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June, 2016

FINANCIAL INSTITUTION INCENTIVE COMPENSATION REGULATORY UPDATE

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EXECUTIVE SUMMARY

Canadian financial institutions with international operations face a number of potentially conflicting incentive compensation rules and related regulatory body supervision.

The rules are intended by the regulators to discourage inappropriate risk-taking on the part of both senior management and other individuals whose decisions may have material consequences for the institutions they serve.

The purpose of this Gallagher McDowall bulletin is to provide a high level overview of the various rules, their common features, and to note important differences.

Background[1]

Canada's financial institutions are required by the Office of the Superintendent of Financial Institutions (OSFI) to comply with the compensation principles and standards developed in 2009 by the international Financial Stability Board (FSB). The FSB principles and standards were designed to ensure that compensation practices of its members around the world in the financial industry are sound and reduce incentives to take excessive risks.

It is up to each financial jurisdiction to decide how to apply the FSB guidance. Whereas some regulators have applied the principles in a more prescriptive, highly regulated manner (e.g. the European Union, the UK and now proposed by the USA), the OSFI has adopted a more principle-based approach under which it provides guidance directly to the affected financial institutions through their regular reviews and communications, rather than through specific compensation rules and regulations.

Meanwhile, a number of Canadian financial institutions with UK operations, such as banks and investment dealers, have had to comply with more stringent deferral and clawback requirements of the Remuneration Code that were introduced by the British regulators in 2010 and were expanded in 2015.

Commencing on April 21, 2016, six US regulators jointly published a series of proposed rules designed to lengthen the period over which incentive-based compensation at banks, broker-dealers and investment advisors must be deferred and placed at risk of both reduction and full recovery if their US operations have consolidated assets of $50 billion or more. While the US proposals are somewhat similar to the current UK rules in their overall approach, there are significant differences in their application, as one would expect.

Common Features

In general, the incentive compensation regulations are intended to apply to both senior management and "material risk-takers". The definitions of senior executive and of material risk-takers vary somewhat from one regime to another in practice.

Minimum incentive deferral percentages ranging from 40% to 60% are required for all incentive compensation awarded to senior management and material risk takers, including annual bonuses. The length of the deferral periods range from a minimum of 3 years up to 7 years from the original grant date.

[1] The Appendix provides an overview of the three regulatory regimes.

All unvested awards must be subject to forfeiture, downward adjustments and cancellation in certain circumstances. In addition, all vested incentives must be subject to clawback (whether or not previously paid out) by employees or former employees in cases of fraud, misconduct or intentional misrepresentation. The length of the clawback period could be as long as 10 years in total.

Different Deferral Requirements

The percentages of incentive compensation awards that must be deferred and the length of the required deferral periods vary (1) by jurisdiction, (2) by employee category, and (3) under the US proposal by organization size, as summarized in the following table: [2]

Table 1:

	2009 FSB Implementation Standards (Canada)	2015 UK Remuneration Code	2016 US Proposed Rule
Minimum Deferral Percentages			
Senior Management	Above 60%	60%	Level 1: 60% of incentive compensation awards[3] Level 2: 50% of incentive compensation awards[4]
Material Risk Takers	40% to 60%	40%	Level 1: 50% of incentive compensation awards Level 2: 40% of incentive compensation awards
Minimum Deferral Period Requirements			
Annual Incentive Awards Time-Vested Equity Grants [5] Time-Vested Option Grants	Not less than 3 years from the original grant date	Senior management: 7 years from the original grant date Material risk takers with senior, managerial or supervisory roles: 5 years from the original grant date Other Material Risk Takers: 3 years from the original grant date	Level 1: 4 years from the end of the performance period for which the award was made Level 2: 3 years from the end of the performance period for which the award was made
Performance Grants [6]	Not less than 3 years from the original grant date	As above	Level 1: 2 years from the end of a 3 year (or longer) performance period; Level 2: 1 year from the end of a 3 year (or longer) performance period
Other Key Requirements Applicable to Deferred Awards			
Vesting	Compensation payable under deferral arrange-ments should generally vest no faster than on a pro-rata basis	Senior management: No vesting allowed on deferred awards during the first three years from the grant date, and then no faster than on a pro-rata basis Material risk takers: Vesting of deferred awards cannot be faster than on a pro-rata basis	Deferred awards for both senior executive officers and significant risk takers cannot vest faster than on a pro-rata annual basis over the deferral period (including required annual bonus deferrals)

