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CLIENT MEMORANDUM

Updated March 4, 2011

Federal Agencies Propose Interagency Rule on Incentive-Based Compensation for Financial Institutions

Contents

This memorandum has been updated to reflect the version of the proposed rule issued by the Securities and Exchange Commission on March 3, 2011 after this memorandum was published.

Introduction

A proposed rule issued under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act would subject financial institutions to the following requirements:

- all covered financial institutions with $1 billion of assets would be subject to principles-based prohibitions on providing incentive-based compensation that is excessive or that could lead to material financial loss to the institution;
- larger covered financial institutions with $50 billion of assets[1] would be required to defer 50% of incentive-based compensation paid to executive officers and to review and approve incentive-based compensation paid to non-executive officers who individually have the ability to expose the institution to a substantial amount of risk; and
- all covered financial institutions with $1 billion of assets would be required to submit annual reports to their appropriate regulators and to establish and maintain policies and procedures governing the award of incentive-based compensation.

These requirements would apply to a wide array of financial institutions, including banks, broker-dealers, investment advisers and, possibly, other institutions, such as insurance companies, if they are subsidiaries of certain covered financial institutions. The prescriptive nature and broad scope of the proposed rule cannot be overemphasized, given the significant oversight, approval, monitoring and documentation requirements imposed on financial institutions, including many that previously have never had their compensation subject to governmental requirements. If the requirements of the interagency rule are implemented in their current form, we expect that many financial institutions would be required to modify their compensation

[1] Lower asset thresholds would apply to credit unions and Federal Home Loan Banks. See below under "Key Definitions: Covered Persons, Institutions and Compensation—Covered financial institutions."

policies and practices. Therefore, after discussing the proposed rule, we suggest a number of action items to help financial institutions comment on the proposed rule and anticipate the new requirements.

Background and Effective Date

Section 956 of Dodd-Frank[2] requires that seven federal agencies—the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the National Credit Union Association (NCUA), the Securities and Exchange Commission (SEC) and the Federal Housing Finance Agency (FHFA)—jointly prescribe regulations or guidelines to mandate that each covered financial institution with assets of at least $1 billion prohibit incentive-based compensation that is excessive or that could lead to material financial loss to the institution and disclose incentive-based compensation arrangements to its appropriate regulator. The statutory deadline is April 21, 2011[3] and, to date, three of the agencies—the FDIC on February 7, the NCUA on February 18 and the SEC on March 3[4]—have proposed substantially similar rules to implement these requirements.

Given the statutory deadline and informal statements made by agency staff, the other four agencies are expected to approve their versions of the interagency rule in the coming weeks. Once the seven agencies agree on the final text of the proposed joint rule, they will publish it in the Federal Register, which will trigger a 45-day comment period. The proposed rule states that the agencies propose to make the rule's requirements effective six months after publication of the final rule in the Federal Register. Therefore, assuming that the rulemaking proceeds according to the anticipated timeline, these requirements would become effective in late 2011 or early 2012.

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[2] Section 956 of Dodd-Frank is included among the investor protection provisions of Dodd-Frank, rather than the systemic risk provisions, and is unrelated to systemic status.

[3] Section 956 of Dodd-Frank requires that the seven agencies jointly "prescribe" regulations or guidelines not later than April 21, 2011. If the term "prescribe" is intended to refer to the promulgation of final regulations, we believe that this deadline is unlikely to be met. If the term "prescribe" is intended to refer instead to issuance of the final text of the proposed rule, it is still possible that this deadline will be met.

[4] Two of the five SEC Commissioners voted not to approve the proposed rule, whereas the FDIC and NCUA votes were unanimous.

Recent History of Efforts to Regulate Financial Institution Compensation

Recent efforts to regulate incentive compensation

- 1995 – Federal Deposit Insurance Act prescribes standards prohibiting excessive compensation for insured depository institutions
- October 2008 – Emergency Economic Stabilization Act imposes compensation restrictions on recipients of assistance under TARP
- September 2009 – Financial Stability Board releases standards for G-20 nations to implement principles for sound compensation practices
- June 2010 – Federal Reserve, OCC, FDIC and OTS jointly issue guidance setting forth principles for incentive compensation standards

Section 956 of Dodd-Frank and the proposed rule that would implement its requirements follow previous efforts to regulate the compensation paid by some financial institutions. The proposed rule's requirements would supplement, rather than supersede, the requirements under these previous efforts.

Section 39(c) of the Federal Deposit Insurance Act (FDIA), enacted in 1995, required the Federal Reserve, OCC, FDIC and OTS to prescribe, for all insured depository institutions, standards prohibiting as an unsafe and unsound practice compensatory arrangements that would provide excessive compensation or that could lead to material financial loss to the institution.

In September 2009, the Financial Stability Board (FSB) released standards for the member nations of the G-20 to implement the principles for sound compensation practices that the FSB had issued earlier that year.[5] The standards focused on the following priority areas: pay structure and risk alignment, disclosure, corporate governance and supervisory oversight.

In June 2010, the Federal Reserve, OCC, FDIC and OTS jointly issued guidance that, consistent with the FSB standards, was intended to help ensure that incentive compensation paid by a covered banking organization[6] does not encourage imprudent risk-taking that threatens the organization's safety and soundness.[7] The guidance set forth the following three high-level principles for designing and implementing incentive compensation standards:

- incentive compensation arrangements should balance risk and financial results so that employees do not have incentives to take excessive risks;
- compensation should be compatible with effective controls and risk management; and

[5] Financial Stability Forum Principles for Sound Compensation Practices (April 2, 2009); Financial Stability Board Principles for Sound Compensation Practices—Implementation Standards (Sept. 25, 2009).

