New Jersey Bankers
113th Annual Conference

Executive & Director
Compensation/Regulatory
Update and Current Trends

May 19, 2017
On September 8, 2016, the Consumer Financial Protection Bureau (CFPB), the Office of the Comptroller of the Currency (OCC) and the City of Los Angeles Attorney announced the results of investigations into systemic fabrication of “cross-sales” by Wells Fargo employees without customer knowledge or consent, including:

- Opening and funding deposit accounts
- Submitting credit card applications
- Enrolling in online banking services
- Ordering and activating debit cards

The practices were found to have violated consumer protection laws and to be unsafe and unsound practices under OCC regulations. Wells Fargo was required to cease these practices and:

- Pay $185 million in civil penalties and at least $5 million in restitution
- Commission independent inquiries into its sales practices, enterprise-wide governance and risk management oversight, and the root causes of the unsafe/unsound practices
- Develop an enterprise-wide sales practices risk management and oversight program
- Provide for board (or independent committee) oversight of compliance with CFPB and OCC consent orders

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On September 8, 2016, Wells Fargo announced that 5,300 employees had been terminated for improper sales practices. Since that time, the following further consequences have been announced:

- **Former Chairman and CEO John Stumpf**
  - Retired from the Bank; all outstanding unvested equity awards forfeited

- **Former Senior Executive VP of Community Banking Carrie Tolstedt**
  - Left the Bank; all outstanding unvested equity awards forfeited; no bonus for 2016; no severance or retirement enhancements

- In the wake of John Stumpf’s retirement, the roles of Chairman and CEO were split
  - Lead Director Stephen Sanger serves as non-executive Chairman; Tim Sloan serves as CEO

- In February 2017, terminated 4 senior managers
  - No bonus for 2016; all unvested equity awards and vested outstanding options were forfeited

- In March 2017, announced that CEO Tim Sloan and seven other high-ranking executives would not receive cash bonuses for 2016 and would lose some stock compensation

- In April 2017, announced that it would clawback an additional $75 million in compensation from John Stumpf and Carrie Tolstedt
  - According to the Wells Fargo report issued on April 10, 2017, the Board “has imposed forfeitures, clawbacks and compensation adjustments on senior leaders totaling more than $180 million.”
Wells Fargo – Issues Raised

- Structure of “sales” incentive programs
- Board role in establishment/oversight
- Who was watching?
  - 2nd and 3rd lines of defense?
- Executive officer responsibility/accountability
- Clawback policy design and decisions on use
In October 2016, in the wake of Wells Fargo, the OCC initiated its horizontal examination to investigate sales practices and incentive compensation at large and mid-size national banks.

- Phase 1: focused on determining if there are systemic or bank-specific issues with regard to bank employees opening accounts on behalf of consumer and small business customers without customer consent (October 2016 – March 2017).
- Phase 2: focused on evaluating sales, referral, and retention goals and strategies, as well as quota and incentive programs, to assess whether they are appropriately designed to balance sales and revenue targets with risk management and customer satisfaction (March – May 2017).
- Phase 3: focuses on determining if banks and thrifts have risk governance frameworks that effectively control the risks associated with sales practices and incentive compensation programs (May – ?).

It is likely that the OCC’s efforts will have a trickle down effect to the FDIC and state regulators.
On November 28, 2016, the CFPB issued a compliance bulletin entitled “Detecting and Preventing Consumer Harm from Production Incentives.”

- The bulletin describes the risk of “significant” harm to consumers posed by incentive programs for employees or service providers that tie compensation to various benchmarks, such as “cross-selling,” quotas and collections benchmarks.

The CFPB outlines the following steps that supervised entities may take (among others) to ensure their compliance management system is effective:

- Board and management oversight
- Compliance program, which includes:
  - Policies and procedures
  - Training
  - Monitoring
  - Corrective action
- Consumer complaint management program
- Independent compliance audit
After Wells Fargo, the Comptroller directed the Ombudsman to perform an independent review of the Wells Fargo supervisory record to identify any supervision gaps and lessons learned to improve the OCC’s supervisory processes going forward.

On April 19, 2017, the OCC Ombudsman released a report concluding that the OCC did not take timely and effective supervisory actions after the Bank and the OCC identified significant issues with complaint management and sales practices.

The report indicated that OCC examiners failed to properly take action with respect to 700 whistleblower complaints relating to gaming of sales incentives.

