

## ADVISORY | DODD-FRANK ACT

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### SEC JOINS FDIC AND NCUA IN APPROVING PROPOSED REGULATION OF INCENTIVE-BASED COMPENSATION

The Securities and Exchange Commission (SEC) approved last week proposed regulations that would limit incentive-based compensation at financial institutions. The regulations would implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Section 956). The proposed regulations are a joint rule making among seven federal agencies including the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (the Federal Reserve Board), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), and the Federal Housing Finance Agency (FHFA). Last month, the regulations were approved in substantially the same form by the FDIC and the NCUA. The proposed regulations must be approved by all seven agencies before they are published in the Federal Register. The new rules would take effect six months after publication of final regulations.

Section 956 prohibits incentive-based compensation that would encourage inappropriate risks. It also requires covered financial institutions to report to federal regulators the structure of their incentive-based compensation. The new rules are premised on the assumption that “a person who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to expose the institution to more risk.”

The proposed regulations would expand the group of institutions covered by these rules beyond the group listed in the statute and require the boards of directors of covered institutions to actively review and monitor incentive-based compensation. Importantly, the rules would supplement, but not replace, any existing restrictions on compensation. Key features of the proposed regulations are described below.

#### Covered Financial Institutions

The incentive-based compensation rules apply to covered financial institutions with assets totaling at least \$1 billion. The \$1 billion threshold, however, would not apply to institutions regulated by FHFA. Section 956 defines a covered financial institution to

#### THE PROPOSED REGULATIONS WOULD...

- Expand the scope of financial institutions covered by Section 956
- Provide a broad definition of “incentive-based compensation”
- Require the board of directors (or a board committee) to establish policies, approve and monitor compensation arrangements, and evaluate and document compliance
- Impose enhanced requirements for larger institutions (generally institutions with assets totaling \$50 billion or more)

include depository institutions, registered broker-dealers, credit unions, investment advisors (whether registered with the SEC or not), Fannie Mae, and Freddie Mac. Under the proposed regulations, the definition of

“covered financial institution” would be expanded to include:

- ✓ a national bank and federal branch and agency of a foreign bank (with respect to the OCC);
- ✓ a state member bank, a bank holding company, a state-licensed uninsured branch or agency of a foreign bank, and the U.S. operations of a foreign bank (with respect to the Federal Reserve Board);
- ✓ a state nonmember bank and an insured U.S. branch of a foreign bank (with respect to the FDIC); and
- ✓ a savings association, including an operating subsidiary of a federal savings association (with respect to OTS).

The proposed definition would also include the Federal Home Loan Banks and the uninsured branches and agencies of a foreign bank, as well as the other U.S. operations of foreign banking organizations that are treated as bank holding companies under the International Banking Act of 1978. The rules would apply to the Office of Finance, a joint agency of the 12 Federal Home Loan Banks, but, because the Office of Finance is not a financial institution, the rules would be promulgated under authority other than Section 956.

For banking entities and credit unions, the \$1 billion threshold for total consolidated assets would be measured generally using a rolling average based on the entity’s four most recent call reports. For investment advisers and registered broker-dealers, this threshold would be measured by reference to total assets as of the end of the firm’s most recent fiscal year. The SEC has noted that, because of the \$1 billion threshold, “there should not be any small broker-dealers or investment advisers impacted by this proposed rule.” The FHFA does not offer rules regarding the \$1 billion threshold because it is proposing to apply the new rules (based on authority other than Section 956) to all entities it regulates.

## Incentive-Based Compensation

Incentive-based compensation under Section 956 refers to variable compensation that serves as an incentive for performance. Compensation solely for continued service and compensation for activity that does not involve risk-taking are not included. All types of compensation, however, are taken into account, including equity, perquisites, and other non-cash awards. Compensation includes amounts that are earned based on total compensation, such as retirement plan contributions equal to a percentage of total pay.

## Prohibited Arrangements

Section 956 prohibits incentive-based compensation that either is excessive or that could lead to material financial loss by the financial institution. The proposed regulations would not impose a dollar limit or percentage-of-pay limit on incentive-based compensation. Instead, the proposed regulations would set forth general rules, together with guiding principles, designed to minimize the possibility that an individual’s compensation package would incentivize undue risk-taking. The prohibitions, described below, apply with respect to executive officers, employees, directors, and principal shareholders.

**Excessive Compensation.** Under the proposed regulations (which are based on standards under Section 39 of the Federal Deposit Insurance Act), excessive compensation would refer to amounts paid that are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed. The proposed regulations identify a number of factors that the appropriate regulator will consider in determining whether compensation is excessive under the foregoing standard, including: (1) the total value of all compensation paid to the individual; (2) the compensation history of the individual and similar individuals; (3) the financial condition of the institution; (4) comparable compensation practices at other institutions; (5) the projected cost and benefit to the

institution of post-employment benefits; and (6) misconduct by the individual. In addition, the proposed regulations empower the regulators to take into account any other factors they deem relevant in determining whether compensation is excessive.

