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Regulators Issue Proposed Rule Regarding
Incentive Based Compensation Under Section 956 of Dodd-Frank

Last week, federal regulators, including the Federal Reserve, FDIC, OTS and SEC (the "agencies") issued the proposed rule regarding incentive-based compensation under section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 956 of Dodd-Frank prohibits covered financial institutions from having incentive compensation arrangements that encourage inappropriate risk because they provide excessive compensation or pose a risk of material financial loss to the covered institution. The proposed rule goes beyond the express provisions of the statute in several respects, most notably by imposing a mandatory deferral requirement on the compensation paid to the executive officers of larger financial institutions.

The proposed rule would dramatically expand the administrative burdens on bank financials, without an obvious enhancement to their financial stability, and would regulate non-bank financials that have not previously been subject to bank compensation guidelines. Covered financial institutions will need to dedicate significant resources towards compliance with the growing list of compensation regulations, putting increased demands on their legal, compliance and risk management functions, as well as their boards of directors. It is not clear how already strained regulatory agencies, including the SEC, will have the capacity to learn and administer another set of compensation regulations that are comparable to, but not entirely consistent with, an already complex regulatory framework, taking into account the diverse compensation structures of the covered institutions.

Covered Financial Institutions. The proposed rule applies to financial institutions that have $1 billion or more in "total consolidated assets." The definition of "covered financial institution" includes depository institutions and their holding companies (including the U.S. operations of a foreign bank, whether or not insured), broker-dealers registered under section 15 of the Securities and Exchange Act of 1934, investment advisers under the Investment Advisers Act of 1940 (whether or not registered), credit unions, Fannie Mae, Freddie Mac and Federal Home Loan Banks. The methodology for determining total consolidated assets under the proposed rule varies depending upon the category of the institution and the applicable regulator, and for bank financials is generally determined based on a rolling average of the four most recent call reports.

The proposed rule and statute explicitly include as covered financial institutions depository institutions and their related holding companies. In contrast, it appears that with respect to broker/dealers and investment advisors that are part of a non-bank financial, the covered financial institution includes only the specific entity engaged in the regulated business, and not a related holding company. Accordingly, for a non-bank financial institution (1) having a broker/dealer or investment adviser subsidiary that is a covered financial institution would not cause affiliated entities to be covered financial institutions and (2) there is no requirement to consolidate the assets of different institutions with a common parent for purposes of determining total consolidated assets and the $1 billion threshold.

Covered Persons. The proposed rule applies to "covered persons," which includes executive officers, employees, directors and principal shareholders. While all employees are potentially covered persons, the proposed rule is intended to apply to the incentive compensation arrangements for covered persons or groups of covered persons that encourage inappropriate risk to the covered financial institution. The "executive officers" of a covered financial institution include any person who holds the title or performs the function of one or more of 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 head of a major business line.

Incentive-Based Compensation. Under the proposed rule, "incentive-based compensation arrangement" means any variable compensation that serves as an incentive for performance, including equity-based compensation.

Prohibitions under the Proposed Rule. The proposed rule would prohibit a covered financial institution from establishing or maintaining for covered persons any incentive-based compensation arrangements that encourage inappropriate risks by providing excessive compensation. Excessive compensation means amounts that are unreasonable or disproportionate to, among other things, the nature, quality and scope of the services performed. In evaluating excessive compensation, the agencies will consider:

- 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 covered financial institution;
- comparable compensation practices at comparable institutions; and
- for post-employment benefits, the projected total cost and benefit to the covered financial institution.

Accordingly, while the proposed rule would apply directly only to incentive-based compensation, regulators will consider all compensation and benefits arrangements in the evaluation of the incentive-based arrangements, as well as factors that are external to the particular institution.

The proposed rule also would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangement that encourages a covered person to expose the institution to a material financial loss. A compliant incentive-based compensation arrangement must (1) balance risk and financial rewards (e.g., through payment deferrals, risk adjustment of awards, and/or longer performance periods), (2) be compatible with effective controls and risk management and (3) be supported by strong corporate governance, namely through board oversight of incentive-based compensation arrangements.

Additional Requirements Applicable to Larger Covered Financial Institutions. "Larger covered financial institutions" are covered financial institutions with total consolidated assets of $50 billion or more. The proposed rule would require larger covered financial institutions to defer at least 50% of the incentive-based compensation of their executive officers over a period of at least three years, with a distribution schedule no more rapid than equal annual installments over a three year deferral period, and payouts adjusted for actual losses or other performance results. The proposed rule does not address earlier payment, such as upon an executive's death or disability. In addition, under the proposed rule, the board or committee of larger covered financial institutions must identify as additional covered persons any non-executive employees, such as traders with large positions, who have the ability to expose the institution to substantial losses and must approve the incentive-based compensation arrangements for such individuals.

Policies and Procedures. To help ensure compliance with the proposed rule, covered financial institutions would be required to implement policies and procedures with respect to incentive-based compensation, including with respect to the following:

- appointing a monitor who has a separate reporting line to senior management;
- providing the board or committee data and analysis sufficient to allow it to assess the design and performance of incentive arrangements;
- requiring ongoing oversight by the board or committee of incentive compensation arrangements;
- where applicable, implementing deferral arrangements; and
- documenting the adoption, implementation and monitoring of incentive compensation arrangements in a manner sufficient for the applicable regulator to determine compliance with section 956.

Required Reports. The proposed rule would require covered financial institutions to provide annually to their designated Federal regulator(s) information sufficient for the regulator to assess whether incentive-based compensation arrangements for covered persons provide excessive compensation or could lead to material financial loss. This annual report would include (1) a description of the arrangements applicable to covered persons, (2) a description of the institution's policies and procedures applicable to its incentive arrangements, (3) for larger institutions, a description of the policies and procedures applicable to covered executives and other covered persons identified as having the ability to expose the institution to substantial risk, (4) any material changes to such arrangements and policies and procedures since the last annual report and (5) the specific reasons the institution believes the structure of its arrangements and policies and procedures do not provide covered employees with incentives to behave in a manner that is likely to cause a material financial loss to the institution and do not provide excessive compensation.

There is a 45 day comment period for the proposed rule, and the agencies have specifically sought comment on numerous aspects of it, including the methodology for determining total consolidated assets. Each agency would codify its own version of the rule to address differences between regulated entities and any other regulatory requirements. The final rule would become effective six months after publication in the Federal Register. Bank financials and non-bank entities that could be covered institutions should review the proposed rule, evaluate its potential application and impact and take the opportunity to seek clarification through the comment process. Companies should consider the need to maintain flexibility in the design of their 2011 incentive compensation arrangements in order to accommodate the final rule, in particular, the mandatory deferral requirement, to the extent it would be applicable.

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