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New Rules Proposed for Incentive-Based Compensation at Covered Financial Institutions

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Proposed rules were published in the Federal Register last week pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act to regulate the incentive-based compensation arrangements ("Incentive Arrangements") for nearly all financial institutions operating in the United States having assets in excess of $1 billion, including broker/dealers and investment advisors.

Section 956 of the Dodd-Frank Act requires the relevant federal agencies (the "Federal Regulators")[1] to issue regulations or guidelines to (i) prohibit Incentive Arrangements that encourage inappropriate risk taking by providing excessive compensation or that may lead to material losses to the financial institution and (ii) require affected institutions to submit annual reports disclosing their incentive pay schemes to the relevant Federal Regulator. The proposal issued jointly by the Federal Regulators (the "Proposed Rule") expands on these provisions by imposing a three-year deferral requirement on half of the incentive compensation paid to executive officers of larger financial institutions and requiring all covered institutions to implement compensation policies and procedures that meet prescribed standards.

Note that there is no provision for any joint agency interpretation of these rules and therefore future guidance and enforcement may vary from one Federal Regulator to another.

Scope of Proposed Rule

If enacted as proposed, the Proposed Rule would apply to Incentive Arrangements of "covered financial institutions" that have total consolidated assets of $1 billion or more ("CFIs").[2] CFIs would include:

- Bank holding companies and the U.S. operations of foreign banks that are treated as bank holding companies;

[1] The agencies are the five members of the Federal Financial Institutions Examination Council ("FFIEC")—the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration); the Securities and Exchange Commission ("SEC"); and the Federal Housing Finance Agency ("FHFA").

[2] Total consolidated assets would be based on a rolling four year average for CFIs overseen by the FFIEC or on the previous year's reported assets for CFIs overseen by the SEC. The asset threshold does not apply to Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Home Loan Bank System's Office of Finance (the "FHFA Entities").

- National banks and federal branches and agencies of a foreign bank;
- State member and non-member banks, insured U.S. branches of foreign banks, state-licensed uninsured branches or agencies of foreign banks;
- Savings associations, subsidiaries of federal savings associations and savings and loan holding companies;
- Credit unions;
- Broker-dealers registered under the Securities Exchange Act of 1934;
- Investment advisers under the Investment Advisers Act of 1940; and
- Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Home Loan Bank System's Office of Finance.

The Proposed Rule would apply to Incentive Arrangements between a CFI and its executive officers, employees, directors or principal shareholders ("Covered Persons").[3] No specific categories of employees are excluded from the scope of the Proposed Rule, although certain prohibitions apply only to a subset of Covered Persons.

Incentive-based compensation is broadly defined to mean any variable compensation that serves as an incentive for performance. The form of payment, whether it is cash, an equity award or other property, does not affect whether compensation meets the definition of incentive-based compensation. However, there are types of compensation that are excluded from the scope of this definition, such as compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary). In addition, a compensation arrangement that rewards a Covered Person solely for activities or behaviors that do not involve risk taking (e.g., for achieving or maintaining a professional certification or higher level of educational achievement) would not be considered incentive-based compensation.

Proposed Rule Requirements

Annual Reports

All CFIs would be required to submit an annual report to the relevant Federal Regulator. While disclosure of the actual compensation of any particular Covered Person would not be required, the report would need to contain at least the following information:

- A narrative description of the components of the CFI's Incentive Arrangements applicable to Covered Persons, specifying the types of Covered Persons to which they apply (i.e., executive officer, employee, director or principal shareholder);
- A description of the CFI's policies and procedures governing such arrangements;
- Any material changes to the CFI's Incentive Arrangements and related policies and procedures since the previous report;

[3] "Executive officers," "directors" and "principal shareholders" are defined terms in the Proposed Rule.

