for clawing back these amounts. This clawback requirement raises issues similar to those noted above, and a covered institution should consider the implications under Code section 409A both when drafting its clawback policies and procedures and when actually attempting to recover compensation paid to a covered person.

Required Use of Non-Financial Performance Measures. Code section 162(m) imposes an annual $1 million deduction limit on compensation paid to top executives at public companies. In order to be performance-based compensation exempt from this limit, compensation must, among other things, be paid solely on account of the attainment of one or more pre-established objective performance goals approved by shareholders. Often, the shareholder approved goals contained in short- and long-term incentive-based compensation arrangements are financial in nature. As a result of the requirement to use non-financial performance measures, many covered institutions may need to get new goals approved by shareholders or use the non-financial performance measure solely to reduce the amount of the incentive-based compensation awards (i.e., negative discretion) to covered employees subject to Section 162(m).

Conclusion

The proposed rules most certainly will impact the design of incentive-based compensation arrangements sponsored by certain financial institutions. As covered institutions and their executives work through the many potential ramifications of the proposed rules, they should keep in mind the likely impact the proposed rules will have on their nonqualified deferred compensation plans.