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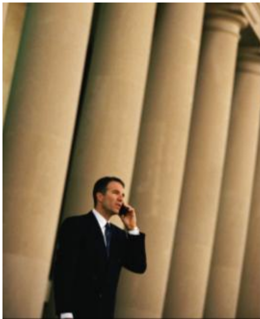

Proposed Rules – Incentive Compensation Arrangements Under the Dodd-Frank Act

By Jim Bean, Todd Leone and Lex Verweij
March 1, 2011

The United States federal regulators are proposing rules (the "Rules") to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") addressing incentive compensation arrangements with a focus on prohibited and excessive compensation. On Monday, February 7, 2011, the FDIC published their version of the proposed Rules. This client alert focuses on both the proposed rules as published, as well as specific areas where the regulators are asking for comment.

EXECUTIVE SUMMARY

- The Rules explicitly apply to all banks and financial institutions with assets greater than $1 billion providing incentive compensation. These Rules *do not* currently apply to banks below $1 billion in assets.
- All "covered" financial institutions will be required to annually report incentive compensation arrangements to their primary regulator within 90 days of the fiscal year end.
- The Rules prohibit incentive compensation arrangements that *either* provide "excessive" compensation or that could expose an institution to inappropriate risks that could lead to a material financial loss.
- For larger institutions (e.g., banks with assets over $50 billion) the proposed Rules call for a mandatory deferral of 50% of incentive compensation over a three year period for the population of executive officers.
- Financial institutions that have performed incentive compensation plan risk reviews from either a TARP or the Sound Incentive Compensation Policy perspective should be well positioned to promptly address the risk review provisions of the regulations.
- These are proposed Rules; the final Rules are expected to be published this year and will most likely be effective for fiscal years beginning in 2012.

REGULATORY AGENCIES

The enforcement power under the proposed Rules is derived from a number of regulatory bodies (collectively the "Agencies"): the Department of the Treasury, the Federal Reserve System, the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA"), the U.S. Securities and Exchange Commission ("SEC") and the Federal Housing Finance Agency.

EFFECTIVE DATE

As of the date of this client alert, the Rules have yet to be published in the Federal Register. After the Rules are published this will trigger a 45-day comment period. After the comment period, the final Rules will be published and become effective six months thereafter. The overall sense of timing is that this will be effective for calendar year 2012.

COVERED FINANCIAL INSTITUTIONS

The Sound Incentive Compensation Policy (SICP) guidance published in June 2010 that applies to all banking institutions[1] serves as the foundation for the Rules. As a result of the Dodd-Frank Act, the proposed Rules effectively extend the SICP guidance beyond just banks to include non-bank entities.

The Agencies propose to include the uninsured branches and agencies of a foreign bank and the other U.S. operations of foreign banking organizations considered bank holding companies as covered financial institutions.

> **McLagan comment:** *As legislated by the Dodd-Frank Act, this will be the first time that many of the non-bank entities (e.g. credit unions, home loan banks, broker-dealers and banking subsidiaries of foreign owned banks) will be exposed to risk review audits of their incentive compensation arrangements.*

COVERED PERSONS

Importantly, the proposed Rules include directors and principal shareholders (defined as controlling 10% or more of voting shares) in the definition of "*covered" persons. This is* in addition to any executive officer and employee. No specific category of employee is outside the scope of the Rules. However, certain jobs and classes of jobs may not be classified as exposing the organization to a material financial loss, thus incentive compensation arrangements for these employees are likely outside the scope of these restrictions. Examples of jobs and classes of jobs that are unlikely to expose the institution to material risk include tellers, bookkeepers, operations staff, couriers, or data processing personnel.

> **McLagan comment:** *In a departure from both TARP law and SICP guidance, this is the first time that directors and principal shareholders have been in the "eligible group" of covered employees.*

INCENTIVE COMPENSATION

The definition of *incentive compensation* includes any variable compensation that serves as an incentive for performance, regardless of the form of payment or form of agreement. For example, it includes direct and indirect cash, equity, fees and benefits both during and post employment. Excluded from the definition are salary, employer 401(k) fixed rate contributions, dividends and appreciation of stock owned outright not subject to vesting or deferral.

Larger financial institutions with assets of $50 billion or more will be required to defer 50% of incentive compensation for executive officers. Most institutions with total consolidated assets under $50 billion would be required to adopt procedures applicable to deferred compensation only when the firm elects to use deferral in its incentive-based compensation program.

ANNUAL REPORTING

The Rules also require covered financial institutions to provide certain specific information to the appropriate Federal regulator(s) concerning the incentive-based compensation arrangements for covered persons. The annual reporting requirement will include:

- A clear narrative description of the components of the incentive compensation arrangements and persons to which they apply;
- A succinct description of the policies and procedures governing incentive 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 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;

[1] Guidance on Sound Incentive Compensation Policies adopted June 25, 2010 by the Federal banking agencies, meaning the OCC, Federal Reserve Board, FDIC and OTS.