The report provided numerous Lessons Learned, focusing on the importance of comprehensive complaint and whistleblower analysis and follow-up, effective supervision of controls around high-risk incentives, quality MRA communication and follow-up, clear supervisory records, supervision of reputation risk, and enterprise-wide whistleblower processes.

The public disclosure of the report is a black eye for OCC examiners and likely will lead to a stricter supervision and examination environment.
Incentive Compensation at Financial Institutions – Regulation & Guidance

- For Insured Depository Institutions:
  - Section 39 of the FDI Act
  - 2010 Interagency Guidance on Sound Incentive Compensation Policies
  - 2011 Federal Reserve Horizontal Review
  - 2016 joint proposed rulemaking under Dodd-Frank

- For Public Companies:
  - Clawback requirements of Sarbanes-Oxley
  - Clawback requirements of Dodd-Frank (pending final regulations and addition to listing requirements)
  - Proxy advisory firm guidance
  - Proposed SEC regulations on disclosure of pay for performance and CEO compensation relative to median employee compensation
Section 39 of FDI Act

- Requires federal banking agencies to issue standards prohibiting unsafe/unsound compensation arrangements with any executive officer, employee, director or principal shareholder that:
  - Provide excessive compensation; or
  - Could lead to material financial loss

- Compensation is excessive if it is unreasonable or disproportionate to the services performed

- Factors to be considered include:
  - Combined value of all compensation received (cash and noncash)
  - Financial condition of the institution
  - Peer practices
  - Any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse
2010 Guidance on Sound Incentive Practices

- Issued by the OCC, Federal Reserve, FDIC, and OTS under Section 39 of the FDI Act (among other provisions)

- Applies to incentive compensation for:
  - Senior executives
  - Others responsible for oversight of firm-wide activities or material business lines
  - Individual employees whose activities may result in exposure to material risk
  - Groups of employees with similar incentive arrangements who, in the aggregate, may expose the organization to material risk
Three key principles:

- Balance between risks and results
  - Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks

- Be compatible with effective controls and risk management
  - Risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangement

- Supported by strong corporate governance
  - Including active and effective Board oversight
2010 Guidance on Sound Incentive Practices

- Unbalanced risk/reward may be mitigated by:
  - Risk adjusting the payments
  - Deferring payment so as to adjust actual payments based on actual outcomes
  - Lengthening performance periods
  - Reducing sensitivity to short-term performance
    - Reducing the rate at which awards increase as higher levels of performance are achieved
    - Improving reliability of estimates used to set performance goals

- Organization-wide performance metrics are unlikely to provide employees, other than senior executive officers and senior risk-takers, with unbalanced risk-taking incentives

- Careful consideration should be given to how “golden parachutes” and the vesting of deferred compensation may affect risk-taking behavior. The 2010 Guidance suggests that an appropriate risk-balancing safeguard for “golden parachutes” may include deferral requirements past an employee’s departure from the organization.
2010 Guidance on Sound Incentive Practices

- Guidelines on effective control
  - Integrate incentive compensation into risk management and internal control functions
  - Implement appropriate controls to ensure processes for achieving balance are followed
  - Monitoring and processes should be commensurate with size of institution

- Guidelines on effective governance
  - Board is responsible for incentive compensation of all covered employees
  - Board should assess whether incentive compensation arrangements are consistent with safety and soundness
  - Board to have access to such experts as Board deems appropriate
  - Board deliberations and decisions must be documented to allow for regulatory examination
2010 Guidance on Sound Incentive Practices

- Heightened standards for “Large banking organizations” (LBOs)
  - Assess incentive compensation risks in advance
  - Monitor and adopt emerging practices in the field to improve safety/soundness
  - Incentive-based compensation arrangement (IBCA) for senior executives should include:
    • Multi-year deferral periods
    • Equity awards with multi-year service and performance vesting conditions
  - Concern over “golden handshakes”
  - Maintain procedures for establishing and monitoring IBCAs
  - Board (or independent Compensation Committee) oversight of IBCAs, with annual assessment by management and risk-management

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In 2011, the Federal Reserve published findings from its “horizontal review” of IBCAs at 25 LBOs (including Wells Fargo)

- **Most-used methods to balance risk/reward:**
  - Risk adjustment (such as charge to internal profit measures for liquidity risk)
  - Multi-year deferrals (with downward adjustment for large losses)

- **Risk-management and control personnel were included in IBCA design and operation**

- **Boards and Compensation Committees began to focus on risk-taking incentives created by IBCAs for employees**
  - Not just on IBCAs for senior management

- **Communication increased between Compensation Committees and Risk and Audit Committees**

- **Boards beginning to review effectiveness of IBCAs and payouts relative to risk outcomes**
In June 2016, federal regulators published re-proposed regulations on incentive compensation at financial institutions.