- Specific reasons the CFI believes its Incentive Arrangements do not encourage inappropriate risks by providing Covered Persons with excessive compensation or Incentive Arrangements that could lead to a material financial loss to the CFI; and
- For Larger CFIs (defined below), a description of specific policies and procedures that apply to Covered Persons who are determined to have the ability to expose the CFI to substantial losses.

Prohibited Pay Arrangements – Excessive Pay

The Federal Regulators deem incentive compensation for a Covered Person to be excessive if the "amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality and scope of services performed," The Proposed Rule sets forth the following factors to be considered in making this determination:

- Combined value of all cash and non-cash benefits provided to the Covered Person;
- Compensation history of the Covered Person and other individuals with comparable expertise at the CFI;
- Financial condition of the CFI;
- Comparable compensation practices at comparable institutions (based on, e.g., asset size, geographic location and complexity of operations and asset holdings);
- For post-employment benefits, the projected total cost and benefit to the CFI;
- Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse with regard to the CFI; and
- Any other factors the relevant Federal Regulator determines to be relevant.

Prohibited Pay Arrangements – Potential for Material Financial Loss

In formulating rules for the prohibition of Incentive Arrangements with Covered Persons that encourage inappropriate risks that could lead to a material financial loss to a CFI, the Federal Regulators drew extensively from guidance issued by the banking oversight agencies on Incentive Arrangements in 2010 (the "2010 Guidance")[4] and looked to standards adopted by the Financial Stability Board and other material.

This prohibition would be limited to Incentive Arrangements that could expose the CFI to a material financial loss. However, the preamble to the Proposed Rule notes that the provision would apply not only to Covered Persons whose activities pose such risk (e.g., a trader with a relatively large position), but also to **groups** of Covered Persons that in the aggregate pose such a risk, even if the potential loss caused by each individual in the group would not be material, as well as to Covered Persons having oversight responsibility for firm-wide activities or material business lines.

To comply with the Proposed Rule, each applicable Incentive Arrangement must (A) appropriately balance risk and financial reward, (B) be compatible with effective controls and risk management, and (C) be supported by strong corporate governance. Comments from the preamble to the Proposed Rule

[4] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation and Office of Thrift Supervision, "Guidance on Sound Incentive Compensation Policies," 75 Fed. Reg. 36395 (June 25, 2010).

concerning each of these requirements are summarized below. Further elaboration on these principles can be found in the 2010 Guidance.

A. Balancing Risk and Financial Reward. An Incentive Arrangement must appropriately take into account the risks, as well as the financial benefits, from each Covered Person's activities and the impact of those activities on the CFI. Incentive Arrangements should not reward short-term gains without due regard for the full range of risks associated with the Covered Person's activities. Notably, non-financial risks are to be taken into account in evaluating Incentive Arrangements, including credit, market, liquidity, operational, legal, compliance and reputational risks. The Federal Regulators provided a non-exhaustive list of methods commonly used to mitigate the risk of Incentive Arrangements:

- Risk adjustment – adjusting the amount of an award based on the risk posed to the CFI;
- Deferral of payment and/or longer performance periods – increasing the time horizon to better assess long-term effects of the activity in question; and
- Reduced sensitivity to short-term performance – capping awards or reducing the rate of increased payments for exceeding short-term performance criteria.

B. Compatibility with Effective Controls and Risk Management. This standard is met if the CFI has effective processes in place for designing, implementing and monitoring Incentive Arrangements. These controls should reinforce existing risk management controls to ensure that the arrangements remain balanced and do not undermine risk management related to the Incentive Arrangements or other aspects of the CFI, whether through the actions or influence of the relevant Covered Person or otherwise. Safeguards should be in place to prevent Incentive Arrangements from leading to a weakening of the information or processes the CFI uses for risk management, internal control or financial purposes.

C. Strong Corporate Governance. The board of directors would bear ultimate responsibility for ensuring that a CFI's Incentive Arrangements are compliant with the Proposed Rule. Thus, the board or a committee thereof should actively oversee the development and operation of such arrangements and the related control processes. This role includes not only approval of the overall goals of the compensation structure, but also ensuring consistency with the CFI's overall risk tolerance.

