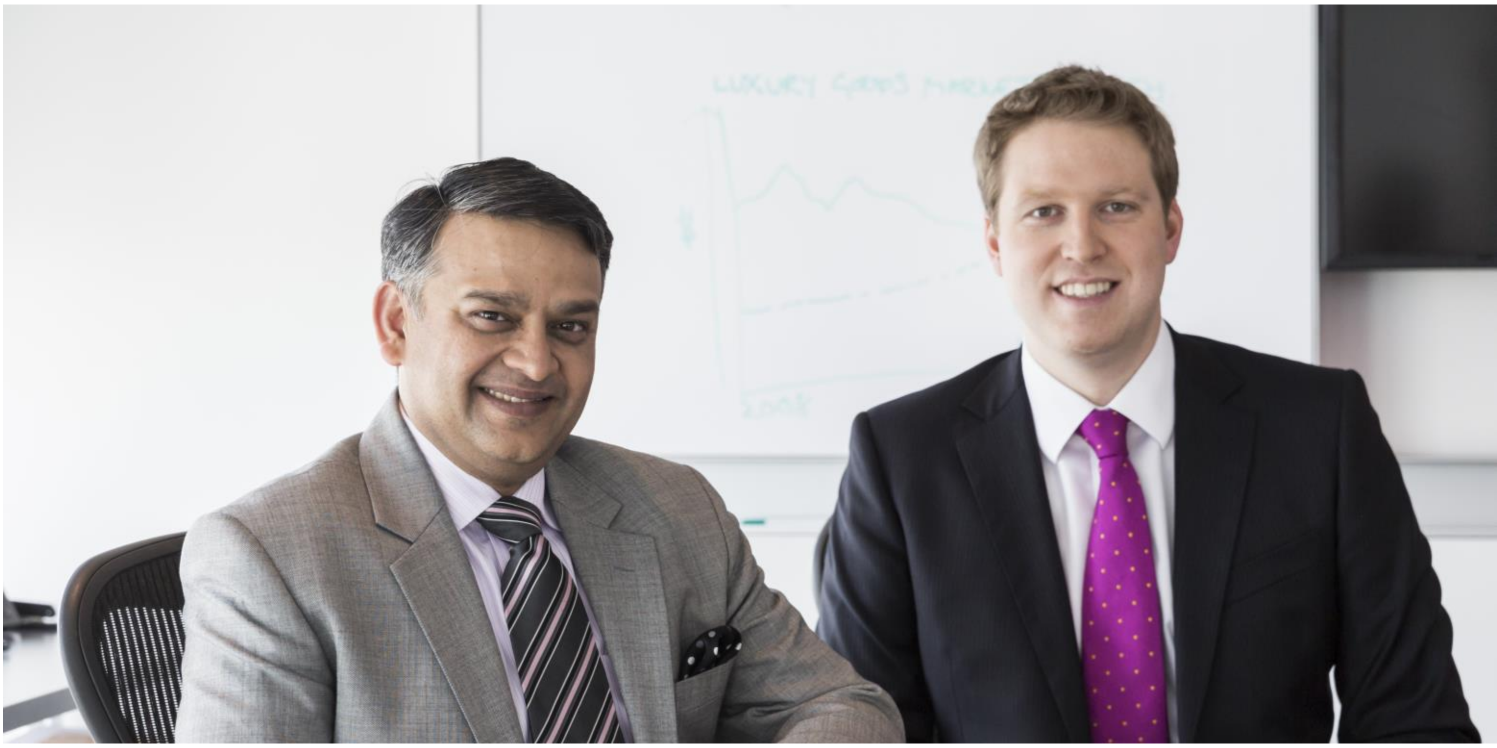
May 2016

US federal agencies publish joint consultation paper on Incentive-based Compensation Arrangements