- Initial proposed regulations were published in April 2011

Rules will take effect 18-21 months after final regulations are published

- But may inform corporate governance reviews before effective date in light of the 2010 Guidance

It is not yet clear how the proposed rule will be affected by the CHOICE Act, if at all.
The proposed regulations use a 3-tiered approach with requirements increasing in stringency with the average total asset size of the institution:

- **Level 1** ($250 billion and up)
- **Level 2** ($50 billion to $250 billion)
- **Level 3** ($1 billion to $50 billion)

Covered institutions under common control are aggregated for purposes of Level 1/2/3 determination:

- For a bank holding company with $50 billion in consolidated assets, each bank subsidiary with $1 billion or more in assets is a Level 2 institution.
The proposed regulations define “covered person” as any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution.

For Level 1 and Level 2 institutions, the proposed regulations broaden the IBCA restrictions to a larger group of “senior executive officers” and “significant risk takers.”

“Senior Executive Officers” (SEOs) include:
- Executive Chairman, CEO, President, COO, CFO
- Chief Investment, legal, lending, risk, compliance, audit, credit, and accounting officers
- Heads of major business lines or control functions
- Function over title
“Significant Risk Takers” (SRTs)
- For whom incentive compensation is \( \frac{1}{3} \) of the sum of salary and incentive compensation and
- Satisfies either an exposure test (can expose 0.5% or more of common equity tier 1 capital) or a relative compensation test
  - At institutions with $50 billion or more
    » Top 5% of highest compensated covered persons (excluding SEOs)
  - At institutions with $250 billion or more
    » Top 2% of highest compensated covered persons (excluding SEOs)
- Also, any other person designated by either the institution or primary federal regulatory agency
The proposed regulations have three main components that would apply to *all* covered institutions:

- **(1) Prohibitions:**
  - No IBCAs that encourage inappropriate risk by providing excessive compensation or could lead to material financial loss
  - Determination and factors similar to 2010 Guidance
  - Inappropriate risk that could lead to material financial loss presumed unless IBCA
    - Appropriately balances risk and reward
      - Includes financial and non-financial performance measures
      - Non-financial performance measures override financial
      - Awards are subject to adjustment to reflect:
        - Actual losses
        - Inappropriate risks taken
        - Compliance deficiencies
        - Other measures of financial & non-financial performance
2016 Proposed Regulations – All Covered Institutions (Levels 1/2/3)

- **(2) Board of Directors:**
  - Conduct oversight of IBCA program
  - Approve IBCAs for SEOs including amount of awards, vesting, and payouts
  - Approve material exceptions or adjustments

- **(3) Disclosure and Recordkeeping Requirements:**
  - Required to create and retain annual records that document the structure of all IBCAs and demonstrate compliance with the proposed regulations
  - Maintain records for 7 years
  - Records must be disclosed to examiners upon request
Mandatory deferral
- 50% of incentive compensation for SEOs for 3 years
- 40% of incentive compensation for SRTs for 3 years
- No acceleration other than for death or disability

Forfeiture or downward adjustment
- All unvested deferred compensation subject to forfeiture
- During performance period, subject to downward adjustment
- Must consider both downward adjustment and forfeiture if certain triggering events occur. These triggering events include, but are not limited to, inappropriate risk-taking and certain poor financial performance

Clawback
- To recover all vested incentive compensation paid to any SEO or SRT for 7 years after vesting date, regardless of whether still employed by the institution
- Events triggering a clawback include:
  • Misconduct resulting in significant financial or reputational harm
  • Fraud
  • Intentional misrepresentation of information used to determine IBCA payouts
Annual recordkeeping – required to maintain more detailed records, including:
- List of all SEOs and SRTs
- Specific information about IBCAs, forfeiture/downward adjustment/clawback reviews and decisions made
- Material changes to IBCAs and policies
- Must create and maintain records in a manner that allows for an independent audit of IBCAs, policies, and procedures
2016 Proposed Regulations – $50 Billion or More in Assets (Levels 1 & 2)