[2] Note: The above summary is based on our understanding of the regulations and is not intended to provide professional advice.
[3] Level 1: Institutions with US $250 billion consolidated assets or more
[4] Level 2: Institutions with US $50 billion to $250 billion consolidated assets
[5] E.g. Restricted Shares, Restricted Share Units and Deferred Share Units with no post-award performance conditions
[6] E.g. Performance Shares, Performance Share Units and Performance Unit Plans

Performance Requirements

The regulators differ on the performance measures they require financial institutions to use, thus creating potential conflicts not only from one jurisdiction to another, but also with typical proxy advisor methodologies:

Table 2:

2009 FSB Implementation Standards (Canada)	2015 UK Remuneration Code	2016 US Proposed Rule
Minimum Deferral Percentages		
Individual, business-unit and firm wide measures that adequately measure performance	Assessment of individual, business unit and overall firm performance. When assessing individual performance, financial as well as non-financial measures must be taken into account. Financial performance assessments must be based principally on profits, provided they are adjusted for risk. Performance measures such as EPS, TSR and ROE are not suitably adjusted for longer-term risk factors and have a tendency to incentive highly leveraged activities.	Incentive arrangements must include financial and non-financial measures of performance, and be designed to allow non-financial measures to override financial measures when appropriate. Non-financial measures may include assessments of risk-taking, compliance with limits on risk-taking, policy compliance, adherence, etc. Additional Level 1 and 2 requirements: 1) Employee incentives cannot be based solely on transaction or revenue volumes. 2) Industry peer performance measures (e.g. relative TSR) can only be used in combination with absolute performance measures. 3) Policies and procedures required to describe how discretion is expected to be exercised in order to balance risk and reward.

Income Tax Considerations

The FSB, the EU and the UK regulations do not take into consideration any potential income tax conflicts that may arise from the length of their required deferral periods. This issue is particularly important for Canadian financial institutions, given the 3 year limit on bonus deferrals under the Income Tax Act (ITA).

We understand that the OSFI would like to see some deferrals longer than 3 years in order to better match the long tail risks of key decisions, but they also understand the limitations posed by the current Canadian income tax regime. As a member of the FSB, the Department of Finance could resolve this issue, if it so wished, either by asking Parliament to amend the ITA, or by adding deferrals mandated by regulatory bodies to the current exemptions to the salary deferral arrangement rules in ITA Regulation 6801(a).

In the interim, financial institutions need to be able to provide convincing arguments to the Canada Revenue Agency that longer bonus deferrals resulting from foreign legislation are not being made partly for the purpose of deferring Canadian income taxes, and thus should not be subject to the 3 year bonus deferral limit. Having said this, any deferral amounts that exceed the levels specifically required by the regulators or that exceed the minimum deferral periods could be at risk of being taxed in the year in which services were provided by Canadian employees.

While the US proposals recognize the special US income tax treatment of credit union deferrals as not-for-profit entities, no consideration is given to the implications on foreign income tax rules that might apply to non-US senior management employees and non-US material risk takers whose incentive compensation must comply with the US rules.

Incentive Payout Requirements

The jurisdictions also differ in their approach to incentive payouts, both with respect to overall limits on incentives and how deferred payouts must be allocated as between cash and equity-based instruments.

Table 3:

	2009 FSB Implementation Standards (Canada)	2015 UK Remuneration Code	2016 US Proposed Rule
Minimum Deferral Percentages			
Maximum incentive payouts	Not mentioned, but the European Union has implemented regulations that limit variable compensation to 100% of fixed pay (unless formally approved by the shareholders or owners, in which case the variable component cannot exceed 200%)	The variable component of total remuneration must not exceed 100% of the fixed component (unless formally approved by the shareholders or owners, in which case the variable component cannot exceed 200%).	Incentive plan awards cannot exceed 125% of pre-set targets for senior executive officers, nor can they exceed 150% of target for senior risk takers.
Incentive payout forms	A substantial portion, such as 50%, of variable compensation should be awarded in shares or share-linked instruments (or in other forms of non-cash compensation) and should be subject to an appropriate retention policy.	A substantial portion, such as 50%, of variable compensation should be awarded in shares or share-linked instruments (or in other forms of non-cash compensation) and should be subject to an appropriate retention policy.	All deferrals must be in a mixture of cash and equity based instruments (including annual bonus deferrals), but no specific percentages are proposed by the agencies. Time-vested options can be used to satisfy the deferral requirements, but only to the extent that their grant values do not exceed 15% of the total incentive-based compensation awarded for a given performance period.