[6] Banking organizations covered by the guidance include U.S. bank holding companies, state member banks, Edge and agreement corporations, U.S. operations of foreign banks with a branch, agency or commercial lending company in the United States, national banks, state nonmember banks, savings associations and savings and loan holding companies.

[7] Guidance on Sound Incentive Compensation Policies (June 21, 2010). For a more detailed summary of the guidance, see our client memorandum entitled Bank Supervisory Agencies' Final Guidance: Aligning Incentive Compensation with Safety and Soundness Concerns, dated June 28, 2010.

- organizations should have strong and effective corporate governance structures in place to oversee and monitor compensation practices.

Earlier, the Emergency Economic Stabilization Act, enacted in October 2008 in response to the financial crisis and amended in February 2009, had imposed restrictions on compensation paid by companies (primarily financial institutions) that received government assistance under the Troubled Asset Relief Program (TARP). These restrictions included limitations on bonuses, a prohibition on severance, change in control and tax gross-up payments and a requirement to recoup bonus awards based on materially inaccurate information.

The preamble to the new proposed rule makes clear that the rule is intended to supplement existing rules, guidance and ongoing supervisory efforts of the various agencies. Therefore, the proposed rule would not supersede the safety and soundness requirements of the FDIA or the joint guidance regarding incentive compensation issued in June 2010. Similarly, a financial institution that has assistance outstanding under TARP when the proposed rule's requirements become effective would be subject to the compensation provisions under both regimes.

Key Definitions: Covered Persons, Institutions and Compensation

Key definitions

- "Covered person"
- "Covered financial institution"
- "Larger covered financial institution"
- "Incentive-based compensation"
- "Total consolidated assets"

The proposed rule contains principles-based prohibitions that would apply to "incentive-based compensation" that is provided to all or a subset of "covered persons" of all "covered financial institutions". Additional requirements would apply to a subset of covered persons of "larger covered financial institutions".

Covered persons. The term "covered persons" would be defined broadly to include any of the institution's "executive officers," employees who are not "executive officers," "directors" and "principal shareholders". The proposed rule would define these terms as follows:

- "***executive officer***":[8] a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more

[8] This definition would differ from the definition of "executive officer" for purposes of various requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934. For example, for purposes of the proxy statement compensation disclosure requirements applicable to U.S. public companies under Item 402 of Regulation S-K under the Securities Exchange Act of 1934, "executive officer" is defined as the company's president, any vice president of the company in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the company.

The definition of "executive officer" under the proposed rule would be different for the institutions regulated by the FHFA. For Fannie Mae and Freddie Mac, the definition would be adapted from the definition of "executive officer" in the Safety and Soundness Act of 1992, as (*cont.*)

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of the following positions with the institution: 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;[9]

- "***director***": a member of the board of directors[10] of the institution or of a board or committee (or other governing body) performing a similar function to a board of directors; and
- "***principal shareholder***": an individual who, directly or indirectly, or acting through or in concert with one or more persons, owns, controls or has the power to vote 10% or more of any class of voting securities of the institution.

Executive officers, non-executive officer employees, directors and principal shareholders would be covered by the proposed rule as follows:

- all covered persons of a covered financial institution would be covered by the prohibition on excessive compensation and the requirements that the institution submit annual reports to regulators and establish and maintain policies and procedures governing the award of incentive-based compensation;
- covered persons of a covered financial institution who are responsible for oversight of the institution's firm-wide activities or material business lines, and other covered persons of the institution who (individually or as a group) could expose the institution to material financial loss, would be covered by the prohibition on incentive-based compensation that could lead to such loss;
- executive officers of a larger covered financial institution would be covered by the requirement that at least 50% of the executive officers' incentive-based compensation be deferred for at least three years; and
- employees (other than executive officers), directors and principal shareholders of a larger covered financial institution who individually (and not as a group) could expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance would be covered by the

(*cont.*)

reflected in 12 CFR 1770.3(g)–(1). For the Federal Home Loan Banks and the Office of Finance, the FHFA has determined an appropriate definition.

[9] The proposed rule does not define "major business line," and it is not clear whether the term is intended to have the same meaning as "material business line". The latter term, which also is not defined, is relevant to determining whether certain non-executive officers would be covered by the prohibition on incentive-based compensation that could lead to material financial loss. See below under "Substantive Requirements Applicable to All Covered Financial Institutions—Prohibition on incentive-based compensation that could lead to material financial loss". The SEC's version of the proposed rule requests comment on whether the agencies should define "head of a major business line." See "Appendix C: Requests for Comment".

[10] For a foreign banking organization, "board of directors" would refer to the relevant senior management or oversight body for the firm's U.S. branch, agency or operations, consistent with the organization's overall corporate and management structure.

requirement that the institution's board or a board committee review and approve their incentive-based compensation.

Therefore, although the definition of "covered person" is broad, many of the proposed rule's most significant provisions would apply only to a subset of covered persons. In addition, independent contractors who are not directors or principal shareholders would be excluded; however, the proposed rule contains an anti-abuse provision that would prohibit an institution from evading the rule by classifying substantial numbers of its covered persons[11] as independent contractors.

Covered financial institutions. The proposed rule would define a "covered financial institution" as any of a wide array of specified financial institutions with at least $1 billion of total consolidated assets, including institutions such as investment advisers and registered broker-dealers that have not been covered under previous efforts to regulate compensation paid by financial institutions.

