

# Clients & Friends Memo

## Joint Agencies' Proposed Rules Governing Incentive-Based Compensation at Covered Financial Institutions

June 1, 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**")<sup>1</sup> requires seven Federal agencies (the "**Agencies**") to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions.<sup>2</sup> On April 14, 2011, the government published proposed rules governing such incentive-based compensation arrangements at covered financial institutions (the "**Proposed Rules**").<sup>3</sup>

The Proposed Rules are broad in scope and generally cover incentive-based compensation arrangements for any executive officer, employee, director or principal shareholder of a covered financial institution. As required by the Act, the Proposed Rules prohibit incentive-based payment arrangements at a covered financial institution that encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss, and require a covered financial institution to disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements in sufficient detail to determine whether the structure provides "excessive compensation, fees, or benefits" or "could lead to material financial loss" to the institution. A covered financial institution need not report the actual compensation of particular individuals as part of this requirement. The Proposed Rules also require a "larger covered financial institution" (which is generally defined as a covered financial institution with assets of \$50 billion or more) to defer a portion of incentive-based compensation paid to its executive officers and subjects the compensation of any 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,

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<sup>1</sup> Cadwalader has prepared a summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these memoranda, please see [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>2</sup> Section 956 of the Act. The seven Agencies are: Office of the Comptroller of the Currency ("**OCC**"); Board of Governors of the Federal Reserve ("**Board**"); Federal Deposit Insurance Corporation ("**FDIC**"), Office of Thrift Supervision ("**OTS**"), National Credit Union Administration ("**NCUA**"); Securities and Exchange Commission ("**SEC**"); and the Federal Housing Finance Agency ("**FHFA**").

<sup>3</sup> A copy of the Proposed Rules can be found at <http://www.fdic.gov/news/news/press/2011/pr11061a.pdf>.

capital or overall risk tolerance to additional limitations and board approval. The board or a committee of the board at such institutions must approve the incentive-based compensation arrangements for such individuals and maintain documentation of such approval. The Agencies propose to make the terms of the Proposed Rules, if adopted, effective six months after publication of the final rules in the Federal Register.

Financial institutions subject to the Proposed Rules should review their compensation arrangements in consultation with their counsel and compensation advisors in order to adequately prepare for compliance with the mandates and restrictions set forth in the Proposed Rules once they are finalized. As part of their preparation, financial institutions will need to determine whether any of their incentive arrangements would be covered by the Proposed Rules and how to design and implement an internal framework to ensure compliance with the Proposed Rules.

### Highlights

#### *“Covered Financial Institutions”*

The Act defines the term “covered financial institution” to include any of the following types of institutions that have \$1 billion or more in assets: (A) a depository institution or depository institution holding company; (B) a broker-dealer; (C) a credit union; (D) an investment adviser; (E) the Federal National Mortgage Association (Fannie Mae); (F) the Federal Home Loan Mortgage Corporation (Freddie Mac); and (G) any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for these purposes.

Under the Proposed Rules, a “covered financial institution” includes:

- in the case of the OCC, a national bank and Federal branch and agency of a foreign bank;
- in the case of the Board, 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 more than \$1 billion of U.S. assets that is treated as a “bank holding company”;
- in the case of the FDIC, a state nonmember bank and an insured U.S. branch of a foreign bank;
- in the case of the OTS, a savings association and a savings and loan holding company;
- in the case of the NCUA, an insured credit union or a credit union eligible to make application to become an insured credit union;
- in the case of the SEC, a broker-dealer and an investment adviser;

- in the case of the FHFA, Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Home Loan Bank System's Office of Finance.

