

April 2011 / Special Alert

A legal update from Dechert's Employee Benefits and Executive Compensation, Financial Services and Financial Institutions Groups

## Incentive Compensation Under the Dodd-Frank Regulatory Spotlight

Seven federal regulatory agencies<sup>1</sup> have issued joint proposed rules pursuant to Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") that are expected to significantly impact current incentive-based compensation arrangements maintained by certain financial institutions for their executive officers and certain other covered persons.

The proposed rules, which are broad in scope and vague in many respects, generally would:

- Prohibit "covered financial institutions" from maintaining incentive-based compensation arrangements for "covered persons" that involve "excessive" compensation or encourage inappropriate risks;
- Impose additional stringent requirements on "larger covered financial institutions," including a requirement that at least half of the annual incentive-based compensation for covered persons be deferred for at least three years;
- Require covered financial institutions to adopt policies and procedures regarding incentive-based compensation arrangements; and
- Impose reporting obligations on covered financial institutions regarding incentive-based compensation arrangements.

The proposed rules are similar to those already applicable to insured depository institutions and their holding companies under Section 39 of the Federal Deposit Insurance Act. Thus, the proposed rules may have their greatest impact on broker-dealers, investment advisers, credit unions and government-sponsored entities that would be newly covered. The deadline for commenting is 45 days after the proposed rules are published in the Federal Register.

### Key Terms

#### "Covered Financial Institutions"

A "covered financial institution" is defined as any of the following types of institutions that have \$1 billion or more in total consolidated assets:

- Broker-dealers registered under Section 15 of the Securities Exchange Act of 1934;
- Investment advisers as defined in Section 202(a)(11) of the Investment Advisers Act of 1940;
- State and federal banks and savings associations, bank holding companies, savings and loan holding companies, insured branches and agencies of foreign banks and the U.S. operations of foreign banking organizations that are treated as bank holding companies under the International Banking Act of 1978;
- Credit unions; and
- Fannie Mae and Freddie Mac.

<sup>1</sup> The seven agencies are the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, the Securities and Exchange Commission ("SEC") and the Federal Housing Finance Agency (each, an "Agency").

In addition, Section 956 of the Dodd-Frank Act authorizes the Agencies to issue rules that subject other financial institutions to the incentive-compensation regulations. The Agencies have proposed applying the rules to the Federal Home Loan Banks (FHLBanks) and the Office of Finance, which serves the FHLBanks.

### “Larger Covered Financial Institutions”

A “larger covered financial institution” is generally a covered financial institution with \$50 billion or more in total consolidated assets, credit unions with \$1 billion or more in total consolidated assets, Fannie Mac, Freddie Mac, the FHLBanks and the Office of Finance.

For investment advisers, both the \$1 billion and \$50 billion thresholds are determined not by assets under management, but by the adviser’s total assets as shown on its balance sheet as of the most recent fiscal year-end. The SEC is seeking comment, however, on whether the determination of total assets should be tailored for certain types of investment advisers, e.g., advisers to hedge funds and private equity funds. The SEC has estimated that advisers with \$100 billion or more of assets under management would have total consolidated assets of \$1 billion or more, and that approximately 70 investment advisers would be covered, of which approximately 10 would also be larger covered financial institutions. The SEC has also estimated that 130 broker-dealers would be covered financial institutions and 18 broker-dealers would be larger covered financial institutions.

Thus, so long as an adviser’s status as a covered financial institution is based on the adviser’s own total assets, and not assets under management, relatively few private fund advisers will be subject to the proposed rules.

### “Covered Persons”

A “covered person” is defined as any executive officer, employee, director, or principal shareholder of a covered financial institution. As a practical matter, however, the proposed rules will focus on executive officers and employees whose actions may have a material impact on the institution.

### “Incentive-Based Compensation”

The term “compensation,” which is generally defined as any “payments, fees or benefits, both cash and non-cash, awarded to, granted to or earned by any covered person in exchange for services rendered to the covered

financial institution”, is very broad. It includes, for example, stock options. “Incentive-based compensation” is defined to mean “any variable compensation that serves as an incentive for performance.” It is unclear whether a purely discretionary bonus (for example, a holiday bonus) would be considered “incentive-based compensation.”

The preamble to the proposed rules indicates that incentive-based compensation would not include base salary or an arrangement that provides rewards solely for activities or behaviors that do not involve risk taking (for example, payments solely for achieving a professional certification). The preamble also states that the definition would not include dividends paid and appreciation realized on stock or other equity instruments that are owned outright by a covered person, but that stock or other equity instruments awarded to a covered person would not be considered owned outright while subject to any vesting or deferral arrangement. Thus, it appears that unvested restricted stock or other equity instruments may be deemed “incentive-based compensation.”

### Prohibitions Applicable to All Covered Financial Institutions

The proposed rules prohibit covered financial institutions from maintaining any type of incentive-based compensation arrangement that encourages inappropriate risks by the covered financial institution by providing:

- a covered person with excessive compensation; or
- incentive-based compensation to a covered person that could encourage that individual to take inappropriate risks for the covered financial institution or could lead to a material loss for the institution.