"Covered financial institutions"

- Specified financial institutions with at least $1 billion of total consolidated assets

"Larger covered financial institutions"

- Specified financial institutions regulated by OCC, Federal Reserve, FDIC, OTS or SEC with at least $50 billion of total consolidated assets
- Credit unions with at least $10 billion of total consolidated assets
- Federal Home Loan Banks with at least $1 billion of total consolidated assets

The rule would define a "larger covered financial institution" as a covered financial institution with at least $50 billion of total consolidated assets, in the case of an institution regulated by the OCC, Federal Reserve, FDIC, OTS or SEC. A credit union regulated by the NCUA or a Federal Home Loan Bank regulated by the FHFA would be considered a larger covered financial institution if it had at least $10 billion or $1 billion of total consolidated assets, respectively.

Appendix A sets forth for each financial regulator:

- the types of institutions that, if they have at least $1 billion of total consolidated assets, would constitute "covered financial institutions";
- if specified, the number of institutions that the regulator estimates would qualify as "covered financial institutions" and "larger covered financial institutions"; and
- the method for calculating "total consolidated assets".

As authorized by Dodd-Frank, the proposed rule would expand the definition of "covered financial institution" to two types of institutions that are not specifically enumerated by the statute. One, the proposed rule would include the uninsured branches and agencies of a foreign bank, as well as the other U.S. operations of foreign banking organizations that are treated as bank holding companies pursuant to Section 8(a) of the International Banking Act of 1978. Two, the proposed rule would include the Federal Home Loan Banks, because of the view that these banks pose similar risks as the institutions enumerated in the statute and therefore should be subject to the same regulatory regime, as well as the Office of Finance,

[11] The proposed rule's reference to "substantial numbers of its covered persons" presumably is not intended to suggest that misclassifying a single individual (or a few individuals) as independent contractors would be considered *per se* not abusive.

which issues and services all debt securities for the Federal Home Loan Banks. As written, the proposed rule would not include insurance and reinsurance companies, unless, possibly (as discussed below), they are "subsidiaries" of a covered financial institution.

One reading of the proposed rule is that, within a financial institution's group, each entity that has at least $1 billion of total consolidated assets would be subject to the rules of its applicable regulator. If this entity-by-entity approach is correct, then more complex financial institutions could be subject to multiple sets of similar, although potentially not identical, rules, as well as differing application and enforcement of those rules. On the other hand, if the rule is intended to apply on a group basis, it is not clear which regulator's rules would apply (*e.g.*, the regulator of the parent entity or of the entity that has the greatest amount of total consolidated assets).

Based on the versions of the proposed rule issued to date, the Federal Reserve and OTS would include "subsidiaries" as part of their definitions of "covered financial institution". An interpretative question is whether this would have the effect of sweeping up all entities in a group in which the parent entity that is regulated by the Federal Reserve or OTS (such as a bank or savings and loan holding company) satisfies the total consolidated asset threshold, even if its subsidiaries would not otherwise qualify as covered financial institutions or would not otherwise satisfy the relevant asset thresholds.

"Incentive-based compensation"

- Variable compensation that serves as an incentive for performance

Not "incentive-based compensation"

- Compensation tied solely to continued employment
- Compensation tied solely to activities or behaviors that do not involve risk-taking
- Compensation tied solely to fixed compensation that does not vary based on performance
- Dividends and appreciation on stock owned outright

Incentive-based compensation. The proposed rule would define "incentive-based compensation" as any variable compensation[12] that serves as an incentive for performance, regardless of the form of payment (cash, equity award or other property). The definition is deliberately intended to be broad and principles-based and to address the objectives of Section 956 of Dodd-Frank in a manner that provides for flexibility as forms of compensation evolve.

The proposed rule distinguishes incentive-based compensation from the following types of compensation, which would not be covered:

- compensation awarded solely for, and the payment of which is solely tied to, continued employment (*e.g.*, salary);
- compensation that provides rewards solely for activities or behaviors that do not involve risk-taking (*e.g.*, payments solely for

[12] The proposed rule would define "compensation" as any direct or indirect payment, fee or benefit, whether cash or non-cash, awarded to, granted to or earned by or for the benefit of any covered person in exchange for services rendered to the covered financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit or other compensatory arrangement. For credit unions, the definition would specifically exclude reimbursement for reasonable and proper costs incurred by covered persons in carrying out official credit union business, provision of reasonable health, accident and related types of personal insurance protection and indemnification.

achieving or maintaining a professional certification or higher level of educational achievement);

- compensation that is determined based solely on a covered person's level of fixed compensation and that does not vary based on performance (*e.g.*, employer contributions to a 401(k) plan computed based on a fixed percentage of salary); and
- dividends paid and appreciation realized on stock or other equity instruments that a covered person owns outright (*i.e.*, not subject to any vesting condition or mandatory or voluntary deferral).[13]

Substantive Requirements Applicable to All Covered Financial Institutions

Factors to be used to determine whether compensation is "excessive"

- Combined value of cash and non-cash benefits
- Compensation history of covered person and comparable individuals
- Financial condition of institution
- Compensation practices at comparable institutions
- Cost and benefit to institution of post-employment benefits
- Connection between covered person and misbehavior with regard to institution
- Other factors regulators deem relevant

The proposed rule would prohibit a covered financial institution from providing incentive-based compensation that is "excessive" or that could lead to material financial loss to the institution.

Prohibition on excessive compensation. The proposed rule would prohibit a covered financial institution from providing a covered person with "excessive" incentive-based compensation that encourages inappropriate risk-taking. Under the proposed rule, whether incentive-based compensation is "excessive" would be determined on the same basis as under Section 39(c) of the FDIA: such compensation would be excessive if the 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 regulators would consider the following factors:

- 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 on 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 institution;

[13] That is, dividends on vested stock and appreciation on such stock would not be subject to the requirements applicable to incentive-based compensation, such as the deferral requirement applicable to larger covered institutions described below. On the other hand, the proposed rule may require dividends on unvested stock, dividend equivalents with respect to restricted stock units and deferred stock and appreciation on such dividends and dividend equivalents to be deferred to the same extent as the underlying award.