On 16 May 2016, six of the US federal agencies published joint proposed rules on 'Incentive-based Compensation Arrangements' under the Dodd Frank Wall Street Reform and Consumer Protection Act (the 'proposed rules'). The rules will apply to the majority of banking (and some other financial services) organisations' operations in the US. Generally, the current UK rules, based on EU Directives, are tougher than the proposed rules in the US and consequently the impact on US subsidiaries of UK firms will be less than on their US counterparts. The rules, however, do bring much closer alignment between the US and UK in areas such as deferral and clawback. As such, they may help to reduce the competitive disadvantage that has existed for EEA firms operating in US to date. As might be expected, the US regulators do not propose a bonus cap, but do propose the introduction of limits on the amount of leverage in variable pay.

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In a nutshell

What is it?

Consultation paper on incentive based compensation rules, published under the remit of the Dodd Frank Wall Street Reform and Consumer Protection Act.

Who has published it?

Six of the US federal agencies (the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, National Credit Union Administration and the US Securities and Exchange Commission).

When was it published?

16 May 2016 (the National Credit Union Administration published on 21 April 2016).

Who is this relevant to?

All US regulated banks, investment advisors, broker-dealers and other financial institutions as determined by the regulators by joint rule, including firms headquartered outside of the US, but operating within the US.

Where can I find it?

A link to the consultation paper can be found here.

What is the timing?

The consultation period will close on 22nd July 2016. The rules will apply from the first full performance years commencing on or after the compliance date. This compliance date is not yet known but is likely to be in Q3 2018.

What should I do next?

- Determine which entities within your Group are impacted;
- Consider whether a response to the consultation paper is appropriate;
- Determine what proportionality level your firm will fall into;
- Start assessing the population of staff members who will be impacted by the proposed rules (i.e. who may be identified as a senior executive officer or a significant risk taker); and
- Conduct a review of the impact of the proposed requirements, taking into account any sectoral remuneration regulation regimes which already apply by entity and population group.

Who can I contact?

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Overview

On the 16th May 2016, five of six of the US federal regulatory agencies published a consultation paper on the rules on compensation that will apply to US banks, asset managers, broker dealers, and other financial institutions, as determined by the regulators. The National Credit Union Administration published their initial (very similar) version on 21 April 2016.

Background and context

The Dodd Frank Wall Street Reform and Consumer Protection Act (the "Act") was signed into US law in 2010 as part of the US regulatory response to the financial crisis. Within the Act is a requirement that any compensation arrangements that encourage inappropriate risks or that could lead to material financial loss for the institution should be prohibited. To enforce this requirement, the Act tasks six of the US federal regulatory agencies ('the agencies') to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at certain financial institutions. In April 2011, the agencies published a set of rules that established limitations on the timing of bonuses, but not the size. Since this publication, incentive-based compensation practices and the regulation of them have evolved in the financial services industry. This can be seen most notably in Europe where, through EU regulation, there has been a significant shift towards prescriptive rules on the structure of remuneration, including a cap on variable pay relative to fixed pay for certain individuals (the "bonus cap"). Given this change, and in the interest of international coordination and consistency, the agencies have therefore reviewed their rules and submitted for Consultation an updated approach.

Who is impacted?

The proposed rules apply to 'covered institutions'. These are institutions with more than $1bn of consolidated assets that meet one of the types of firm defined by the Act (including depository institutions, broker-dealers, credit unions and investment advisors). In line with the European approach, the proposed rules also include the ability for smaller firms to apply proportionality and introduces a "level" approach which is similar in principle to that operated by the UK regulators. This approach is summarised below:

US	UK
• Level 1: firms with more than $250bn of consolidated assets	• Level 1: firms with more than £50bn of consolidated assets
• Level 2: firms with consolidated assets of between $50bn and $250bn	• Level 2: firms with consolidated assets of between £15bn and £50bn
• Level 3: firms with consolidated assets of between $1bn and $50bn	• Level 3: firms with consolidated assets of less than £15bn

The more onerous rules (such as identification of senior management and risk takers) and the more prescriptive requirements for the structure of pay (such as deferral, malus, clawback, payment in shares and the leverage limit) only apply to level 1 and 2 institutions. Level 3 firms will only be subject to the most basic principles and disclosure requirements. For smaller subsidiaries, the proposed rules also allow these firms to utilise their parent company's governance structures to achieve compliance rather than having to establish their own.