**Risks that Could Lead to Material Financial Loss.** Section 956 prohibits compensation arrangements that could lead to a material financial loss.

➤ **Who Is Covered.** This prohibition applies only to individuals who could expose the institution to material financial loss. Under the proposed regulations, these individuals would include: (1) executive officers and others responsible for firm-wide activities or material business lines; (2) others who could expose the institution to material loss, such as traders with large position limits; and (3) groups of individuals who, together, could expose the institution to material loss.

➤ **What Is Prohibited.** Incentive-based compensation arrangements for covered individuals will not comply with the proposed regulations unless they (1) balance risk and financial rewards; (2) are compatible with effective controls and risk management; and (3) involve strong corporate governance. These requirements are described below:

✓ **Balance of risk and financial rewards.** The proposed regulations suggest four ways to balance risk and financial rewards:

1. Risk Adjustment—The amount of performance-based compensation is adjusted based on the extent to which the individual’s activities expose the institution to risk.
2. Deferral—Payment is deferred significantly beyond the performance period and adjusted during the deferral period to reflect the long-

term effect of the individual’s activities.

3. Longer Performance Periods—Performance periods are extended (for example, from one year to two years) to allow compensation to reflect the ultimate outcomes of an individual’s activities.

4. Reduced Sensitivity to Short-term Performance—Reducing the magnitude of the incentive to achieve short-term performance by reducing the rate at which awards increase with higher levels of performance.

✓ **Effective controls and risk management.** Risk management personnel must have a role in designing and monitoring incentive-based compensation arrangements. Employees should not be able to influence inappropriately the risk measures, information, or judgments used to balance compensation.

✓ **Corporate governance and the active role of the board.** The proposed regulations would require a covered institution’s board to “actively oversee incentive-based compensation arrangements.” Under the proposed regulations, the board is “ultimately responsible for ensuring that the covered financial institution’s incentive compensation arrangements are appropriately balanced.” The board (or a board committee) should review and approve the overall goals and purposes of an institution’s incentive-based compensation system, in light of the institution’s risk tolerance. The proposed regulations would also require the board (or committee) to receive data and analysis to assess whether the incentive-based compensation system is consistent with Section 956.

### **Mandatory Deferral and Other Requirements for Larger Institutions**

The proposed regulations would impose additional requirements on incentive-based compensation paid by larger financial institutions (generally institutions with assets of \$50 billion or more, although FHFA would impose these requirements on all institutions it regulates). Larger institutions must defer at least 50 percent of the incentive-based compensation of an executive officer over a period of at least three years. Deferred amounts must be adjusted for losses or other measures of performance that are realized or become better known during the deferral period. In addition, release or vesting of deferred amounts may not be faster than a pro rata equal-annual-increments distribution.

The board (or board committee) of a larger institution must, in addition, identify non-executive officers who individually have the ability to expose the institution to substantial losses. The board or committee must approve incentive-based compensation for these individuals as risk balanced, and they must document their approval. The board or committee must also evaluate the effectiveness of risk balancing approaches to incentive-based compensation for these individuals.

### **Disclosure Requirements**

Section 956 requires a covered financial institution to submit an annual report to its Federal regulator disclosing the structure (but not the dollar amounts) of its incentive-based compensation arrangements. Under the proposed regulations, the report would need to include:

- ✓ a description of the incentive-based compensation arrangements and the types of individuals covered by these arrangements;
- ✓ the institution’s policies and procedures governing incentive-based compensation;
- ✓ for large financial institutions (generally institutions with assets of \$50 billion or

more), a description of any policies and procedures specific to executive officers and individuals who the board (or a board committee) determines to have the ability to expose the institution to substantial losses;

- ✓ material changes since the last the report;
- ✓ the reasons why the incentive-based compensation plan (a) does not provide incentives to engage in behavior that is likely to cause the institution to suffer a material financial loss, and (b) does not provide excessive compensation.

The regulatory agencies expect that these disclosures will generally remain confidential and will not be available to the public under the Freedom of Information Act.

### **Policies and Documentation**

The proposed regulations would require the board (or a board committee) of each covered institution to establish policies and procedures governing incentive-based compensation. The regulatory agencies expect risk-management, risk oversight, and internal control personnel to be involved in designing, monitoring, and evaluating incentive-based compensation arrangements. In addition, the proposed regulation would require incentive-based arrangements to be monitored by an individual or group that is independent of the individual receiving the compensation. The institution would also be required to have procedures to provide the board with sufficient information and data to evaluate compliance with Section 956.

Under the proposed regulations, the board or committee would need to document its oversight of incentive-based compensation arrangements. The documentation would include copies of incentive-based arrangements, individuals covered by the arrangements, awards made, and the identity of individuals who approved and monitored the arrangements.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our executive compensation practice group:

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