- any connection between the covered person 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 regulators determine to be relevant.

Prohibition on incentive-based compensation that could lead to material financial loss. Unlike the prohibition on excessive incentive-based compensation, which would apply to all covered persons, the proposed rule's prohibition on incentive-based compensation that could lead to material financial loss would apply only to incentive-based compensation for a covered person, or a group of covered persons, whose activities could expose the covered financial institution to such loss, including:

- executive officers and other covered persons who are responsible for oversight of the institution's firm-wide activities or material business lines;
- other covered persons, including non-executive employees, whose activities could expose the institution to material financial loss (*e.g.*, traders with large position limits relative to the institution's overall risk tolerance or loan officers with significant approval authority); 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 institution to material financial loss, even if no individual covered person in the group could expose the institution to such loss (*e.g.*, loan officers who, as a group, originate loans that account for a material amount of the institution's credit risk).

Although the proposed rule does not define "material financial loss," the rule specifies that incentive-based compensation provided by a covered financial institution to a covered person would violate the prohibition on incentive-based compensation that could lead to material financial loss unless the compensation:

- balances risk and financial rewards (*e.g.*, by using deferral of payments, risk adjustment of awards or reduced sensitivity to short-term performance or longer performance periods);
- is compatible with effective controls and risk management; and
- is supported by strong corporate governance.

As with the interagency guidance regarding incentive compensation issued in June 2010, the proposed rule does not provide additional specificity as to how these high-level principles should be applied.

Additional Substantive Requirements Applicable to Larger Covered Financial Institutions

The proposed rule would apply additional substantive requirements to larger covered financial institutions (*i.e.*, covered financial institutions with at least $50 billion of total consolidated assets—other than credit unions and Federal Home Loan Banks, to which lower asset thresholds would apply), including mandatory deferral of incentive-based compensation paid to executive officers and review and approval of incentive-based compensation paid to non-executive officers.

Deferral requirement for larger covered financial institutions

- 50% of incentive-based compensation paid to executive officers must be deferred for at least 3 years
- Deferred amounts may not be "released" or "vested" more rapidly than in 3 equal annual installments
- Deferred amounts must be adjusted to reflect losses or other measures or aspects of performance

Deferral of executive officer compensation. Under the proposed rule, a larger covered financial institution would be required to provide that at least 50% of the incentive-based compensation paid to an "executive officer" (see definition above) be deferred over a period of at least three years. As discussed below under "Procedural Requirements—Policies and procedures—Deferrals," the deferred amount would need to be adjusted to reflect the institution's actual losses or other measures or aspects of performance that are realized or become better known during the deferral period. The proposed rule does not specify how this adjustment should be applied.

The proposed rule would permit flexibility in designing the deferral periods, so long as the deferred amounts are not "released" or "vested" more rapidly than in three equal annual installments. The following table sets forth examples of schedules for releasing or vesting deferred amounts that would and would not be permitted:

Permissible	Not Permissible
One-third each year over 3 years[14]	50% each year over 2 years
20% in year 1 and 40% in each of years 2 and 3	40% in year 1 and 30% in each of years 2 and 3
50% in year 2 and 50% in year 4	50% in year 1 and 50% in year 3
100% in year 3	100% in year 2

We have listed in Appendix B questions relating to the deferral requirement that may be clarified as the rule is finalized and eventually implemented by the respective agencies.

Review and approval of non-executive officer compensation. The proposed rule would require a larger covered financial institution's board of directors, or a board committee, to identify those covered persons (other than executive officers) who individually have the ability to expose the

[14] It is not clear, however, whether releasing or vesting deferred amounts one-sixth each six months over three years would be permitted.

institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance (*e.g.*, traders with large position limits relative to the institution's overall risk tolerance, loan officers with significant approval authority or other individuals with authority to place at risk a substantial part of the institution's capital). The board or committee would need to approve the incentive-based compensation arrangements for such individuals and document such approval.

The board or committee could not approve such an arrangement for such an identified individual unless it determined that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the individual and the range and time horizon of risks associated with the individual's activities. To achieve such balance, the arrangement would need to employ appropriate methods for ensuring risk sensitivity, which could include deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, longer performance periods or other appropriate methods.

Procedural Requirements

Annual reports

- Due 90 days after fiscal year
- Description of components of incentive-based compensation arrangements and policies and procedures governing arrangements
- Material changes to arrangements, policies and procedures since last report
- Reasons why incentive-based compensation structure does not encourage inappropriate risks
- For larger covered financial institutions, description of incentive compensation policies and procedures for executive officers and other covered persons who could expose institution to substantial losses

The proposed rule also contains procedural requirements, including a requirement that covered financial institutions submit annual reports to their regulators and a requirement to establish and maintain policies and procedures governing the award of incentive-based compensation. Except as noted below, these requirements would apply to all covered financial institutions.

Reports. Section 956(a)(1) of Dodd-Frank requires that a covered financial institution submit an annual report to its appropriate regulator disclosing the structure of its incentive-based compensation arrangements in a manner sufficient to determine whether the incentive-based compensation structure provides covered persons with excessive compensation, fees or benefits or could lead to material financial loss to the institution. To fulfill this requirement, the proposed rule would require a covered financial institution to submit a report annually to its appropriate regulator in a format to be specified by the regulator that describes the structure of the institution's incentive-based compensation arrangements for covered persons. The report, which would be due within 90 days after the end of the institution's fiscal year, would need to contain the following:

- a clear narrative description of the components of the institution's incentive-based compensation arrangements applicable to covered persons;
- a succinct description of the institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;
- any material changes to the institution's incentive-based compensation arrangements and policies and procedures made since the institution's last report was submitted;

- the specific reasons why the institution believes that the structure of its incentive-based compensation plan does not encourage inappropriate risks by the institution by providing covered persons incentive-based compensation that is excessive or that could lead to material financial loss to the institution; and
- 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 whom the board or a board committee 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.

