[buck research]

A Xerox Company

fyi© for your information©

Volume 34 | Issue 37 | April 26, 2011

Federal Regulators Propose Rules on Incentive-Based Compensation Arrangements

The Dodd-Frank Wall Street Reform and Consumer Protection Act charged federal regulators with prescribing regulations or guidelines on incentive-based compensation practices at covered financial institutions. On April 14, 2011, seven federal regulatory agencies jointly issued proposed rules that would require enhanced compensation structure reporting by the institutions and prohibit arrangements that provide excessive compensation or could expose them to inappropriate risks.

Background

Along with sweeping financial reforms, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) contains provisions that will require enhanced compensation structure reporting by "covered financial institutions." (See our July 16, 2010 *For Your Information*.) For this purpose, covered financial institutions include any of the following types of institutions that have total consolidated assets of $1 billion or more: depository institutions or depository institution holding companies; broker-dealers registered under the Securities Exchange Act of 1934; credit unions; investment advisors under the Investment Advisers Act of 1940 (regardless of whether the firm is registered as an investment advisor under the Act); the Federal National Mortgage Association (Fannie Mae); the Federal Home Loan Mortgage Corporation (Freddie Mac); and other financial institutions jointly designated by the appropriate federal regulators.

Section 956 of Dodd-Frank required the appropriate federal regulators to prescribe regulations or guidelines within nine months after the enactment of the law that would:

- Require covered financial institutions to report incentive-based compensation arrangements; and
- Prohibit incentive-based payment arrangements (or features of such arrangements) at covered financial institutions that provide excessive compensation or encourage inappropriate risks that could lead to material financial loss.

On April 14, 2011, seven federal regulatory agencies jointly issued proposed regulations to enhance the disclosure and reporting of compensation structures and to prohibit certain compensation arrangements. The issuers were the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), U.S. Securities and Exchange Commission (SEC), and Federal Housing Finance Agency (FHFA) (collectively, the Agencies or federal regulators). Key provisions are highlighted below.

Proposed Regulations

The proposed regulations, which are broad in scope, apply to covered financial institutions that offer incentive-based compensation arrangements to their executive officers, employees, directors, or principal shareholders (covered persons). As discussed below, the regulations prohibit covered financial institutions from maintaining incentive-based compensation arrangements that encourage imprudent risk-taking, and impose additional restrictions on incentive-based compensation arrangements at larger financial institutions.

Key Terms Defined

Compensation. Under the regulations, compensation is broadly defined to include all direct and indirect payments, fees or benefits (cash and non-cash) awarded to, granted to, or earned by a covered person for services rendered to the covered financial institution. Compensation subject to the regulations would include, for example, payments or benefits pursuant to an employment contract, perquisites, stock options, or postemployment benefits. For credit unions, the definition excludes reimbursement for reasonable costs incurred by covered persons for credit union business, the provision of reasonable health, accident and certain other related insurance, and indemnification.

Incentive-Based Compensation. As proposed, incentive-based compensation means any variable compensation that serves as an incentive for performance, and would include cash, equity awards, or other property. Specifically excluded from incentive-based compensation is compensation awarded solely for and tied to continued employment (e.g., base salary, 401(k) contributions) and compensation arrangements that reward individuals for behaviors that do not involve risk-taking, such as payments for achieving a professional certification or higher education level. The proposed definition also would not include dividends paid and appreciation realized on stock or other equity instruments owned by a covered person outright. Stock or other equity awards would not be considered to be owned outright while subject to any vesting requirement or deferral arrangement (regardless of whether deferral is mandatory).

> ***BUCK COMMENT.*** *Although not specifically described in the proposed regulations, presumably equity-based arrangements including restricted shares, stock options or stock appreciation rights, and restricted stock units would all be considered incentive-based compensation under the regulations whether or not vesting is tied to performance conditions or time-based vesting conditions.*

Covered Financial Institution. As noted above, only covered financial institutions with total consolidated assets of $1 billion or more would be subject to the new regulations. The types of institutions covered would include:

- National banks and federal branches and agencies of foreign banks;
- State member and nonmember banks, insured U.S. branches of foreign banks, and state-licensed uninsured branches or agencies of foreign banks;

- Bank holding companies, and the U.S. operations of foreign banks that are treated as bank holding companies under the International Banking Act of 1978;
- Savings associations, subsidiaries of federal savings associations, and savings and loan holding companies;
- Insured credit unions or credit unions eligible to apply to become insured;
- Broker-dealers registered under the Securities Exchange Act of 1934;
- Investment advisors under the Investment Advisors Act of 1940; and
- Fannie Mae, Freddie Mac, the Federal Home Loan Banks (FHL Banks), and the Office of Finance that serves the FHL Banks.