High level comparison of US and EU requirements

The table below summarises key aspects of the US proposed rules compared to the existing EU rules that apply to banks. Further detail on certain aspects of the rules are provided in an appendix at the end of this update (highlighted with a * in the table). Please note that this table does not provide a complete summary of all of the requirements within the proposed rules, but aims to highlight key areas of the regulation, focusing on the alignment with existing EU and UK regulation.

Topic	US proposed rules (primarily level 1 and 2)	Similarity with EU requirements	PwC commentary
Individuals to whom the structural requirements apply*	Senior management and risk takers identified based on a proportion of the top earning individuals and authority to commit the firm's capital		The principles of the approach are similar, but US requirements may include different individuals and cover a larger group, particularly due to the quantitative pay definitions which, unlike in Europe, cannot be disapplied
Deferral*	Prescriptive requirements based on size of the institution and type of individual, including specific requirements for long-term incentives		Prescriptive approach is similar to that operated in Europe, but with differing proportions and time periods required for deferral
Payment in shares or 'equity like' instruments	Substantial portion of deferred compensation to be paid in shares/equity like instruments and cash. Payments of options are limited to no more than 15% of total incentives (over 15% options cannot count towards deferral) in each performance year.		Unlike European requirements, the proportion of equity is not prescribed and applies only to the deferred amount (although it is likely that a 50% mix would align with the requirements) – a holding period is also not required. Limits on options are not included in EU regulation.
Forfeiture (malus)	Unvested compensation can be reduced for subsequent losses, inappropriate risk taking or material restatement		Consistent approach within the regulation, although enforcement and supervision could vary
Leverage	Leverage restricted to 125% of target for senior executive officers and 150% of target for risk takers		Unlike Europe, the US regulation does not include a bonus cap, but instead limits the leverage within variable pay plans
Clawback	7 year clawback from vesting		Aligned in principle, but requirement for clawback to begin for 7 years from vesting rather than award (as in the UK) will significantly lengthen the clawback period for deferred awards under US rules

Topic	US proposed rules (primarily level 1 and 2)	Similarity with EU requirements	PwC commentary
Control functions	Control functions to be involved in remuneration governance and remunerated independently of the business unit they oversee	🟠	Although principles here are aligned to the EU approach, the implied cap on control function pay within EBA Guidelines is not replicated here
Performance measures	Performance conditions should include a mixture of financial and non-financial measures, and relative measures or volume driven measures cannot be used in isolation. Awards should be subject to downwards adjustment to reflect losses, compliance breaches and inappropriate risks taken (i.e. ex ante risk adjustment)	🟢	Similar principles and wording to that seen in European and regulation can be seen here, although supervisory interpretation and implementation of this could vary in practice
Guarantees and retention awards	Not considered incentive-based compensation so not covered by rules	🔴	Significant restrictions on awards of this type (including buy outs) can be seen in UK/EU regulation
Governance and disclosure	Requirements depend on size and formal remuneration policy. Independent Remuneration Committee required. Record of covered individuals required	🟠	Similar requirements in terms of policy and record keeping but no requirement to disclose amounts paid
Other	Prohibitions of personal hedging strategies with respect to compensation and accelerated vesting of deferral except in certain circumstances (e.g. death/disability)	🟢	Consistent approach

🟢 - Significant similarities with EU banking requirements
🟠 - Some similarities with EU banking requirements
🔴 - Few similarities with EU banking requirements

Implications of the proposed rules

The proposed rules signal a change in approach for the US regulators. Up to now, US regulators have monitored remuneration policies and practices at the larger firms through guidance and, where necessary, private supervisory discussions. This new approach brings in a more publically transparent and rule-based regime which applies to a wider group of firms.

