

Proposed Rules on Incentive-Based Compensation Arrangements

Hinshaw Alert | 9 min read

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Introduction

Under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), various federal agencies must issue rules which will require the reporting of incentive-based compensation arrangements by covered financial institutions (specified institutions with consolidated assets of more than \$1 billion) and prohibit incentive-based compensation arrangements at covered financial institutions that (1) provide excessive compensation; or (2) that could expose the institution to inappropriate risks that could lead to a material financial loss. These agencies (collectively, “the Agencies”) include: the Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); National Credit Union Administration; U.S. Securities and Exchange Commission (SEC); and the Federal Housing Finance Agency.

On February 7, 2011, the FDIC issued a proposed rule (Proposed Rule). Comments are due within 45 days of the publication of the rules in the Federal Register. The other of the Agencies must approve the Proposed Rule before it is published in the Federal Register.

The Proposed Rule would be effective six months after publication of the final rule in the Federal Register, with annual reports due within 90 days of the end of each covered financial institution’s fiscal year.

This alert contains a brief description of the Proposed Rule. Download to read the detailed analysis here: [Proposed Rules on Incentive-Based Compensation Arrangements](#).

Summary of the Proposed Rule

The Proposed Rule would supplement the Agencies’ existing rules, guidance and ongoing supervisory efforts. It prohibits:

- incentive-based compensation arrangements at a covered financial institution that encourage executive officers, employees, directors or principal shareholders (covered persons) to expose the institution to

inappropriate risks by providing the covered person excessive compensation; and

- a covered financial institution from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the covered financial institution that could lead to a material financial loss. The standards for determining whether an incentive-based compensation arrangement may encourage inappropriate risk-taking are consistent with the principles established for incentive compensation in the Interagency Guidance on Sound Incentive Compensation Policies (Banking Agency Guidance) adopted by the federal banking agencies (the OCC, Board, FDIC and OTS). Download to read the memo discussing this guidance and other issues related to financial institution executive compensation here: [Regulatory Issues in Financial Institution Executive Compensation](#).

The Proposed Rule also requires:

- that the institution's board of directors, or a committee thereof, must approve the incentive-based compensation arrangement for such individuals and maintain documentation of such approval;
- covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with these requirements and prohibitions;
- covered financial institutions to provide annually certain information to their appropriate federal regulator concerning their incentive-based compensation arrangements for covered persons;
- deferral over three years of 50 percent of the incentive-based compensation for executive officers of "larger covered financial institutions" (The term "larger covered financial institution" for the federal banking agencies and the SEC means those covered financial institutions with total consolidated assets of \$50 billion or more. All credit unions and all Federal Home Loan Banks with total consolidated assets of \$1 billion or more are deemed to be larger covered financial institutions); and
- that, at larger covered financial institutions the board of directors or a committee thereof identify those covered persons (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.

The Proposed Rule

Prohibition of Certain Incentive-based Compensation Arrangements

The Proposed Rule would prohibit a covered financial institution from having incentive-based compensation arrangements that may encourage inappropriate risks by providing excessive compensation, or that could lead to a material financial loss.

Excessive Compensation. Standards for determining whether an incentive-based compensation arrangement provides excessive compensation are set out below. These are based on the standards established under Section 39 of the Federal Deposit Insurance Act (FDIA). Compensation for a covered person would 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.

Calculating Compensation. In making such a determination, the Agencies will consider:

- the combined value of all cash and noncash 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 covered financial institution's financial condition;
- comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location and the complexity of the institution's operations and assets;
- for post-employment benefits, the projected total cost and benefit to the covered financial 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 covered financial institution; and
- any other factors the agency determines to be relevant.

Inappropriate Risks That May Lead to a Material Financial Loss. The Proposed Rule prohibits a covered financial institution from establishing or maintaining any incentive-based compensation arrangement, or any feature of one, that encourages a covered person to expose the institution to inappropriate risks that could lead to a material financial loss at the covered financial institution.

This prohibition will apply only to those incentive-based compensation arrangements for individual covered persons, or groups of covered persons, whose activities may expose the covered financial institution to a material financial loss. Such covered persons include:

- executive officers and other covered persons who are responsible for oversight of the covered financial institution's firmwide activities or material business lines;
- other individual covered persons, including nonexecutive employees, whose activities may expose the covered financial institution to a material financial loss (e.g., traders with large position limits relative to the covered financial institution's overall risk tolerance); and
- groups of covered persons who are subject to the same or similar incentive-based compensation arrangements and who, in the aggregate, could expose the covered financial institution to a material financial loss, even if no individual covered person in the group could expose the covered financial institution to a material financial loss (e.g., loan officers who, as a group, originate loans that account for a material amount of the covered financial institution's credit risk).