BUCK COMMENT. *The proposed regulations expand the definition of a covered financial institution specified in Dodd-Frank Section 956 by adding the uninsured branches and agencies of a foreign bank, other U.S. operations of foreign banking organizations that are statutorily treated as bank holding companies, and the FHL Banks.*

Larger Financial Institutions. For purposes of the proposed regulations, a larger financial institution generally refers to a covered financial institution with total consolidated assets of $50 billion or more, a credit union with total consolidated assets of $10 billion or more, Fannie Mae, Freddie Mac, and FHL Banks with total consolidated assets of $1 billion or more. In addition, the FHFA proposes to subject the FHL Bank System's Office of Finance to the same requirements applicable to larger covered financial institutions.

BUCK COMMENT. *Because the $1 billion and $50 billion thresholds for investments advisors would be determined by the advisor's total assets shown on its last fiscal year's balance sheet rather than by total assets under management, the proposed regulations may not apply to many private fund advisors.*

Covered Person. Under the proposed regulations, a covered person is defined as any executive officer, employee, director, or principal shareholder of a covered financial institution.

- *Executive Officer* is a person who holds the title or performs the function of one or more of the following – 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.
- *Director* is a member of the institution's board of directors or a board or committee performing a similar function. *Board of directors* is the governing body of the financial institution. With respect to a foreign banking corporation, the term refers to the senior management or oversight body for its U.S. branch, agency or operations.
- *Principal shareholder* is an individual that directly or indirectly, alone or in concert with others, owns, controls, or has the power to vote at least 10 percent of any class of a covered financial institution's voting

securities. Because credit unions are not-for-profit financial cooperatives with member owners, the NCUA's proposed rule does not include this definition.

BUCK COMMENT. *Although the proposed regulations cover all employees, it is expected that the regulators will largely focus on compensation arrangements for executive officers and employees that individually or as a group have the most potential to lead to material loss for the institution (e.g., traders with large position limits, loan officers who, as a group, originate loans that account for a material amount of the covered financial institution's credit risk, etc.).*

Total Consolidated Assets. As noted above, the proposed regulations would apply to all covered financial institutions that have total consolidated assets of $1 billion or more. With the exception of the FHFA, the Agencies have set out in their agency specific texts how to calculate the assets of the entities they regulate to determine whether they are subject to the new rules.

Prohibited Compensation Arrangements

Excessive Compensation. The proposed regulations would prohibit incentive-based compensation arrangements at covered financial institutions that encourage executive officers, employees, directors, or principal shareholders (covered persons) to take inappropriate risks by providing excessive compensation. The Agencies propose using standards comparable to those developed under Section 39 of the Federal Deposit Insurance Act (FDIA) to determine whether incentive-based compensation is excessive in particular cases.

BUCK COMMENT. *Dodd-Frank requires the Agencies to ensure that standards adopted with regard to excessive compensation are comparable to the compensation-related and other safety and soundness standards that already apply to insured depository institutions and their holding companies under FDIA Section 39. Each of the federal banking agencies (i.e., OCC, Board, FDIC, and OTS) has adopted guidelines implementing the FDIA standards. Thus, broker-dealers, investment advisors, credit unions and government-sponsored entities that were not previously subject to the FDIA standards are likely to feel the greatest effect of the new requirements.*

The regulations set forth standards for determining whether an incentive-based compensation arrangement provides excessive compensation. Under the proposed regulations, the compensation for a covered person would be excessive "when amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed by the covered person." Factors the Agencies will consider in making individual determinations include:

- The combined value of a covered person's cash and non-cash benefits;
- The covered person's compensation history and the compensation history of other individuals with comparable expertise at the same institution;

- The institution's financial condition;
- Comparable compensation practices at comparable institutions;
- For postemployment benefits, the projected total cost and benefit to the institution;
- Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and
- Any other factors the Agencies deem relevant.

Possible Material Financial Loss. The proposed regulations would also prohibit a covered financial institution from establishing or maintaining incentive-based compensation arrangements for covered persons that encourage inappropriate risk-taking that could lead to material financial loss by the institution. The prohibition would be limited to incentive-based arrangements for individuals or groups of individuals whose activities pose a risk of material financial loss to the institution, including executive officers and others with oversight responsibility for firm-wide activities or material business lines, individuals whose activities may expose the institution to material financial loss (e.g., traders with relatively large position limits), and groups of persons that in the aggregate pose such a risk.

The Agencies propose to adopt standards to determine whether a compensation arrangement encourages such risk-taking that are consistent with the federal banking agencies' Guidance on Sound Incentive Compensation Policies. (See our July 2, 2010 *For Your Information*.) The proposed standards would require incentive-based compensation arrangements established or maintained by a covered financial institution to:

- Balance risk and financial rewards so as not to encourage imprudent risk-taking;
- Be compatible with effective controls and risk management; and
- Be supported by strong corporate governance.

Additional Restrictions on Larger Covered Financial Institutions. The proposed regulations would impose additional restrictions on larger covered institutions, including the requirement to defer a substantial portion of their executive officers' incentive-based compensation. The larger institutions would be required to defer at least 50 percent of their executive officers' incentive-based compensation over a period of at least three years. In addition, deferred amounts paid would have to be adjusted for actual losses of the covered institution or other performance measures that are realized or become known during the deferral period.