Required Deferral of Incentive Pay for Larger CFIs

CFIs having total consolidated assets of $50 billion or more (or $10 billion or more for credit unions) and any of the FHFA Entities ("Larger CFIs") are subject to additional requirements under the Proposed Rule, primarily a mandatory three-year deferral requirement for Incentive Arrangements covering any executive officer.[5] In addition, Larger CFIs would have disclosure obligations relating to Incentive Arrangements for any non-executive officers who have the ability to expose the institution to substantial losses.

Larger CFI Deferral Requirement. The Proposed Rule would require the deferral of at least 50% of any Incentive Arrangement with an executive officer of a Larger CFI over a period of three years, and the deferred amount must be adjusted for "actual losses or other measures or aspects of performance that are realized or become better known during the deferral period." Such Incentive Arrangements would comply with the Proposed Rule provided the deferred amount is released or vests over the three year period at a rate that is no faster than a pro rata equal-annual-increment distribution. For example, if the deferred amount was $150,000, then permissible payment schedules would include: (i) $50,000 after each

[5] "Executive officer" is defined, in most cases, as persons holding the title or performing the function of president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief lending officer, chief legal officer, chief risk officer or head of a major business line.

of the first, second and third years; (ii) the entire $150,000 after the third year; or (iii) no amount after year one, up to $100,000 after year two and the balance paid after year three.

Larger CFI Disclosure Requirement. The deferral requirement would apply only to Incentive Arrangements with executive officers, but the boards of directors (or applicable committees) of Larger CFIs would also be required to:

- Identify any Covered Person other than executive officers who individually has the ability to expose the institution to losses that are substantial in relation to the institution's size, capital or overall risk tolerance;
- Approve any Incentive Arrangements for such individuals, upon its determination that the arrangement appropriately balances the financial rewards and the range and time horizon of risks associated with the individual's activities;
- Document such approval; and
- Evaluate the overall effectiveness of the balancing methods used in the arrangement in reducing incentives for inappropriate risk-taking and making payments sensitive to all the risks arising from the Covered Person's activities.

Policies and Procedures

Finally, the Proposed Rule would prohibit any Incentive Arrangement that is not adopted pursuant to written policies and procedures that meet prescribed standards and are approved by the CFI's Board. At a minimum the policies and procedures must:

- Be consistent with the Proposed Rule's reporting requirements;
- Ensure that risk management, risk oversight and internal control personnel have an appropriate role in the design, implementation and monitoring of Incentive Arrangements;
- Provide for monitoring of Covered Persons (or groups thereof), with respect to awards and payments received, risks taken and actual risk outcomes to determine whether payments are reduced to reflect adverse risk outcomes or high levels of risk taken, and, where practicable in light of the CFI's size and complexity, such monitoring should be performed by an individual or group independent of such person (i.e., having a separate reporting line to senior management);
- Provide procedures for the board of directors (or applicable committee) to receive the data and analysis needed from management and other sources to fulfill its oversight duties;
- Ensure sufficient documentation of the processes for establishing, implementing, modifying and monitoring Incentive Arrangements is maintained;
- Where deferral methods are used for any Incentive Arrangements, ensure that (i) the amount deferred and the deferral period are appropriate in respect of the duties and responsibilities of the relevant Covered Person, the risks involved and the size and complexity of the CFI, and (ii) the amount deferred is adjusted for actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

- Subject any Incentive Arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors (or applicable committee), including approval of such arrangements.

Effective Date

It is contemplated that the rulemaking will become effective 6 months after publication of the final rule, with annual reports due within 90 days after the end of each CFI's fiscal year. The Federal Regulators are soliciting comments on the Proposed Rule, including as to whether the proposed effective date will provide sufficient time to comply and whether various aspects of the Proposed Rule should have different effective dates.

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