U.S. Regulators Propose Rules on Incentive-Based Compensation Arrangements at Large Financial Institutions

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In the latest round of rulemaking under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Federal Deposit Insurance Corporation recently issued proposed rules governing incentive-based compensation arrangements at major financial institutions, including new reporting requirements and prohibitions on compensation arrangements that are excessive in nature or that could expose such institutions to material financial loss. In the case of financial institutions that have $50 billion or more in consolidated assets, at least 50% of incentive-based compensation payable to the executive officers of such institutions must be deferred for a period of no less than three years, with the deferred amount subject to a look-back review based on actual losses or other performance measures that become better known during the deferral period. The same rules are soon expected to be issued by the other major banking and financial regulators, including the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission.

Section 956 of the Dodd-Frank Act requires that the major banking and financial regulators to jointly issue regulations or guidelines that prohibit incentive-based payment arrangements, or any feature of such arrangements, that encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to a material financial loss to the institution. The proposed rules are intended to satisfy that requirement.

Following a 45-day public comment period, the proposed rules are expected to become effective six months after their final adoption and publication in the Federal Register by the various regulators. This memorandum reviews some of the key features of the proposed rules, which are intended to supplement, rather than replace, existing rules and guidance adopted by these regulators regarding compensation practices.[1]

A. The Broad Scope of the Proposed Rules

The proposed rules apply to "covered financial institutions"—that is, generally, any of the following types of institutions that have, on a consolidated basis, assets of $1 billion or more:

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1 These rules and guidance include the Guidance on Sound Incentive Compensation Policies (75 Fed. Reg. 36935 (June 25, 2010)), which was adopted by the federal banking regulators last year; the Standards for Safety and Soundness (60 Fed. Reg. 35678 (July 10, 1995), as amended at 61 Fed. Reg. 43950 (Aug. 27, 1996)); and the compensation-related disclosure requirements adopted by the SEC for public companies (*see, e.g.*, Item 402(s) of Regulation S-K, 17 C.F.R. § 229.402(s), adopted in Securities Act Release No. 9080, 74 Fed. Reg. 68334 (Dec. 23, 2009)).

- depository institutions (including the uninsured U.S. branches and agencies of foreign banks),
- depository institution holding companies (including foreign banks that are treated as bank holding companies under the International Banking Act),
- registered broker-dealers under the Exchange Act,
- investment advisers under the Investment Advisers Act, and
- any other financial institution that the federal banking and financial regulators jointly determine should be treated as covered by the rules.

Only incentive-based compensation paid by covered financial institutions to "covered persons" would be subject to the requirements of the proposed rules. The term "covered person" includes any executive officer, employee, director, or principal shareholder (*i.e.*, any individual that directly or indirectly, or acting in concert through one or more persons, owns or controls 10% or more of any class of voting securities) of a covered financial institution. An "executive officer" is defined broadly to include any person who holds the title of (or, without such title, performs the function of) one the following positions: 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 the head of a major business line.

"Incentive-based compensation" means "any variable compensation that serves as an incentive for performance." The definition of "compensation" covers all direct and indirect payments, fees or benefits, both cash and non-cash (including equity), awarded or granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution. Examples of compensation included in the definition are payments or benefits pursuant to an employment contract, compensation or benefit arrangement, fee arrangement, perquisites, stock option plan, post-employment benefit, or "other compensatory arrangement."

Compensation that is specifically excluded from these rules is, generally: compensation awarded solely for, and the payment of which is solely tied to, continued employment (*e.g.*, salary); compensation that provides rewards solely for activities or behaviors that do not involve risk-taking (*e.g.*, payments for achieving or maintaining professional certification); and compensation based solely on the employee's level of fixed compensation that does not vary based on performance metrics (*e.g.*, employer contributions to a 401(k) plan based on a fixed percentage of the employee's salary).

B. Prohibition on "Excessive" Compensation Arrangements and Those Arrangements That May Lead to "Material Financial Loss"

The proposed rules prohibit a covered financial institution from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk-taking by providing excessive compensation or that could otherwise lead to a material financial loss to the covered financial institution.

1. “Excessive” Compensation

Under the proposed rules, a covered financial institution is prohibited from establishing or maintaining incentive-based compensation arrangements, or any individual feature of such arrangements, that encourage a covered person to expose a covered financial institution to inappropriate risks by providing that person with excessive compensation.