- **Prohibition on Hedging**
  - Institution cannot provide a hedge or offset for decreases in IBCA value

- **Maximum Award Opportunities**
  - Cannot exceed 125% of target opportunity for SEO, 150% of target opportunity for SRT

- **Restrictions on Performance Metrics**
  - Cannot be solely based on performance relative to industry peers
  - Cannot be solely based on transaction revenue or volume without regard to quality or compliance

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2016 Proposed Regulations – $50 Billion or More in Assets (Levels 1 & 2)

- **Internal Risk Management and Control**
  - Framework must be independent of business lines
  - Include an independent compliance program that provides for internal controls, testing, monitoring, and training with written policies and procedures
  - Commensurate with size and complexity of operations
  - Provide individuals involved in risk control functions the authority to influence risk-taking of monitored business
  - Must ensure that incentive compensation for risk control functions are linked to control objectives and not performance of monitored business

- **Independent Monitoring**
  - Must provide for independent monitoring of incentive compensation plans, events and decisions relating to forfeiture and downward adjustment reviews, and compliance with policies and procedures
Compensation Committee

- Compensation Committee of independent directors to assist board in oversight of IBCA program and awards of IBCAs to SEOs (with material exceptions or adjustments)
- Compensation Committee must obtain:
  - Input from Risk and Audit Committees
  - Input from organization’s risk management function
  - Management’s written assessment of IBCA program and compliance and control policies
  - Independent written assessment of same
Develop and maintain policies and procedures for IBCA program
- Consistent with proposed regulations
- Criteria for forfeiture and clawback
  - Include process for determining amount to be clawed back
- Criteria for acceleration of deferred IBCAs on death/disability
- Role of employees, committees or groups authorized to make incentive compensation decisions
  - Including when discretion is authorized
- How discretion is to be exercised to appropriately balance risk/reward
- Requirements for documentation of IBCAs to support covered institutions decisions
- How IBCAs will be monitored
- Requirements of independent compliance program
- Roles for risk management, oversight, and control function personnel in
  - Designing and administering IBCAs
  - Assessing effectiveness of IBCAs in restraining inappropriate risk-taking
2016 Proposed Regulations – $250 Billion or More (Level 1)

- Mandatory Deferral
  - 60% of incentive compensation for SEOs for 4 years
  - 50% of incentive compensation for SRTs for 4 years
For Public Companies – Clawback

- Sarbanes-Oxley
  - CEO and CFO
  - Materially non-compliant financial report due to misconduct

- Dodd Frank (pending final regulation)
  - Executive officers
  - Materially non-compliant financial report

- Proxy advisory firm, ISS, considers disclosed clawback policies in its recommendations on
  - Say-on-pay
  - Equity plan approval, and
  - Shareholder proposals seeking to impose compensation policies

- ISS considers maintenance of a clawback policy exceeding Sarbanes-Oxley as a best practice
  - Must at least provide for clawback of cash-based incentive compensation
  - Should apply in the event of fraud, restatement of results, errors/omissions, or other activities related above
ISS emphasizes pay-for-performance alignment in its review of say-on-pay recommendations

Other ISS considerations relating to IBCAs for say-on-pay recommendations

- Minimum vesting periods for equity awards
  - Must be specified in an equity plan approved in the last 3 years
- Minimum holding periods for shares acquired from equity awards
  - At least 50% of net (after taxes) or 25% of gross shares acquired
- Stock ownership guidelines for CEO
  - Anything less than 3x annual salary is a concern
- Disclosure of performance metrics
  - For short-term incentive plans, ISS considers it a best practice to disclose target metrics at least retrospectively
  - For long-term incentive plans, ISS considers whether performance conditions are disclosed for latest proposed plan
- Vesting of equity-based or long-term-cash plans on change of control
  - Single-trigger vesting tends to disconnect pay from performance
For Public Companies – Pay Ratio Disclosure

- SEC issued final rules on pay ratio disclosure on August 5, 2015
- Must be disclosed for fiscal year to begin after January 1, 2017 (in proxy for annual meeting in 2018)
- Each issuer must identify its “median employee” based on annual compensation
  - Using same method used in the “Summary Compensation Table” in the proxy for named executive officers
  - Median employee can be used for three years in absence of changes that would significantly affect pay ratio disclosure
- Proxy disclosure of ratio of CEO’s annual compensation to median employee’s annual compensation for last fiscal year
- On February 6, 2017, Acting Chairman Piwowar announced that the SEC would seek public input on any unexpected challenges that issuers have experienced as they prepare for compliance with the rule and whether relief is needed.
- The comment period ended in March and additional guidance is expected soon.
Section 953(a) of Dodd-Frank requires the SEC to issue rules requiring proxy disclosure of relationship between executive compensation actually paid and the issuer’s financial performance.

