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Federal Agencies Propose Rules on Dodd-Frank Financial Institution Incentive Compensation Requirements

On February 7, the Federal Deposit Insurance Corporation (FDIC) approved a joint proposed regulation to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") regarding the incentive-based compensation arrangements of certain financial institutions. On March 2, the Securities and Exchange Commission (SEC) also approved the joint proposed regulation on this provision. In addition to the FDIC and SEC, five other federal banking regulators – the Office of the Comptroller of the Currency (OCC); Board of Governors of the Federal Reserve System (Board); Office of Thrift Supervision (OTS); National Credit Union Administration (NCUA); and Federal Housing Finance Agency (FHFA) (collectively the "Agencies") – also are involved in the joint rulemaking on the provision. The Agencies propose to make the rules effective six months after publication of final rules in the Federal Register. Comments on the proposed regulation are due within 45 days after publication in the Federal Register (which has not yet occurred).

Section 956 of Dodd-Frank directs the Agencies to jointly prescribe regulations (by April 21, 2011) requiring covered financial institutions to disclose the structures of incentive-based compensation arrangements offered by the institution, and prohibiting any incentive-based compensation arrangement that encourages inappropriate risks by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or that could lead to material financial loss to the institution. The provision and new proposed regulation are similar to the principles and rules issued by other national and international financial institution regulatory bodies in the last several years.

Below is a brief summary of the key provisions in the proposed regulation.

Covered Financial Institutions – The proposed regulation applies to "covered financial institutions" that have $1 billion or more of total consolidated assets. Some of the covered financial institutions identified in the proposed regulation include: national banks; Federal branches and agencies of a foreign bank; state member banks; bank holding companies; U.S. operations of a foreign bank; credit unions; broker-dealers; investment advisers; Fannie Mae; Freddie Mac; and Federal Home Loan Banks. Additional requirements apply to larger financial institutions with $50 billion or more of total consolidated assets.

Covered Persons/Executive Officers – "Covered persons" subject to the incentive-based compensation requirements are: executive officers, employees, directors, or principal shareholders of a covered financial institution. Although the definition is very broad, certain restrictions in the proposed regulation apply only to individuals in higher-level positions, most notably executive officers. The proposed regulation defines executive officer as "a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer,

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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."

Incentive-Based Compensation – Incentive-based compensation is defined as any variable compensation that serves as an incentive for performance. According to the preamble, 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. It does, however, note that certain types of compensation do not fall within the scope of this definition, including compensation solely tied to continued employment (e.g., salary), arrangements that provide rewards solely for activities or behaviors that do not involve risk-taking (e.g., payments for achieving a professional certification), and compensation determined 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 solely on a fixed percentage of salary).

Prohibition on Excessive Compensation – As required by section 956 of Dodd-Frank, the proposed regulation prohibits covered financial institutions from having any incentive-based payment arrangement that encourages inappropriate risks by providing covered persons with excessive compensation. The proposed regulation provides generally that an arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by the covered person. In making this determination, the Agencies will take into consideration the following:

- 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 institution;
- the financial condition of the institution;
- comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of operations and assets;
- for post-employment 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 Agency determines to be relevant.

Material Financial Loss Prohibition – As required by section 956 of Dodd-Frank, the proposed regulation prohibits covered financial institutions from having any incentive-based compensation arrangement that encourages inappropriate risks by providing covered persons (either individually or as a group) with incentive-based compensation that could lead to material financial loss to the institution. An incentive-based compensation arrangement does not comply with this requirement unless it:

- balances risk and financial rewards, for example, by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or extended performance periods;
- is compatible with effective controls and risk management; and

- is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof.

<u>Mandatory Deferral of Incentive-Based Compensation for Executive Officers</u> – A large covered financial institution with $50 billion or more in consolidated assets must provide for the mandatory deferral of incentive-based compensation for its executive officers and identify certain other covered persons who individually have the ability to expose the institution to substantial risks. Specifically, the proposed regulation requires that large covered financial institutions defer at least 50 percent of the incentive-based compensation of executive officers for at least 3 years, with the release of deferred amounts to occur no faster than on a pro rata basis. In addition, the deferral arrangement must provide for the adjustment of the amounts required to be deferred to "reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period." These prescriptive new requirements will undoubtedly impact the design of incentive-based compensation arrangements for top officers at these large financial institutions.

<u>Other Employees Presenting Particular Loss Exposure</u> – In addition, the proposed regulation requires that the board of directors (or committee thereof) of a large covered financial institution identify individuals (e.g., traders) other than executive officers who 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. It requires that the board or committee approve the incentive-based compensation of any such identified individuals and that it do so only where it determines that the arrangement effectively balances the financial awards to the employee and the range and time horizon of risks associated with the individual's activities.

<u>Required Reports</u> – A covered financial institution must submit an annual report to its appropriate Federal regulator disclosing the structure of its incentive-based compensation arrangements that is sufficient to determine whether the arrangements provide covered persons with excessive compensation, fees, or benefits, or could lead to material financial loss to the financial institution. The proposed regulation lists certain types of information that the report must include, but disclosure of the actual compensation of any particular covered persons is not required.

<u>Policies and Procedures</u> – The proposed regulation also requires that covered financial institutions adopt and maintain policies and procedures reasonably designed to ensure and monitor compliance with the proposed rules, and that the policies and procedures be commensurate with the size and complexity of the financial institution. It also lists minimum standards that the policies and procedures must satisfy.