The proposed rules introduce stricter and more prescriptive requirements for US financial institutions, bringing closer alignment with the European compensation requirements. Many of the provisions, including the requirement to identify senior management and risk takers, apply deferral, payment in shares, malus and clawback, bear a strong resemblance to EU regulation. Significantly, although the proposed rules introduce a limit on the level of leverage in variable compensation, the US regulators have stopped short of introducing an overall cap on bonuses. It is also significant from the perspective of international consistency that the rules do not address guaranteed bonuses or retention awards.

In one area, clawback, the rules arguably go further than both the EU and the additional UK requirements related to clawback. The US rules state that clawback should apply for 7 years from vesting (rather than from grant, as in the UK). This could mean ultimately a period of 11 years where either malus or clawback applies to some aspect of pay for senior individuals in the largest organisations. Impacted firms will need to carefully consider the implications of this for their senior management and in particular the additional uncertainty introduced by this requirement.

The regulations will apply to all firms operating in the US that meet the definition of “covered institutions”, including those that are headquartered outside of the US. They will also apply to any overseas operations that sit within the US regulated entity – effectively meaning that they will apply to all entities within a US headquartered covered institution. This will create complexity for US firms’ operations in Europe and European firms operating in the US who will be required to apply different potentially conflicting, sectoral regimes across different parts of their organisations. Ultimately, firms will likely have to apply the strictest of each regulation in each area, but the practical challenges of doing so should not be underestimated – for example when combining the long deferral for senior managers in the UK with the stricter interpretation of clawback introduced in the US proposed regulation. The rules will go some way to levelling the playing field not only in the US but also in territories such as Asia where historically EEA headquartered firms have been at a competitive disadvantage to US firms. However, these markets will remain challenging, as local regulation outside of the US and Europe generally does not include prescriptive requirements on compensation.

It is worth remembering that, although many of these regulations are new, supervisors have been monitoring US firms’ compensation policies and practices closely for a number of years to ensure alignment with sound risk management. As a result, many firms are likely to have compensation policies and structures that broadly align with the requirements of the proposed regulation. Indeed, industry practice and prior inter-agency guidance already called for bonus deferrals of three or four years. The impact will therefore be more keenly felt by smaller firms. However, all firms will likely have to make some changes to meet the requirements of the proposed rules and the challenges of managing global regulatory compliance, as well as the additional governance and documentation that the proposed rules require should not be underestimated.

What next?

The consultation period ends on 22 July 2016. The agencies will then need to review responses to the consultation and prepare final rules. This process will take some months and the final rules will only be implemented 18 months after they are confirmed. The implementation date could therefore be in the second half of 2018, but much will depend on the speed with which the rules are confirmed. The rules will only apply to the first full performance period on or after the implementation date, so for firms with a performance period starting in January the effective date of implementation is unlikely to be before January 2019.

Appendix - Detailed commentary on certain aspects of the proposed rules

Individuals to whom the structural requirements apply

The structural pay requirements such as deferral and clawback only apply to 'senior executive officers' and 'significant risk takers' ('Covered Individuals'). As in EU regulation, the identification of these individuals is made through a mixture of role based definitions and quantitative definitions based on compensation levels. The US approach can be summarised as follows:

- Senior executive officers: Defined as including the president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line. This category also includes executives who are not traditionally seen as major risk takers, such as the chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, and heads of control functions.

- Significant risk takers: Defined as those whose annual bonus is at least equal to 50% of base salary, and are either

  a) Among the top 5% (for Level 1 institutions) or top 2% (for Level 2 institutions) highest compensated employees; or

  b) Have the authority to commit or expose over 0.5% of the institution's capital, as determined based on institution type (e.g., CET1 for most bank holding companies).