An incentive-based compensation arrangement generally would be deemed to provide excessive compensation if the amounts paid were unreasonable or disproportionate to, among other things, the amount, nature, quality and scope of services performed by the covered person. Relevant factors include: the combined value of the covered person’s cash and non-cash benefits; the covered person’s compensation history; the compensation of comparable individuals with similar expertise at both the same institution and comparable institutions; the financial condition of the covered financial institution; and any connection between the individual and any

fraudulent act or omission, breach of trust or fiduciary duty or insider abuse with regard to the covered financial institution. The appropriate Agency might also consider any other facts that such Agency determines to be relevant.

Incentive-based compensation arrangements may be deemed to encourage inappropriate risks that could lead to a material loss for the institution if they do not effectively balance risk and financial rewards (e.g., by using deferred payments, risk adjustment of awards or longer performance periods), are not compatible with effective controls and risk management and are not supported by strong corporate governance.

### **Prohibitions Applicable to Larger Covered Financial Institutions**

Under the proposed rules, executive officers at larger covered financial institutions would be required to defer at least 50 percent of their annual incentive-based compensation for no fewer than three years. The release of deferred amounts may be no faster than on a pro rata basis. The deferred amounts must be adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period. To the extent that a larger covered financial institution is in bankruptcy, receivership or placed under regulatory control, the relevant Agency may seek to block payments of deferred amounts to covered persons.

Larger covered financial institutions should take care to structure the required compensation deferrals in accordance with Section 409A of the Internal Revenue Code, which governs the taxation of compensation deferrals. Failure to do so could result in a covered person becoming subject immediately to income tax plus a 20% additional tax on the amounts deferred, which, pursuant to the proposed rules, could not be distributed to help the covered person pay his or her tax liability.

In addition, the board of directors (or a committee thereof) of a larger financial institution must identify those covered persons (other than executive officers) who individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance. Examples in the proposed rules of these covered

persons include traders with large position limits relative to the institution's overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the institution.

The board or committee would be required to approve any incentive-based compensation arrangements for these persons. In so doing, it would be required to determine, among other things, that the arrangement "effectively" balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities. The proposed rules do not provide any guidance regarding what is an "effective" balance.

### **Policies and Procedures**

An incentive-based compensation arrangement would be prohibited unless it is adopted pursuant to policies and procedures developed and maintained by the covered financial institution and approved by its board of directors (or a committee thereof) and reasonably designed to ensure and monitor compliance with the requirements of the proposed rules. The proposed rules prescribe certain minimum standards for the contents of the policies and procedures, including, for example, that the policies and procedures must ensure that risk management, risk oversight and internal control personnel have an "appropriate" role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking.

### **Disclosure to Regulators**

Each covered financial institution would be required to submit an annual report to the appropriate Agency, within 90 days of the end of the covered financial institution's fiscal year, that describes the structure of the entity's incentive-based compensation arrangements for covered persons. The report would include a narrative description of the components of the institution's incentive-based compensation arrangements, a description of the policies and procedures that govern such arrangements and an explanation why that structure does not expose the institution to material financial loss by providing excessive compensation to covered persons. The report also must state any material changes made to the institution's incentive-

based compensation arrangements since the previous filing.<sup>2</sup>

It is important to note that the report is *not* required to state the actual compensation of particular covered persons. Further, the preamble to the proposed rules notes that the Agencies will generally maintain the confidentiality of the information submitted to them. In particular, the proposed rules note that there are at least two exemptions under the Freedom of Information Act (“FOIA”) under which the Agencies have authority to withhold certain information. FOIA Exemption 4 provides an exemption for trade secrets and FOIA Exemption 8 provides an exemption for examination-related information.

This annual report represents a new requirement for investment advisers, who have not previously been obligated to disclose to the SEC information related to incentive-based compensation. The burden for compiling such report is likely to fall on the investment advisers’ compliance staff. The SEC estimates that the annual report will require approximately 100 hours to prepare, which figure does not include any time required to draft the policies and procedures.

Employees at investment advisers that primarily advise private funds are likely to be most impacted by the proposed rules as, generally, their compensation is more incentive-based than the compensation of their counterparts at advisers that work primarily with registered funds.

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<sup>2</sup> Although it is not completely clear, it appears that such annual report should describe the incentive-based compensation arrangements for the fiscal year that was most recently completed.

## Conclusion

Section 956 of the Dodd-Frank Act and the proposed rules provide a broad avenue for financial institution regulators to impact compensation through their review of an institution’s incentive-based compensation plans, as a result of subjective concepts such as “excessive” compensation and “inappropriate risk.”

Unless the Agencies provide more guidance, including, for example, concerning the definitions of “excessive” and “incentive-based compensation,” the scope of the proposed rules will remain unclear and the proposed rules could therefore have a very broad reach. Under these circumstances, covered institutions may wish to recommend to the Agencies that these proposed rules be clarified so that such institutions will have more certainty when designing their incentive-based compensation arrangements.

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