Terminology

The incentive compensation terminology used by the US agencies differs substantially from that which is typically used in compensation circles and in official reports, such as those required by the Canadian and US securities regulators in management proxy circulars.

The differences can be best illustrated by a three year performance share unit (PSU) example. Under a typical PSU arrangement, a target “award” is granted for compensation purposes at the beginning of a performance period (e.g. 2016) and “cliff vests” at the end of the three year “deferral period” (e.g. in 2019), based a comparison of actual performance results vs. target performance. The after-tax value of the vested PSU is then immediately paid out, either in cash or in shares.

Under the US proposals, however, the term “award” only applies to the final value of the PSU as determined as of the end of the three year performance period. In addition, the “deferral period” that applies to that portion of the PSU that is required to be deferred only starts from the end of the performance period, not from the original grant date.

Furthermore, the amount of the PSU award that must be deferred cannot vest immediately at the end of the performance period. Instead, the deferred award must vest no faster than on a pro-rata basis over the mandated deferral period, and thus be subject to forfeiture and downward adjustment in the interim.

Correspondingly, time vested equity-based grants, such as Restricted Shares, Restricted Share Units, Deferred Share Units and Options, would not be considered “long-term incentives” under the proposed US rule if they are not subject to performance conditions after they have been awarded. They could, however, be used as incentive deferral mechanisms.

APPENDIX

Canada

In Canada, the federal government's Office of the Superintendent of Financial Institutions ("OSFI") oversees banks, life insurance companies, property and casualty insurance companies and loan companies, each of which is referred to as a "federally-regulated financial institution" or "FRFI".

In January 2013, the OSFI released its "Corporate Governance Guideline" that applies to all FRFIs, except for the branch operations of foreign banks and foreign insurance companies. The "Role of the Board of Directors" section of the Guideline includes a requirement to "review and discuss the FRFI's" "compensation policy for all human resources, to be consistent with the Financial Stability Board (FSB) Principles for Sound Compensation Practices and related Implementation Standards".

The Guideline indicates that, while this and certain other functions are the responsibility of "Senior Management", the Board has a critical role in providing high-level guidance with respect to these matters and should establish procedures to periodically assess the assurances provided by Senior Management.

No detailed compensation regulations have been promulgated by the OSFI. Thus, for Canada we need to turn to the international principles developed by the Switzerland-based FSB, of which Canada, the UK, the US and the European Union are all members.

Financial Stability Board

The FSB *Principles* and *Implementation Standards* were published in 2009. The *Standards* state that "a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years and these proportions should be increased significantly along with the level of seniority and/or responsibility. The deferral period should not be less than three years."

European Union

The FSB Principles and Standards were adopted by the European Union (EU). In June 2013, for example, the EU adopted banking sector Capital Requirements Directive IV which provides that at least 50% of total variable remuneration should consist of equity-linked instruments and at least 40% of the variable component must be deferred over a period of three to five years.

United Kingdom

The Bank of England Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), published *Remuneration Code* rules that came into force in 2010 and applied to banks, building societies, certain investment firms, including UK branches of non-EEA headquartered firms. The Code was derived from the 2009 FSB Principles and the subsequent European legislation, including the EU Capital Requirements Directive on which much of the *Code* was based.

The *Remuneration Code* was revised in 2015 for performance periods beginning on or after January 1, 2016 and now go well beyond the minimum requirements of the EU.

United States

Section 956 of the Dodd-Frank Act instructed six US federal financial regulatory agencies[7] to jointly issue rules limiting incentive-based executive compensation for certain financial institution senior officers and employees that would:

1) prohibit incentive-based payment arrangements that the agencies determine encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss, and
2) require financial institutions with $1 billion or more in total assets to disclose information regarding the structure of their incentive-based compensation arrangements to their federal regulators.

The agencies published their proposed rule on April 21, 2016. The proposed rule reflects the numerous comments on a previous 2011 proposal, as well as the experience the agencies gained on incentive-based compensation plans during their reviews over the ensuing five year period.

The proposed effective date is at least 18 months after the final rule is published, and as proposed, would not apply to any incentive-based compensation plan with a performance period that begins before the effective date. If the final rule were to be published on November 1, 2016, for example, the compliance period would start on July 1, 2018.

The agencies have set a July 22, 2016 deadline for feedback on the proposed rule. Given the length of time since the original proposal was published, it may be reasonable to assume for planning purposes that the final rule will closely follow the thrust of the proposed rule.

[7] The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the Federal Housing Finance Authority (FHFA), and the National Credit Union Administration (NCUA)

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