Although to some extent the principles involved in the identification process are similar, there are significant differences in the detail. Most notably, the EU roles include far more detailed and complex criteria for identifying specific roles (which will likely result in more people being caught than in the US under these "qualitative" criteria). Conversely, the quantitative compensation based criteria in the US proposed rules will likely capture significantly more individuals than the EU equivalent – the 5% and 2% thresholds are significantly higher than the 0.3% required under CRD IV. More importantly, whilst EU rules allow for individuals captured by the compensation requirements to still be removed from the definition in certain circumstances, this is not permitted under US regulations. These variations in the identification process mean that the proposed rules will likely capture a different and relatively larger group of individuals than those identified under equivalent European requirements. It is worth noting, however, that if a level 1 firm can demonstrate that, in terms of its organisational structure and complexity, it more resembles a level 2 firm it can apply the 2% threshold rather than the 5% threshold.

Deferral

The table and graphics on the next page give a comparison of the proposed rules and existing UK and EU regulation (deferral, malus and clawback (Level 1 and 2 only in all territories)).

	UK rules	EU rules	US proposed rules
Senior managers (under senior manager regime for UK)/ Senior Management in significant firms/ Senior Management & Senior Executive Officers (US)	• 7 year deferral, no vesting before 3 years, no faster than pro rata between years 4 and 7 • 40% deferral if less than £500k variable • 60% deferral if more than £500k variable	• 5 years, no faster than pro rata • 40% deferral unless 'particularly high' variable compensation in which case 60%	• Level 1 – 60% of bonus for 4 years, 60% of LTI for 2 years after vesting, no faster than pro rata • Level 2 – 50% of bonus for 3 years, 50% of LTI for 1 year after vesting, no faster than pro rata. • No accelerated vesting of deferred compensation unless on death or disability
Risk takers (under senior manager regime for UK)	• 5 year deferral, no faster than pro rata • 40% deferral if less than £500k variable • 60% deferral if more than £500k variable		
Other identified staff (UK and EU)/Risk takers (US)	• 3 years, no faster than pro rata • 40% deferral if less than £500k variable • 60% deferral if more than £500k	• 3 years, no faster than pro rata • 40% deferral unless 'particularly high' variable compensation in which case 60%	• Level 1 – 50% of bonus for 4 years, 50% of LTI for 2 years after vesting, no faster than pro rata • Level 2 – 40% of bonus for 3 years, 40% of LTI for 1 year after vesting, no faster than pro rata. • No accelerated vesting of deferred compensation unless on death or disability

	Deferral for Identified Staff (UK/EU)/ Risk Takers (US)			
	Year 1	**Year 2**	**Year 3**	**Year 4**
UK/EU	*60% of variable remuneration**			
US (Level 1)	*50% of variable remuneration***			
US (Level 2)	*40% of variable remuneration***			

**** 40% of variable remuneration in some circumstances (e.g. if, in the UK, variable remuneration is less than £500k).***

***** This reflects deferral of bonuses. Additionally, LTIs are subject to 2 year deferral (level 1) / 1 year deferral (level 2) once vested, applying to 50% or 40% of the LTI awarded, respectively.***

<table>
<tr><th></th><th colspan="7">Deferral for Senior managers (under senior manager regime for UK)/ Senior Management in significant firms/ Senior Management Senior Executive Officers (US)</th></tr>
<tr><th></th><th>Year 1</th><th>Year 2</th><th>Year 3</th><th>Year 4</th><th>Year 5</th><th>Year 6</th><th>Year 7</th></tr>
<tr><td>UK</td><td></td><td></td><td></td><td colspan="4">60% of variable remuneration*</td></tr>
<tr><td>EU</td><td colspan="5">60% of variable remuneration*</td><td></td><td></td></tr>
<tr><td>US (Level 1)</td><td colspan="4">60% of variable remuneration**</td><td></td><td></td><td></td></tr>
<tr><td>US (Level 2)</td><td colspan="3">50% of variable remuneration**</td><td></td><td></td><td></td><td></td></tr>
</table>

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Start a conversation

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