The SEC proposed a rule on April 28, 2015.

Proxy would include a table disclosing executive pay and company performance for the five most recent fiscal years (three for smaller reporting companies).
- Initial phase-in would start from three fiscal years (two for smaller reporting companies), with one year added each subsequent year.

Performance will be measured by total shareholder return (TSR) on an annual basis.
- Both absolute and relative to peers.

Pay will be reported for the CEO, and the average of all other named executive officers.
- Both “actual” and as reported in the Summary Compensation Table.
- Actual compensation would include:
  - Value of equity awards received rather than the prospective value of equity awards granted.
  - Service cost of pension benefits rather than the change to the present value of those benefits.
What Needs To Be Done Now

- Board education on IBCA regulatory issues
- Understand examiner expectations
- Evaluate IBCA design against existing and proposed regulations
- Evaluate and adjust IBCA governance structure
  - Integration of risk function into IBCA design
  - Decisions on who is “covered”
  - Identification of risks related to IBCA design
  - Adding 2nd and 3rd lines of defense to monitoring IBCA-related risk
  - Review/adjust control and monitoring structure of IBCA-related risks
  - Review/implement clawback policy and criteria/procedures for adjustment of awards
  - Review and enhance as needed the documentation of information provided to Board/Committee and IBCA related decisions
Current Environment

- The events in 2008 and recent unsafe/unsound sales practices of Wells Fargo has once again brought incentive based executive compensation to the forefront of Risk Management and Regulation.
- These types of events can bring scrutiny to executive compensation regardless of bank size.
- BUT....retaining and rewarding the top talent remains critical to a Bank’s success
  - Finding future talent to lead the bank and formulating a viable succession plan is difficult without incorporating retention strategies.
  - The workforce is now multi-generational where members of four different generations are working side-by-side and Executive teams now include members from X, Y, and Millennials generations.
    - These developments have shifted compensation strategies to trend in favor of current compensation and incentive based pay.
  - It still remains critical to still retain and reward those that have been leading the bank, but the majority of the leaders are nearing retirement.
    - The more time you have to account and budget for long-term, meaningful benefits the better.
  - Replacing experienced employees, at any age, costs 50% or more of the individuals annual salary in turnover-related costs.
    - Costs are even more staggering among highly-skilled, top executive talent (Up to 213% for highly educated executive position*).

Costs Associated with Losing an Employee

- **Separation Costs**
  - Severance, exit interviews, payroll close out, HR’s time, etc.
- **Hiring a replacement**
  - Advertising, interviewing, screening, outside recruiters, etc.
- **Onboarding**
  - Training, use of upper management’s time, screenings
- **Lost Productivity and Engagement**
- **Cultural impact**
- **Service and errors**
- **Lost Clients**

**Human Capital**

Is an appreciating asset where skills, knowledge, and experience grows over time. The longer we stay with an organization the more productive we become as we develop deeper understanding and have more time to learn processes, procedures, systems, products, culture, etc.
BFS Currently Provides Services and Support For:

- Non-Qualified Supplemental Benefit Plans for top executives, directors, and directors/trustees defined benefit SERPs
- Defined Contribution SERPs
- Executive Deferred Compensation Plans
- Incentive Retirement Plans (performance based DC SERP)
- Phantom Stock Plans
- Phantom Stock Options (SAR)

BFS Can Deliver:
- Cost offset/recovery of employee benefit plan expenses with General and Hybrid/Separate Account BOLI Products.
- Servicing NQ Benefit Plans and BOLI Portfolios for BOLI Clients.

- Group-Term Replacement Plans
- Pre-Retirement & Post-Retirement Life Insurance Death Benefit Plans
- Director Retirement Plans
- Director Deferred Compensation Plans
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