Policies and procedures

- Address substantive prohibitions and reporting requirement
- Risk-management personnel involvement in design and assessment of incentive-based compensation
- Independent monitor to determine if payments should be reduced to reflect risk outcomes or risk taken
- Board or committee assessment of whether incentive-based compensation is consistent with requirements
- Documentation to enable regulator to determine compliance with requirements
- Deferrals in appropriate amount and length and subject to adjustment

The proposed rule emphasizes that the covered financial institution would be expected to provide a streamlined set of materials, rather than voluminous materials that could obfuscate the actual structure and likely effects of the institution's incentive-based compensation arrangements.

The proposed rule notes that the regulators generally would seek to maintain the confidentiality of the information submitted in the reports, and that the information would be nonpublic, to the extent permitted by law. Irrespective of the regulators' commitment to maintaining confidentiality, however, the information still potentially could be subpoenaed from the regulator or the institution by Congress, another regulator or a private litigant.

Policies and procedures. The proposed rule would require all covered financial institutions to establish and maintain policies and procedures governing the award of incentive-based compensation.[15] Although all covered financial institutions would be required to establish and maintain such policies and procedures, the proposed rule notes that the policies and procedures of smaller covered financial institutions with less complex incentive-based compensation programs would be expected to be less extensive than those of larger covered financial institutions with relatively complex programs and business activities.

The proposed rule specifies the following as required components of such policies and procedures:

- ***Minimum requirements***. The policies and procedures would need to address the proposed rule's prohibitions on incentive-based compensation that is excessive or that could lead to material loss, along with the reporting requirements described above.

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[15] For U.S. operations of a foreign banking organization, the organization's policies, including management, review and approval requirements for its U.S. operations, should be coordinated with the organization's group-wide policies developed in accordance with the rules of the organization's home country supervisor. The policies of the organization's U.S. operations should also be consistent with the organization's overall corporate and management structure, as well as its framework for risk management and internal controls.

- ***Risk management***. Personnel responsible for risk management, risk oversight and internal controls would need to be involved in all phases of the process for designing incentive-based compensation arrangements and have responsibility for ongoing assessment of incentive-based compensation policies to help ensure that the institution's processes remain up-to-date and effective relative to its incentive compensation practices.
- ***Independent monitoring***. To the extent practicable given the institution's size and complexity, a group or person independent of the covered person would need to monitor incentive-based compensation awards and payments made to the covered person, risks taken and actual risk outcomes to determine whether the payments to the covered person should be reduced to reflect adverse risk outcomes or high levels of risk taken. To be independent, the monitor and the covered person would need to have separate reporting lines to senior management.
- ***Board-level oversight***. The board of directors, or a board committee, would need to receive data and analyses from management and other sources sufficient to allow it to assess whether the overall design and performance of the institution's incentive-based compensation arrangements are consistent with Section 956 of Dodd-Frank. As if to reinforce the point, the proposed rule provides that incentive-based compensation arrangements and components of such arrangements would need to be subjected to a corporate governance framework that provides for ongoing oversight by the institution's board of directors or a board committee.
- ***Documentation***. The institution would need to document its processes for establishing, implementing, modifying and monitoring incentive-based compensation arrangements sufficient to enable the institution's appropriate regulator to determine the institution's compliance with the requirements of Section 956 of Dodd-Frank and the proposed rule. Such documentation would be expected to include, but would not be limited to, the following:
  - a copy of the institution's incentive-based compensation arrangements or plans;
  - the names and titles of individuals covered by such arrangements or plans;
  - a record of the incentive-based compensation awards made under the arrangements or plans; and
  - records reflecting the persons or units involved in the approval and ongoing monitoring of the arrangements or plans.

  The proposed rule does not specify whether, as with the annual reports described above, the institution would be required to submit such documentation to its appropriate regulator, or whether the institution would retain such documentation for inspection by the regulator. The former could raise confidentiality concerns, notwithstanding efforts by the regulator to maintain confidentiality.

- ***Deferrals***. If a covered financial institution uses deferral in connection with an incentive-based compensation arrangement—*e.g.*, any covered financial institution in balancing risk and financial rewards to comply with the prohibition on incentive-based compensation that could lead to material financial loss, or a larger covered financial institution to comply with the 50% deferral requirement—the institution's policies and procedures would need to provide for deferral of payments under such arrangement in amounts and for periods appropriate to the duties and responsibilities of the institution's covered persons, the risks associated with those duties and responsibilities and the size and complexity of the institution. Such deferred amounts would need to be adjusted for actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

One threshold governance question that arises from the proposed rule's possible entity-by-entity approach is whether compensation decision-making, at least for incentive-based compensation, should take place at the level of a lower-tier subsidiary that happens to be a covered financial institution, or whether the board or appropriate committee of a higher-level entity, such as the ultimate parent entity, could make these decisions on behalf of the lower-tier subsidiary.