The proposed regulations also restrict the manner in which amounts required to be deferred may be released. The full deferred amount may be paid (or allowed to vest) in a lump-sum only at the conclusion of the deferral period. Alternatively, the institution may release the deferred amounts (or allow vesting) on a *pro rata* equal-annual-increments schedule. However, the release or vesting of deferred amounts may not be any faster than on a *pro rata* basis.

***BUCK COMMENT.** To avoid adverse tax consequences for these individuals, required compensation deferrals must be structured in accordance with Internal Revenue Code Section 409A.*

The regulations would also require the larger financial institution's board of directors (or one of the board's committees) to identify covered persons other than executive officers who potentially could expose the institution to substantial losses relative to the institution's size, capital or overall risk tolerance, and to approve any incentive-based arrangements for those individuals. Although the proposed regulations require the board or its committee to determine that the compensation arrangement (including the method of paying compensation) "effectively" balances the individual's financial rewards against the range and time horizons of potential risks to the institution, they provide little guidance on what constitutes an effective balance.

***BUCK COMMENT.** The proposed regulations reference various materials used by the Agencies in considering how to implement Dodd-Frank Section 956 provisions dealing with inappropriate risks, including the Financial Stability Board's FSF Principles for Sound Compensation Practices, Basel, Switzerland (April 2009) and FSB Principles for Sound Compensation Practices: Implementation Standards, Basel, Switzerland (September 2009). These publications provide examples of how compensation arrangements can be tailored to a financial institution's specific operational structures.*

Requirement to Maintain Appropriate Policies and Procedures

To help ensure compliance with the new requirements and prohibitions, the proposed regulations would require covered financial institutions to maintain policies and procedures governing the award of incentive-based compensation that are appropriate to the institution's size, complexity and use of incentive-based compensation. The regulations would require the policies and procedures to meet certain minimum standards, including addressing the prohibitions against excessive compensation and material financial loss as well as the annual reporting requirements discussed below.

The policies and procedures would, for example, have to ensure that risk-management, risk-oversight, and internal control personnel have an "appropriate" role in the institution's compensation design and assessment processes. Among other things, they would also have to provide for the independent monitoring of incentive-based compensation awards and payments, the board of director's assessment of the overall design and performance of the incentive-based compensation arrangements, adequate documentation to ensure compliance, adjustments of deferral amounts to reflect actual losses or other measures of performance realized during the deferral period, and a corporate governance framework that provides ongoing oversight of executive officers' incentive-based compensation.

Reporting Requirements

Dodd-Frank requires a covered financial institution to submit an annual report to the appropriate federal regulator disclosing the structure of its incentive-based compensation arrangements to allow a determination of whether the arrangements provide an executive officer, employee, director or principal shareholder of the financial institution with excessive compensation, fees or benefits or could lead to material financial loss to the institution. The proposed regulations require covered financial institutions to provide such a report annually to their federal regulators, and sets out specific reporting requirements. This disclosure requirement would supplement reporting obligations previously adopted by the Agencies.

The annual report submitted by a covered financial institution under the proposed regulations would not have to disclose the actual compensation of particular individuals, but it must contain the following:

- A clear narrative description of the institution's incentive-based compensation arrangements for covered persons, specifying the types of covered persons to which they apply;
- A succinct description of the institution's policies and procedures governing those arrangements;
- Material changes to the institution's incentive-based compensation arrangements, policies and procedures since submission of the last report;
- Specific reasons why the institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risk-taking by providing covered persons with excessive compensation or incentive-based compensation that could lead to the institution's material financial loss; and
- For larger covered institutions, a succinct description of specific incentive compensation policies and procedures for their executive officers and other covered persons who the board of directors or a committee of the board determines has the ability to expose the institution to potentially substantial losses relative to its size, capital, or overall risk tolerance.

Annual reports would be due within 90 days of the end of each covered financial institution's fiscal year. The Agencies have indicated that, to the extent permitted by law, they will maintain the confidentiality of the information submitted and keep the information nonpublic.

> ***BUCK COMMENT.*** *To comply with the reporting requirements, covered financial institutions would need to ensure that all of their incentive compensation arrangements are accounted for, inventoried, and clearly documented. Without any exemptions for* de minimis *arrangements, this could be an onerous task.*

Effective Date

The Agencies will accept comments on the proposed regulations until May 31, 2011, and propose making the final regulations effective six months after publication in the Federal Register.

Conclusion

Recognizing that improperly structured compensation arrangements can lead to imprudent risk-taking, Dodd-Frank put the onus on federal regulators to deter excessive compensation and other behavior that could affect the safety and soundness of certain financial institutions. While the Agencies seek input and the regulations remain to be finalized, it is clear that they will increase federal oversight of institutions that offer incentive-based compensation. In anticipation of that, financial institutions and their boards should assess their current executive compensation practices and related risk management, control and corporate governance processes. If and as needed, they should modify their compensation programs to appropriately balance risk and financial reward.

Buck's consultants are available to help redesign your compensation policies, programs and individual incentive-based arrangements consistent with your firm's risk management and retention strategies.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.