#### *Mandates and Requirements*

The following is a summary of the mandates and requirements set forth in the Proposed Rules:

- *Prohibition of Excessive Compensation*. The Proposed Rules prohibit incentive-based compensation arrangements that encourage executive officers, employees, directors or principal shareholders<sup>4</sup> ("**Covered Persons**") to expose a covered financial institution to inappropriate risks by providing the Covered Person with excessive compensation.
  - No categories of employees are specifically excluded from the definition of Covered Persons.
  - The Proposed Rules define the term "incentive-based compensation" broadly as "any variable compensation that serves as an incentive for performance" and includes all direct and indirect payments, fees or benefits, cash and non-cash, awarded to, granted to, or earned by or for the benefit of a Covered Person in exchange for services rendered to the covered financial institution regardless of the form of the compensation. Compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (such as salary) would not be considered "incentive-based compensation." In addition, a compensation arrangement that provides rewards solely for activities or behaviors that do not involve risk-taking (for example, payments solely for achieving or maintaining a professional certification or higher level of educational achievement) would not be considered incentive-based compensation.
  - Consistent with the mandate of section 956 of the Act, the Agencies propose using standards comparable to those under section 39 of the Federal Deposit Insurance Act of 1950 (which defines excessive compensation as amounts unreasonable or disproportionate to the services rendered) to determine whether incentive-based compensation is excessive. Under the Proposed Rules, incentive-based 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. In making such a determination, the Agencies will consider:

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<sup>4</sup> The Proposed Rules generally define the term "principal shareholder" as an individual that directly or indirectly, or acting in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.

- 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, 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 relevant Agency determines to be relevant.
- Prohibition of Inappropriate Risk-taking. The Proposed Rules prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements that may encourage inappropriate risks by the institution. This prohibition applies to those incentive-based compensation arrangements for Covered Persons, individually or in the aggregate, whose activities may expose the covered financial institution to material financial loss.
    - The Proposed Rules identify the following Covered Persons as those that may expose a covered financial institution to material financial loss:
      - executive officers and other Covered Persons who are responsible for oversight of the covered financial institution's firm-wide activities or material business lines;
      - other individual Covered Persons, including non-executive employees, whose activities may expose the covered financial institution to material 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 material financial loss, even if no individual Covered Person in the group could expose the covered financial institution to 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).

- The Agencies propose to adopt standards that are consistent with the key principles established for incentive compensation in the Interagency Guidance on Sound Incentive Compensation Policies<sup>5</sup> for determining whether an incentive-based compensation program may encourage inappropriate risk-taking by the covered financial institution. An incentive-based compensation arrangement would not comply with these standards unless it:
  - balances risks and rewards (by using deferred payments, risk adjustments, diminished sensitivity to short-term performance, or longer performance periods);
  - is compatible with “effective controls and risk management”; and
  - is supported by “strong corporate governance.”
- Enhanced Regulation of “Larger Covered Financial Institutions.” The Proposed Rules provide for enhanced regulation of “larger covered financial institutions,” which generally includes all covered financial institutions with assets of \$50 billion or more.<sup>6</sup> The following is a summary of the enhanced regulations mandated by the Proposed Rules for such institutions.
  - Deferral of Incentive-Based Compensation. The Proposed Rules require the deferral of a portion of incentive-based compensation for executive officers at larger covered financial institutions. At these institutions, at least 50 percent of the incentive-based compensation of an “executive officer”<sup>7</sup> would have to be deferred over a period of at least three years; deferred amounts paid would be adjusted for actual losses of the institution or other measures or aspects of performance that are realized or become better known during the deferral period. The Proposed Rules provide for some flexibility in how a required deferral is administered by permitting the release or vesting of deferred amounts in equal pro rata increments for each year of the deferral period (but in no event may the release or vesting of amounts be faster than a pro rata equal-annual increments distribution). For example, an institution required to apply a three-year deferral to a \$150,000 deferral amount could release a maximum of \$50,000

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<sup>5</sup> Guidance on Sound Incentive Compensation Policies, 75 FR 36395 (June 25, 2010), adopted by the Federal banking agencies (*i.e.*, the OCC, Board, FDIC and OTS).