Action items

- Determine entities subject to rule
- Identify incentive-based compensation arrangements
- Determine if any incentive-based compensation could be "excessive"
- Determine if incentive-based compensation that could lead to material financial loss is subject to appropriate risk mitigants
- For larger covered financial institutions, determine if executive officer incentive-based compensation complies with 50% deferral requirement
- Ensure that compensation committee charter covers non-executive officer incentive-based compensation
- Implement or revise policies and procedures governing incentive-based compensation
- Determine appropriate risk-management personnel
- Ensure separate reporting lines for monitors and covered persons
- Consider process required to prepare annual report

Action Items for Financial Institutions

Although the requirements under the proposed rule are not anticipated to become effective until late this year or early next year, it is not too early for financial institutions to begin to prepare for the requirements. We recommend that financial institutions take the following actions:

- Determine which entities within the institution's group are regulated by the agencies and have sufficient total consolidated assets to subject them to the requirements that apply to covered financial institutions and to larger covered financial institutions, assuming that the requirements will apply on an entity-by-entity basis.
- Inventory the compensatory arrangements of all covered persons to identify those that would constitute "incentive-based compensation".
- For those arrangements that would constitute incentive-based compensation, start compiling the information required to analyze the factors under Section 39(c) of the FDIA that would be used to determine whether the compensation could be deemed "excessive".
- Determine the subset of covered persons and groups of covered persons who would be covered by the prohibition on incentive-based compensation that could lead to material financial loss. Apply the factors under the proposed rule to determine whether

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their compensation is subject to appropriate risk mitigants to ensure that the arrangement would not be prohibited.[16] If it would be prohibited, consider appropriate changes.

- For larger covered financial institutions, inventory the incentive-based compensation arrangements of the executive officers and determine the extent to which they would or would not comply with the 50% deferral requirement.
- Consider changes in the design of incentive-based compensation arrangements to enable compensation awarded following the effective time of the rule to meet the deferral requirement.
- Determine whether any executive officers have contractual entitlements to incentive-based compensation that would not meet the deferral requirement, in case the final rule does not grandfather such compensation.
- Review incentive-based compensation that is contemplated to be awarded before the effective time of the deferral requirement and determine whether to proceed if such compensation would not be compliant after the effective time.
- For larger covered financial institutions, identify the non-executive officers who individually have the ability to expose the institution to possible substantial losses. Apply the factors under the proposed rule to determine whether the incentive-based compensation arrangements of such individuals are subject to appropriate risk mitigants to permit the institution's board of directors or a committee to approve the arrangements. If not, consider appropriate changes.
- Review the compensation committee's charter and consider revising it to ensure that its purview includes the approval of incentive-based compensation arrangements of applicable non-executive officers.
- Create a plan for implementing or revising policies and procedures governing the award of incentive-based compensation.

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[16] A public institution may be able to use as a starting point any analysis that it conducted in determining whether to provide disclosure in its proxy statement under Item 402(s) of Regulation S-K of the Securities Exchange Act of 1934 regarding risks arising from compensation policies and practices for its employees that are reasonably likely to have a material adverse effect on the institution. Similarly, an institution that received financial assistance under TARP may be able build on its efforts to meet the requirements under the TARP rules to review executive officer and employee compensation plans to evaluate any risks that the plans could pose to the institution and to identify and limit any features in the plans that could lead senior executive officers to take unnecessary and excessive risks that threaten the value of the institution or that unnecessarily pose risks to the institution or encourage manipulation of earnings.

- Determine the appropriate risk-management, risk-oversight and internal-control personnel to be involved in the process of designing incentive-based compensation arrangements and assessing incentive-based compensation policies.
- Review reporting relationships to ensure that covered persons and the group or person responsible for monitoring the covered persons' incentive-based compensation awards and payments have separate reporting lines to senior management.
- Consider the process required to prepare the annual report that would be submitted to the appropriate regulator.

Requests for Comment

As noted above, once the seven agencies agree on the final text of the proposed joint rule, they will publish it in the Federal Register, which will trigger a 45-day comment period. See Appendix C for a list of selected questions and topics on which the agencies have requested comment, along with additional topics that may be worth commenting on.

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Appendix A

“Covered Financial Institutions” and “Total Consolidated Assets”

Regulator	“Covered Financial Institution”	“Total Consolidated Assets”
OCC[1]	Types of institution: ▪ national bank ▪ federal branch or agency of foreign bank[2] Covered financial institutions: 158 Larger covered financial institutions: 18	National bank: average of total assets reported in four most recent Call Reports Federal branch or agency: average of total assets reported in four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks
Federal Reserve[1]	Types of institution: ▪ state member bank ▪ bank holding company ▪ state-licensed uninsured foreign bank branch or agency ▪ U.S. operations of foreign bank with more than $1 billion of U.S. assets ▪ subsidiaries of the foregoing institutions Covered financial institutions: 664 Larger covered financial institutions: 59	State member bank: average of total assets reported in four most recent Call Reports Bank holding company: average of total assets reported in four most recent Call Reports State-licensed uninsured foreign bank branch or agency: average of total assets reported in four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks[3] U.S. operations of foreign bank: determined by Federal Reserve

[1] The proposed rule states that the use of a rolling average for asset size, as reported in the four most recent applicable reports, would minimize the frequency with which an institution would fall in or out of covered financial institution status. An institution with fewer than four reports would average total assets from its existing reports to determine total consolidated assets. An institution with a mix of two or more types of reports covering the relevant period would average those reports to determine asset size (*e.g.*, an institution with two Call Reports and two Thrift Financial Reports as its four most recent reports would average its total assets from those four reports).

[2] The FDIC’s version of the proposed rule indicates that the OCC would also include the subsidiaries of national banks that are not functionally regulated by another regulator within the meaning of Section 5(c)(5) of the Bank Holding Company Act of 1956. This reference to “subsidiaries” was not included in the NCUA’s and SEC’s versions of the proposed rule.

[3] The FDIC’s version of the proposed rule states that the Federal Reserve would determine total consolidated assets for state-licensed uninsured foreign banks or agencies based on the average of total assets reported in the four most recent Call Reports.