Compensation will be considered “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. The relevant regulators are to assess whether compensation is excessive using the following standards, which are part of the “safety and soundness” compensation standards contained in Section 39 of the Federal Deposit Insurance Act:

- the combined value of all cash and non-cash benefits provided to the covered person;
- the compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
- the financial condition of the institution;
- comparable compensation practices at peer institutions, based upon such factors as asset size, geographic location, and the complexity of the institution’s operations and assets;
- the projected total costs and benefit to the covered financial institution, with regard to post-employment benefits;
- any connection between the individual and any fraudulent acts or omissions, fiduciary duty or trust breaches, or insider abuse with regard to the covered financial institution; and
- any other factors that the applicable regulator considers to be important.

2. Incentive-Based Compensation Arrangements and the Prospect for “Material Financial Loss” at the Covered Financial Institution

The proposed rules also ban incentive-based compensation arrangements for individual covered persons, or groups of covered persons, whose particular activities may expose the covered financial institution to “inappropriate risks that could lead to a material financial loss.” The types of covered persons contemplated by this portion of the rules are: (i) executive officers and other persons who are responsible for oversight of firm-wide activities or material business lines; (ii) other individual covered persons, including non-executive employees, based on the nature of their activities (such as traders with large position limits relative to the institution’s overall risk tolerance); and (iii) groups of covered persons who are subject to the same or similar incentive-based compensation arrangements and who, in the aggregate, could expose the institution to a material financial loss, even if no individual covered person in the group could expose the institution to such loss (such as loan officers who, as group, originate loans that account for a material amount of the institution’s credit risk).

An incentive-based compensation arrangement will not be compliant with the rules unless it (i) balances risk and financial rewards, (ii) is compatible with effective controls and risk

management, and (iii) is supported by strong corporate governance. Covered financial institutions will be required to establish and maintain policies and procedures related to these standards, as described in more detail below.

(i) Balance of Risks and Rewards

A central theme underlying the proposed rules is that of balance. Incentive-based compensation arrangements must balance risk and financial rewards in such a way that covered persons lack incentives to take excessive risks that could lead to a material financial loss at the covered financial institution. The proposed rules state specifically that an incentive-based compensation arrangement will be deemed "balanced" when the amounts paid to a covered person appropriately take into account the risks, as well as the financial benefits, from the covered person's activities and the impact of those activities on the institution. In this regard, regulators will consider a full range of risks associated with a covered person's activities (including credit, market, liquidity, operational, legal, compliance and reputational risks), as well as the time horizon over which those risks may be realized.

The proposed rules cite four methods that covered financial institutions may use to ensure compensation is more sensitive to risk: (i) deferring payment of the compensation beyond the end of a performance period and adjusting the amount payable based on actual losses or other performance criteria; (ii) adjusting awards on account of risk, based on quantitative or other measures that take into account the risk the covered person's activities pose to the institution; (iii) extending performance periods, so that some or all risk outcomes associated with the covered person's activities are realized or better known at the time of payment; and (iv) reducing the rate at which awards increase as a covered person achieves higher levels of the relevant performance measure or measures used in the person's incentive-based compensation arrangement.

(ii) Compatibility with Effective Controls and Risk Management

A covered financial institution's risk management processes and internal controls must buttress the development and maintenance of balanced incentive-based compensation arrangements. Among other things, regulators will look to whether risk-management personnel are engaged in the institution's design of incentive-based compensation arrangements, as well as in the monitoring and assessment of such arrangements to ensure they are balanced with the overall risks of an institution. The proposed rules also require a covered financial institution's policies to provide for the monitoring described above to be done by a group or person that is "independent" of the covered person. To be considered independent, the group or person must have a separate reporting line to senior management from the covered person who is creating the risks.

(iii) Strong Corporate Governance

A covered financial institution's board of directors (or committee thereof) must actively oversee the development and operation of incentive-based compensation arrangements and related control processes. This would include the review and approval by the institution's board of directors (or committee thereof) of the overall goals of any incentive-based compensation program to ensure they are consistent with the institution's risk tolerance, as well as the receipt and analysis of data to test whether the overall design is consistent with the goals and purposes of Section 956 of the Dodd-Frank Act.

C. Special Considerations for Executive Officers and Certain Designated Employees of Very Large Covered Financial Institutions

Not all covered financial institutions are treated alike under the proposed rules. Covered financial institutions with consolidated assets of $50 billion or more[2] will have to comply with the following additional requirements with respect to their executive officers and certain of their employees designated as having the individual ability to expose such institutions to substantial loss.