- Any material changes to the incentive compensation arrangements and policies and procedures made since the last report;
- The specific reasons the structure of the incentive compensation plans do not provide incentives to engage in behavior that is likely to cause the institution to suffer a material financial loss. It must also affirm that the institution does not provide excessive compensation.

EXCESSIVE COMPENSATION

The Rules call for prohibition of compensation that is viewed as "excessive". The standards for determining whether an excessive incentive compensation arrangement exists are based on the standards established under section 39 of the FDIA. Compensation 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:

1. The combined value of all cash and non-cash benefits provided to the covered person;
2. The compensation history of the covered person and other individuals with comparable expertise at the institution;
3. The financial condition of the institution;
4. Comparable compensation practices at comparable institutions;
5. For postemployment benefits, the projected total cost and benefit to the institution;
6. 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;
7. Any other factors the Agency determines to be relevant.

LARGER COVERED FINANCIAL INSTITUTION DEFINITION

The proposed Rules define larger covered financial institution relative to the applicable agency. For the Federal banking agencies and the SEC the definition covers those financial institutions with total consolidated assets of $50 billion or more. For credit unions the definition applies to those financial institutions with total consolidated assets of $1 billion or more. For the FHFA, all Federal Home Loan Banks with total consolidated assets of $1 billion or more are larger covered financial institutions.

> **McLagan comment:** *The asset thresholds are currently inconsistent across the different types of covered institutions. It is unclear as to why a credit union with $1 billion in assets is "larger" and a commercial bank with $10 billion in assets is not. The most likely logic is that the varying thresholds define the "larger" institutions overseen by each of the respective regulatory agencies. We expect this will be strongly challenged during the comment period.*

MANDATORY DEFERRAL FOR LARGER COVERED FINANCIAL INSTITUTIONS

The Rules would require a deferral of at least 50% of incentive compensation for each executive officer at a larger covered financial institution. The deferral would be over a period of at least three years and deferred amounts would be adjusted for actual losses or other measures or aspects of performance that are realized or evidenced during the deferral period. The proposed rules provide flexibility in administering the specific deferral program. An institution may decide to release (or allow vesting of) the entire deferred amount in a lump sum only at the conclusion of the deferral period; alternatively, the institution may release the deferred amounts (or allow vesting) in equal increments, pro rata, for each year of the deferral period. However, under no circumstances may the release or vesting of amounts be faster than a pro rata equal-annual-increments distribution. The Agencies believe that risk management personnel at the institution would play a substantial role in identifying and evaluating risks that become better known with the passage of time and therefore, play a role in the actual adjustment and "release" of the deferred funds.

The Rules would require that the board of directors or a committee of the board identify those covered persons (in addition to executive officers) that 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. Under the proposal, the board or committee of a larger financial institution may not approve the incentive compensation arrangement for an individual identified by the board or committee unless it determines that the arrangement, including the method of compensation under the arrangement, effectively balances the financial rewards to the employee and the range and time horizon of risks associated with the employee's activities.

An additional reporting requirement for larger institutions is a succinct description of any specific incentive compensation policies and procedures for the institution's executive officers and other 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

> **McLagan comment:** *The FDIC is explicitly asking for comments as to how the mandatory deferral should be applied, if at all, for institutions below the Larger Covered Financial Institution threshold, e.g., banks below $50 billion in assets.*

INTERNATIONAL COORDINATION

The proposed Rules are similar in scope to the European standards[2]. In particular, both the proposed Rules and European rules call for a mandatory deferral of incentive compensation over a specified time period. The European Union ("EU") CRD regulations apply a proportional approach to implementation where smaller organizations are considered less risk systemic and therefore have to apply less strict rules. The United Kingdom has implemented the EU proportional approach through applying tiers to the covered institutions. Large credit organizations over $20 billion (US dollar denominated "USD") in assets have to comply with nearly all of the regulations including substantial deferral (40% - 60% for covered staff) and 50% of total variable pay in equity. Smaller organizations (assets below $4 billion USD) are requested to apply the rules to at least some extent (such as a proportionally lower deferral rate).

While the US proposed rules differ from the European Union based rules, there is consistency with respect to the fundamental premise: *compensation for executives and applicable employees should be deferred over time with the potential for loss based on the long-term results of the institution*.