Regulator	"Covered Financial Institution"	"Total Consolidated Assets"
FDIC[1]	Types of institution: ▪ state nonmember bank ▪ insured U.S. branch of foreign bank Covered financial institutions: 301 Larger covered financial institutions: 12	State nonmember bank: average of total assets reported in four most recent Call Reports Insured U.S. branch of foreign bank: average of total assets reported in four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks
OTS[4]	Types of institution: ▪ savings association ▪ operating subsidiary of federal savings association ▪ savings and loan holding company Covered financial institutions: 163 Larger covered financial institutions: 17	All institutions: average of total assets reported in four most recent Thrift Financial Reports[2]
NCUA[1]	Type of institution: credit union Covered financial institutions: 184 Larger covered financial institutions: 6	Average of total assets reported in four most recent 5300 Call Reports
SEC	Types of institution: ▪ broker-dealer registered under Section 15 of the Securities Exchange Act of 1934 ▪ investment adviser (whether or not registered under the Investment Advisers Act of 1940) Covered financial institutions: 200 (130 broker-dealers and 70 investment advisers) Larger covered financial institutions: 30	Broker-dealer: total consolidated assets reported in most recent year-end audited Consolidated Statement of Financial Condition Investment adviser: total assets shown on balance sheet for most recent fiscal year end[5]

[4] The Federal Reserve, OCC and FDIC will assume supervisory and rulemaking authority for entities currently regulated by the OTS on the transfer date provided in Title III of Dodd-Frank, currently expected to be in July 2011 but subject to a possible extension by the Treasury Secretary. It is expected that these agencies will adopt, or incorporate, any final rule adopted by the OTS as part of this rulemaking for the covered financial institutions that these agencies supervise.

[5] The versions of the proposed rule issued by the FDIC, NCUA and SEC indicate that the asset test that will be used for investment advisers is a balance-sheet test, rather than an assets-under-management test. In this regard, the proposed rule references the Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Release No. 3110, nn. 194–196 and related text (Nov. 19, 2010) 75 FR 77052 (Dec. 10, 2010). An interpretative question arises in the not-uncommon situation in which an investment adviser is required to consolidate its assets with those of affiliated entities, for accounting purposes. For example, an (*cont.*)

Regulator	"Covered Financial Institution"	"Total Consolidated Assets"
FHFA	Covered entities: ▪ Fannie Mae ▪ Freddie Mac ▪ Federal Home Loan Banks ▪ Office of Finance	No method specified for calculating total consolidated assets[6]
Total[7]	Covered financial institutions: 1,670 Larger covered financial institutions: 142	

(*cont.*)
adviser may have affiliated general partners whose assets are required to be consolidated with those of the adviser, or the assets of the adviser's affiliated funds may be required to be consolidated with those of the adviser. If so, an adviser that does not itself have $1 billion in assets could be swept up by the proposed rule.

[6] The FDIC's version of the proposed rule indicates that the institutions regulated by the FHFA would calculate total consolidated assets as total assets reported in the most recent annual report of financial condition.

[7] These totals exclude the FHFA, which has not yet provided estimates of the number of FHFA-regulated covered financial institutions and larger covered financial institutions that would be covered by the proposed rule.

Appendix B

Deferral Requirement for Larger Covered Financial Institutions

The following questions relating to the deferral requirement may be clarified as the rule is finalized and eventually implemented by the respective agencies.

- Would pre-existing entitlements to incentive-based compensation be grandfathered?
- Would the following compensation features be considered deferred for the requisite three years?
  - Restricted stock units that vest over fewer than three years but that settle on the third anniversary of the grant date.
  - Stock options or stock appreciation rights that vest over fewer than three years but that become exercisable on the third anniversary of the grant date.
  - Stock options or stock appreciation rights that become exercisable over fewer than three years, but with the shares issued on exercise not vesting until the third anniversary of the grant date.
  - Cash awards that vest over fewer than three years but that are paid on the third anniversary of the grant date.
  - Shares issued on exercise of stock options or stock appreciation rights or settlement of restricted stock units prior to the third anniversary of the grant date that are vested on issuance but subject to restrictions on transfer that lapse on the third anniversary of the grant date.
  - Restricted stock that vests over fewer than three years, subject to a restriction on transfer that lapses on the third anniversary of the grant date.
  - Payment of cash or issuance of vested transferable shares prior to the third anniversary of the grant date, subject to a repayment obligation that lapses on the third anniversary of the grant date.
- Would the 50% deferral requirement applicable to larger covered financial institutions be applied on an award-by-award or aggregate basis?[1] For example, if an executive officer receives an annual bonus paid half in cash and half in stock, could the entire cash portion be paid currently, with the entire stock portion deferred? Or would 50% of each of the cash and stock portions need to be deferred?
- How would awards that pay out based on performance be valued? For example, if an executive officer is entitled to a cash bonus that is payable in three years in an amount ranging from 0% to 200% of base salary based on attainment of objective performance metrics, would the bonus be valued based on the target payout? Or based on the most likely payout? If the latter, would the

[1] If awards could be aggregated, one way to measure the value of an equity award may be its fair value on the grant date for accounting purposes.

bonus be revalued periodically during the performance period to reflect increases or decreases in the most likely payout?

- Could deferred amounts be accelerated on an involuntary termination of employment, a constructive termination or a change in control of the institution?
- Could deferred amounts be accelerated to assist with tax payments (*e.g.*, income taxes on restricted stock, if the executive officer elects under Section 83(b) of the Internal Revenue Code to pay income taxes on grant, or employment taxes on vesting of restricted stock units or deferred cash)?[2]

[2] The proposed rule requests comments as to whether the regulators should consider possible tax or accounting considerations in designing the deferral requirement.

Requests for Comment

The following are selected questions and topics on which the agencies have requested comment with respect to the proposed rule, along with additional topics that may be worth commenting on.