Larger Covered Financial Institutions

Deferral Arrangements Required for Executive Officers

The Proposed Rule would establish a deferral requirement for larger covered financial institutions (i.e., generally those with \$50 billion or more in total consolidated assets). At least 50 percent of the incentive-based compensation of an "executive officer" would have to be deferred over a period of at least three years. In

addition, the deferred amounts must be adjusted for actual losses or other measures or aspects or performance that are realized or become better known during the deferral period.

A larger covered financial institution may decide to: (1) release (or allow vesting of) the full deferred amount in a lump sum only at the conclusion of the deferral period; or (2) release the deferred amounts (or allow vesting) in equal increments, pro rata, for each year of the deferral period. Any such deferral arrangement must be accompanied by the loss adjustment provision mentioned above. In no event, however, may the release or vesting of amounts required to be deferred be faster than a *pro rata* equal-annual-increments distribution.

Special Review and Approval Requirement for Other Designated Individuals

At a larger covered financial institution, the board of directors, or a committee thereof, 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. These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals who have authority to place at risk a substantial part of the covered financial institution's capital. The board of directors, or a committee thereof, must approve the incentive-based compensation arrangement for such individuals, and maintain documentation of such approval.

While these employees will be subject to additional scrutiny, they will not be subject to the mandatory deferral provisions applicable to executive officers of larger covered financial institutions.

Policies and Procedures Governing Awards

Covered financial institutions would have to adopt policies and procedures governing the award of incentive-based compensation designed, at a minimum, to address the prohibitions contained in the Proposed Rule. The prohibition on incentive-based compensation arrangements that could lead to a material financial loss is likely to affect only those arrangements for covered persons that, either individually or as a group, may expose the institution to a material financial loss. The policies and procedures, therefore, must be designed to address these issues.

Certain jobs and classes of jobs may not expose the organization to a material financial loss. Incentive-based compensation arrangements for employees within these job classes may be outside the scope of these restrictions. Examples of jobs and classes of jobs that may be unlikely to expose the institution to material risk include tellers, bookkeepers, couriers or data processing personnel.

Internal Review

Risk management, risk oversight and internal control personnel should be involved in all phases of the process for designing incentive-based compensation arrangements. An ongoing assessment of the policies should be

made by risk management and risk oversight personnel to help to ensure that the processes remain up-to-date and effective relative to the incentive compensation practices. The personnel should be properly trained and compensated.

Such monitoring should be conducted, where practicable, by a group or person independent of the covered person so they can determine whether incentive-based compensation payments are reduced to reflect adverse risk outcomes or high levels of risk taken. To be independent, the group or person monitoring or assessing incentive-based compensation awards must have a separate reporting line to senior management from the covered person who is creating the risks.

Board Involvement

In order to provide appropriate information to the board or committee, a covered financial institution will need to develop and maintain policies and procedures designed to ensure that the board, or a committee thereof, receives data and analysis from management and other sources sufficient to allow it to assess the overall design and performance of the entity's incentive-based compensation arrangements. The policies and procedures relating to an incentive-based compensation arrangement must provide for ongoing oversight by the board of directors or the committee.

Supporting Documentation

A covered institution must maintain sufficient documentation of its processes for establishing, implementing, modifying and monitoring incentive-based compensation arrangements. These must be sufficient to allow the institution's appropriate federal regulator to determine the covered financial institution's compliance with Section 956 of the Dodd-Frank Act and the Proposed Rule. The documentation should include, but not be limited to:

- a copy of the covered financial institution's incentive-based compensation arrangement(s) or plan(s);
- the names and titles of individuals covered by such arrangement(s) or plan(s);
- a record of the incentive-based compensation awards made under the arrangement(s) or plan(s); and
- records reflecting the persons or units involved in the approval and ongoing monitoring of the arrangement(s) or plan(s).

Annual Report

A covered financial institution must submit an annual report to its appropriate federal regulator disclosing the structure of its incentive-based compensation arrangements. The format for the annual report will be specified by the appropriate federal agency. The report must contain:

- a clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to

which they apply;

- a succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements;
- for "larger covered financial institutions," a succinct description of any specific incentive compensation policies and procedures for the institution's executive officers and other covered persons who the board or a committee thereof determines under the Proposed Rule 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;
- any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report was submitted; and
- the specific reasons the covered financial institution believes the structure of its incentive-based compensation plan does not provide covered persons incentives to engage in behavior that is likely to cause the covered financial institution to suffer a material financial loss, and does not provide covered persons with excessive compensation.

Covered financial institutions will be encouraged to avoid submitting voluminous materials that could obfuscate the actual structure and likely effects of an institution's incentive-based compensation arrangements.

Confidentiality

The Agencies generally will maintain the confidentiality of the information submitted to them. The information will be nonpublic to the extent permitted by law.

Tax Advice Disclosure: To ensure compliance with the Internal Revenue Service regulations governing the issuance of advice on Federal tax issues, we advise you that any tax advice in this communication (and any attachments) is not written with the intent that it be used, and cannot be used, to avoid penalties that may be imposed under the Internal Revenue Code.

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