> **McLagan comment***: Note the use of a "rules based" approach is a departure from the Fed's prior assertion that they believed in a principles based approach. This is clearly an effort by the US regulators to become better aligned to the global regulatory standards.*

SOUND INCENTIVE COMPENSATION POLICY FOUNDATION

> **McLagan comment:** *The foundation of the proposed Rules is clearly based upon the SICP guidance[3]. From the three principles of SICP to the utilization of different techniques to defer compensation, the SICP guidance is incorporated in the proposed Rules. Unlike the SICP, these are "rules" versus guidance. This will provide the regulators with more enforcement authority on incentive compensation.*

The proposed Rules prohibit a covered financial institution from establishing or maintaining any type of incentive compensation arrangements or any feature of any such arrangements for covered persons or groups of covered persons that could lead to a material financial loss to the financial institution. This includes:

- Executive officers and other persons who are responsible for oversight of the institution's firm-wide activities or material business lines;
- Other individuals whose activities may expose the institution to a material financial loss (e.g., traders with large position limits relative to the institution's overall risk tolerance); and

[2] See McLagan Alert *"Update on CRDIII Implementation: Part 2 Convergence of EU Regulations,"* December 22, 2010

[3] See McLagan Alert, "*Final Guidance on Sound Incentive Compensation Policies,*" July 1, 2010

- Groups of persons who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, could expose the 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).

The Rules provide that an incentive compensation arrangement established or maintained by an institution for one or more covered persons does not comply unless it follows the three principles as presented in the SICP:

- Balances risk and financial rewards, for example by using deferrals, risk adjustment of awards, longer performance periods, or reduced sensitivity to short-term performance;
- Is compatible with effective controls and risk management;
- Is supported by strong corporate governance.

Each of these principles is covered below.

BALANCED INCENTIVE COMPENSATION ARRANGEMENTS

In assessing whether incentive-based compensation arrangements are balanced, the Agencies will consider the full range of risks associated with a covered person's activities, as well as the time horizon over which those risks may be realized. These activities may create a wide range of risks for an institution, including credit, market, liquidity, operational, legal, compliance, and reputational risks. Some of these risks may be realized in the short term, while others may become apparent only over the long term.

The proposed rules identify four methods that are often used to make compensation more sensitive to risk. These methods are:

1. **Risk Adjustment of Awards:** The amount of the person's incentive compensation award is adjusted based on measures that take into account the risk the person's activities pose to the institution. Such measures may be quantitative, or the size of a risk adjustment may be based on managerial judgment, subject to appropriate oversight.

2. **Deferral of Payment:** The actual payout of an award to a person is delayed significantly beyond the end of the performance period and the amounts paid are adjusted for actual losses or other aspects of performance that become clear only during the deferral period. Deferred payouts may be altered according to risk outcomes either formulaically or based on managerial judgment, although extensive use of judgment might make it more difficult to execute deferral arrangements in a sufficiently predictable fashion to influence the risk-taking behavior of a covered person. The deferral period should be sufficiently long to allow for the realization of a substantial portion of the risk from the person's activities.

3. **Longer Performance Periods:** The time period covered by the performance measures used in determining a person's award is extended (for example, from one year to two years). Longer performance periods and deferrals are related in that both methods allow awards or payments to be made after some or all risk outcomes associated with a person's activities are realized or better known.

4. **Reduced Sensitivity to Short-Term Performance:** Reducing the rate at which awards increase as a covered person achieves higher levels of the relevant performance measure(s) used in the person's incentive compensation arrangement. Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives.

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COMPATIBILITY WITH EFFECTIVE CONTROLS AND RISK MANAGEMENT

The Agencies would expect a covered financial institution to have strong controls governing its processes for designing, implementing and monitoring incentive compensation arrangements. Additionally, the Rules state that risk management personnel must have an appropriate role in the institution's processes for designing incentive compensation arrangements, monitoring their use and assessing whether they achieve balance. Financial institutions should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk management and other functions.

STRONG CORPORATE GOVERNANCE

Strong and effective corporate governance is critical to the establishment and maintenance of sound compensation practices. The board of directors of a financial institution should actively oversee incentive compensation arrangements and is ultimately responsible for ensuring that the institution's incentive compensation arrangements are appropriately balanced. Accordingly, the board of directors or a committee of the board should actively oversee the development and operation of the institution's incentive compensation systems and related control processes. For example, the board of directors or a committee should review and approve the overall goals and purposes of the institution's incentive compensation system and ensure its consistency with the institution's overall risk tolerance. In addition, the board or committee should receive data and analyses to assess whether the overall design and performance of the institution's incentive compensation arrangements are consistent with Section 956.

PERSONAL HEDGING STRATEGIES

The Agencies are concerned that personal hedging strategies may serve to diminish the effectiveness of an institution's policies and procedures. Thus, the Agencies are considering whether an institution's policies and procedures should be required to specifically include limits on personal hedging strategies.

ANTI-EVASION PROVISION

This provision is designed to prevent covered financial institutions from making substantial numbers of its covered employees independent contractors for the purpose of evading these rules.

CONCLUSION

McLagan intends to submit its comments on the proposed rules and will be circulating a copy to its clients. It is critically important that these rules be structured appropriately to ensure both the safety and effective management of financial institutions. Our intention is to reduce the risk that a well-meaning rule has an unintended and dysfunctional impact as has been the case with prior regulations.

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