<sup>6</sup> The Proposed Rules define the term “larger covered financial institution” as follows: for the Federal banking agencies and the SEC, those covered financial institutions with total consolidated assets of \$50 billion or more; for the NCUA, all credit unions with total consolidated assets of \$10 billion or more; for the FHFA, all Federal Home Loan Banks with total consolidated assets of \$1 billion or more.

<sup>7</sup> The Proposed Rules define the term “executive officer” as a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following positions: president, chief executive officer, 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.

each year or could withhold the entire sum for the entire period and distribute it as a lump-sum at the conclusion of the three-year period. Alternatively, the institution could choose a distribution schedule that is less rapid than a pro-rata equal-annual-increments schedule, such as no release after the first year, releasing a maximum of \$100,000 the second year, and then \$50,000 for the third year.

- Identification of Covered Persons. The Proposed Rules require the board of directors or a committee of the board at a larger covered financial institution to identify those Covered Persons (other than executive officers) who have the ability to expose the larger covered financial institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance. The Proposed Rules note that these Covered Persons may include traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution.
- Approval of Incentive-Based Compensation Arrangements. The board or a committee of the board at larger covered financial institutions must approve incentive-based compensation arrangements for Covered Persons identified as described above, and maintain documentation of such approval. Under the Proposed Rules, the board (or a committee of the board) at such institutions may not approve such incentive-based compensation arrangements unless it determines that the arrangement, including the method of paying compensation under 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, employing appropriate methods for ensuring risk sensitivity.
- Maintenance of Policies and Procedures. The Proposed Rules require a covered financial institution to maintain policies and procedures to ensure compliance with the requirements and prohibitions of the Proposed Rules, appropriate to their size, complexity and use of incentive-based compensation to ensure compliance with the requirements and prohibitions of the Proposed Rules. At a minimum, such policies and procedures must:
  - be consistent with the reporting requirements and prohibitions set forth in the Proposed Rules;
  - 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;
  - provide for the monitoring by a group or person independent of the Covered Person, where practicable in light of the covered financial institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk

- outcomes to determine whether incentive-based compensation payments for Covered Persons, or groups of Covered Persons, are reduced to reflect adverse risk outcome or high levels of risk taken;
- provide for the covered financial institution's board of directors (or committee thereof) to receive data and analysis from management and other sources sufficient to allow the board (or committee) to assess whether the overall design and performance of the covered financial institution's incentive-based compensation arrangements are consistent with the Proposed Rules;
  - ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the applicable regulator to determine the covered financial institution's compliance with the Proposed Rules;
  - in the case of larger covered financial institutions, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's Covered Persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and
  - subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors (or a committee thereof), including the approval by the board of directors (or committee) of incentive-based compensation to executive officers.
- Annual Reports. As mandated by section 956(a)(1) of the Act, the Proposed Rules require covered financial institutions to provide certain information concerning incentive-based compensation arrangements for Covered Persons to Federal regulators annually (a "Report").
    - A Report must contain:
      - a clear narrative description of the 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 such 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 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 such arrangements and policies and procedures made since the covered financial institution's last report was submitted; and
  - specific reasons why the covered financial institution believes the structure of its incentive-based compensation plans does not encourage inappropriate risks by the institution by providing Covered Persons with excessive compensation or incentive-based compensation that could lead to material financial loss to the covered financial institution.
- A covered financial institution's annual Report will be due within 90 days of the end of each applicable fiscal year.
- The Proposed Rules provide that the Agencies generally will maintain the confidentiality of the information submitted in Reports, and the information will be nonpublic, to the extent permitted by law.
- The volume and detail of the information provided in Reports should be commensurate with the size and complexity of the institution, as well as the scope of its incentive-based compensation arrangements.
- Anti-Evasion. The Proposed Rules prohibit a covered financial institution from evading the restrictions of the rule by doing any act or thing indirectly, or through or by any other person, that would be unlawful for the institution to do directly under the Proposed Rules.

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If you have any questions regarding this memorandum, please contact the individuals listed below or any other member of the [Cadwalader Tax Department](#).

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