Timeline

- Does the timeline (*i.e.*, the proposed rule becomes effective six months after publication in the federal register and annual reports are due within 90 days after the end of each covered financial institution's fiscal year) provide sufficient time for covered financial institutions to comply with the rule and, if not, why not?

"Executive officer"

- Comment on the proposed definition of "executive officer". Specifically, are the types of positions identified in this proposed definition appropriate, should additional positions be included, or should certain positions be removed?

"Incentive-based compensation"

- Comment on the proposed definition of "incentive-based compensation".
- Are there any particular forms of compensation that should be specifically designated as incentive-based compensation or as not incentive-based compensation?

"Total consolidated assets"

- Should all agencies use a uniform method to determine whether an institution has $1 billion or more in assets? If so, what would commenters suggest as such a uniform method?
- If different calculations are required for each type of institution, should any of the agencies define total consolidated assets differently than the proposed calculations?
- The SEC requests comment on the proposed method advisers must use to determine the amount of their assets. See the first bullet below under "Broker-dealers and investment advisers".

Deferral requirement

- Comment on all aspects of the scope, and specific requirements, of the proposed deferral requirement.
- Comment on whether it is appropriate to mandate deferral for executive officers at larger covered financial institutions to promote the alignment of employees' incentives with the risk undertaken by such employees. For example, comment on whether deferral is generally an appropriate method for achieving balanced incentive compensation arrangements for each type of executive officer at these institutions, or whether there are alternative or more effective ways to achieve such balance.
- Comment on the possible impact that the required minimum deferral provisions for senior executives may have on larger covered financial institutions, and whether the proposed or different deferral requirements should apply to senior executives at institutions other than larger covered financial institutions. For example, would it be prudent to mandate deferred incentive-based compensation for certain types of covered financial institutions but not require such deferral for other institutions (*e.g.*, investment advisers) based on the business, risks inherent to that business or other relevant factors?

- Are there additional considerations, such as tax or accounting considerations, that may affect the ability of larger covered institutions to comply with the proposed deferral requirement or that the agencies should consider in designing this provision of the rule?
- Comment on whether the mandatory deferral provisions of the rule should apply to a differently defined group of individuals at larger covered financial institutions, such as the institution's top 25 earners of incentive-based compensation?
- Comment on whether the three-year and 50% of incentive-based compensation minimums are appropriate. Should the minimum required deferral period be extended to, for example, five years?
- Is the mandatory deferral period appropriate for all larger covered financial institutions, based on differences in business model or other factors?

Risk mitigation

- Comment on the prohibition on a covered financial institution from having incentive-based compensation arrangements that may encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss to the institution.
- Comment on the proposed additional identification, review and approval requirements for larger covered financial institutions with respect to individuals 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.
- Is the proposed special treatment of these covered persons necessary or appropriate, or is their incentive compensation adequately addressed by the prohibitions applicable to all other covered persons (other than executive officers at larger covered financial institutions) under the proposal?
- Is it sufficient that, as under the proposal, such covered persons are not subject to mandatory deferral but instead are separately identified by the institution's board and the board is required to approve the incentive based compensation arrangement for the covered person after ensuring it is balanced and sensitive to risk?
- Should further guidance be provided as to the meaning of the phrase "substantial in relation to the institution's size, capital or overall risk tolerance"?
- Would prohibiting the use of financial derivatives, insurance contracts or other similar mechanisms to hedge against the market risk of equity-based incentive-based compensation be an effective means to help to ensure that incentive-based compensation arrangements remain aligned with the risk assumed by covered persons?

Policies and procedures

- Comment on all aspects of the requirement that covered financial institutions have policies and procedures governing the award of incentive-based compensation as a way to help ensure the full implementation of the prohibitions in the proposed rule.

Information collection

- Comment on whether the collection of information is necessary for the proper performance of the agencies' functions, including whether the information has practical utility.
- Comment on ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology.
- Comment on the estimates of capital or start-up costs and costs of operation, maintenance and purchase of services to provide information.

Broker-dealers and investment advisers

- Comment on the proposed method of determining asset size for investment advisers, and specifically whether the determination of total assets should be tailored for certain types of advisers, such as advisers to hedge funds or private equity funds, and if so, why and in what manner.
- How might the proposed rule affect broker-dealers and investment advisers (in particular, private fund advisers), given the structure of their incentive-based compensation? *E.g.*, how might the rule impact their business models and the variety of services that they provide to investors?
- Comment on whether the proposed prohibitions applicable to covered broker-dealers and investment advisers may disadvantage covered financial institutions as compared to financial institutions not covered under the proposed rules because covered financial institutions would be required to assume costs in designing, implementing, monitoring and maintaining a regulatory program to address the requirements of the proposed rules.
- Comment on whether it is possible that covered broker-dealers and investment advisers would have more difficulty recruiting qualified individuals to work for their firms if such individuals fear that added scrutiny of their incentive-based compensation may lead to lower aggregate pay.
- Comment on whether covered broker-dealers and investment advisers should expect to incur the cost of increased salaries that may result from the implementation of required deferred compensation and look-back policies for certain covered persons.
- Comment on the anticipated impact of the proposal on the competitiveness of covered financial institutions as compared to broker-dealers and investment advisers that do not meet the definition of covered financial institution, as well as the impact of the proposal on the competitiveness of covered broker-dealers and investment advisers with assets of at least $50 billion as compared to covered broker-dealers and investment advisers with assets between $1 billion and $50 billion.

Unintended consequences

- Could the proposed rule's requirements inhibit a covered financial institution's ability to attract and retain talented executives and employees?
- Could the requirements lead executives and employees to avoid taking prudent risks, thereby potentially leading to material financial loss to the covered financial institution or other consequences?
- Could the additional requirements that would apply to larger covered financial institutions limit their ability to compete with smaller institutions?

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