(i) Holdback of Incentive-Based Pay for Executive Officers

These covered financial institutions will be required to defer at least 50% of incentive–based compensation otherwise payable to their executive officers over at least a three-year period. The purpose of such deferral is to allow for risks not previously discernable or quantifiable to materialize by the end of the deferral period, in recognition of the fact that executive officers, unlike other employees, make strategic and high-level decisions, the risks of which may not become apparent for many years. Importantly, these amounts must be adjusted for actual losses incurred by the institution or based on other measures or aspects of performance that become known during the relevant deferral period. Covered financial institutions will be able to release (or allow vesting of) these deferred amounts in a lump-sum at the conclusion of the deferral period or, alternatively, in equal increments, *pro rata*, for each year of the deferral period. For example, an institution required to apply a three-year deferral to a $150,000 incentive-based compensation amount could release a maximum of $50,000 each year, or it could withhold the entire amount for the entire deferral period and release it as a lump-sum at the conclusion of the three-year period. The institution could also employ a less rapid distribution schedule by, for instance, releasing no amount after the first year, and then releasing a maximum of $100,000 the second year, and then $50,000 for the third year.

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[2] As of December 31, 2010, there were 35 bank holding companies that had at least $50 billion in total consolidated assets. *See* National Information Center Website, *available at* http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx.

(ii) Identification of Individual Employees Capable of Exposing an Institution to Substantial Losses

The proposed rules would also require these covered financial institutions to identify individual non-executive officer employees who have the ability to inflict substantial losses on the institution, based on its size, capital, or overall risk tolerance. The rules specifically identify traders with large position limits relative to an institution's overall risk tolerance, and other individuals who have the authority to place a substantial part of an institution's capital at risk, as examples of such employees.

The institution's board of directors (or committee thereof) is charged with the responsibility of indentifying those employees, other than executive officers, who individually may present a substantial risk to the institution. In addition, the board of directors (or committee thereof) will be required to approve the incentive-based compensation arrangements applicable to such individuals, and such approval may not be given unless the board (or committee) determines that the arrangement (including the method of paying such compensation) effectively balances the financial rewards to the employee and the range and time horizon of risks associated with the employee's activities. The rules identify the following methods that can be used to establish this balance: risk-adjustment of awards, deferral of payments, extended performance periods, or "other appropriate methods." The board (or committee) must evaluate the overall effectiveness of the balancing methods used in the applicable incentive-based compensation arrangement in reducing incentives for inappropriate risk-taking by the identified employee, as well as the ability of the methods used to make payments sensitive to the full range of risks presented by the employee's activities.

D. Policies, Procedures, and Reporting Requirements

The proposed rules require all covered financial institutions to have policies and procedures governing the award of incentive-based compensation that balance the risk and reward for institutions of their respective size, complexity, and business activity, as well as the scope and nature of the incentive-based compensation arrangements. The policies and procedures should be particularly focused on those employees who, individually or as a group, may expose the institution to material financial loss. Examples of employees who are unlikely to meet this test include, for example, tellers, bookkeepers, couriers and data processing personnel.

In order for regulators to assess whether incentive-based compensation structures are excessive in nature or could lead to material financial loss, all covered financial institutions will be required to submit an annual report to their respective regulator that describes the structure of their incentive-based compensation arrangements. The report will need to contain, at a minimum: (i) a description of the components of the institution's incentive-based compensation arrangements to covered persons, as well as the types of covered persons to which they apply; (ii) a description of the institution's related policies and procedures on incentive-based compensation; (iii) any material changes to such arrangements and policies and procedures since the prior report; and (iv) the specific reasons why the institution views the structure of its incentive-based compensation arrangements as not encouraging inappropriate risks by providing covered persons with excessive compensation or incentive-based compensation that

could lead to a material financial loss to the covered financial institution. In addition, covered financial institutions with $50 billion or more in consolidated assets will be required to report on their policies and procedures governing executive officers and other employees that have been identified by the institution as capable of exposing the institution to substantial losses. However, covered financial institutions will not be required to disclose the actual compensation of any particular covered persons in the report.

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For more information about these proposed rules and their impact on incentive-based compensation arrangements at large financial institutions, please contact a member of the Firm's Executive Compensation and Employee Benefits Practice Group or Financial Institutions Group.

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