

Incentive Compensation Rules Proposed for Investment Advisers

June 1, 2016

New Incentive Compensation Rules: Implications for Investment Advisers

Introduction

On May 6, 2016 the Securities and Exchange Commission (“**SEC**”) joined the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the National Credit Union Administration in approving substantially identical proposed rules pursuant to Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Proposed Rule**”). The Proposed Rule imposes significant restrictions on incentive-based compensation arrangements at large financial institutions. The SEC’s version of the Proposed Rule, which differs significantly from the original rule as proposed in 2011, applies specifically to investment advisers and broker-dealers.

This memorandum focuses on how the Proposed Rule will affect investment advisers. For a more general discussion of the Proposed Rule, please see the May 12, 2016 Davis Polk Visual Memorandum, “[Incentive Compensation for Financial Institutions: Reproposal.](#)”

Proposed Rule Applies to Advisers with \$1 billion or More of Proprietary Assets

The Proposed Rule is only applicable to investment advisers (regardless of whether they are registered under the Investment Advisers Act of 1940, as amended (the “**Advisers Act**”)) with total assets of \$1 billion or more (such investment advisers, together with other institutions covered by the Proposed Rule, “**covered institutions**”). The SEC has delineated the following three tiers of covered investment advisers:

- *Level 1.* Investment advisers with total assets that are greater than or equal to \$250 billion.
 - *Attribution of Level 1 Status.* An investment adviser with total assets of at least \$1 billion that is a subsidiary of a Level 1 depository institution holding company will itself be considered a Level 1 covered institution.
- *Level 2.* Investment advisers with total assets that are greater than or equal to \$50 billion but less than \$250 billion.
 - *Attribution of Level 2 Status.* An investment adviser with total assets of at least \$1 billion that is a subsidiary of a Level 2 depository institution holding company will itself be considered a Level 2 covered institution.
- *Level 3.* Investment advisers with total assets that are greater than or equal to \$1 billion but less than \$50 billion and that are not Level 1 or Level 2 covered institutions.

Except where the parent entity is a depository institution holding company, the Proposed Rule appears not to attribute the Level of a parent company to a subsidiary investment adviser. For example, it appears that a Level 3 investment adviser subsidiary of a Level 2 broker-dealer would be subject to the Level 3 requirements, not the Level 2 requirements (assuming the broker-dealer is not a depository institution holding company). Nonetheless, we note that corporate groups that include covered institutions of different Levels might implement uniform policies across the corporate group, for ease of administration or other reasons, that have the effect of imposing Level 1 or Level 2 restrictions on investment advisers that would otherwise have been only subject to Level 3.

The Proposed Rule imposes a minimum set of principles-based requirements for those advisers in the Level 3 category and more onerous requirements for those in the Level 1 and Level 2 categories. The SEC estimates that

out of approximately 669 investment advisers that will be covered institutions under the Proposed Rule, 18 will be Level 1 institutions, 21 will be Level 2 institutions and 630 will be Level 3 institutions. In the release accompanying the Proposed Rule, the SEC explained that it had estimated the total number of investment advisers that would be covered institutions by using data as of December 31, 2014, as reported on Form ADV by registered advisers (see Item 1.O of Part 1A).

As the vast majority of investment advisers that are covered institutions under the Proposed Rule fall into the Level 3 category, this memorandum focuses on those requirements. For a more detailed analysis of the additional requirements applicable to Level 1 and Level 2 covered institutions, please see [“Incentive Compensation for Financial Institutions: Reproposal.”](#)

Assets Under Management Are Not Included in Calculation

For investment advisers, total assets are calculated based on the total assets shown on the adviser’s balance sheet as of the most recent fiscal year end. In calculating total assets, third-party assets under management and nonproprietary assets are not included. The SEC clarified that, even if client assets appear on the adviser’s balance sheet, they are not a part of the calculation.

Assets of “Operationally Integrated” Affiliates Are Included in Calculation

Many large advisers establish separate entities to serve as the general partners of their funds. The Proposed Rule requires an analysis of whether those entities are operationally integrated with the adviser to determine whether the assets of those entities should be consolidated for purposes of calculating the \$1 billion threshold. Although each situation should be examined separately, entities such as these general partner entities are usually operationally integrated with the adviser. Similarly, if a separate entity is a “relying adviser” on an adviser’s Form ADV, that entity is likely to be considered operationally integrated with the adviser.

To determine whether two affiliates are “operationally integrated,” the Proposed Rule indirectly refers to the position taken in the *Richard Ellis, Inc.* no-action letter, under which an affiliate of an adviser may be regarded as having a separate, independent existence if it:

1. Is adequately capitalized;
2. Has a buffer, such as a board of directors, a majority of whose members are independent of the parent;
3. Has employees, officers, and directors, who, if engaged in providing advice in its day-to-day business, are not otherwise engaged in the investment advisory business of the adviser;
4. Makes the decision as to what investment advice is to be communicated to, or is to be used on behalf of, its clients, and uses sources of investment information not limited to the adviser; and
5. Keeps its investment advice confidential until communicated to its clients.

Carried Interest May Count in Calculation of Assets

Many private equity fund advisers may have significant amounts of carried interest reflected as assets on their balance sheets. It is possible that the value of this carried interest shown on the balance sheet will count toward the \$1 billion calculation, as the Proposed Rule does not appear to exclude carried interest from the total assets determination.

Requirements for Level 3 Advisers

The Level 3 requirements generally apply to the incentive-based compensation arrangements for all employees of a Level 3 adviser, regardless of the employee’s title or seniority. As noted, the requirements of Level 3 covered institutions are significantly less onerous than the deferral and clawback requirements of Level 1 and Level 2 covered institutions. A Level 3 adviser will be required to:

1. Not use incentive-based compensation arrangements that encourage inappropriate risks by the adviser through excessive compensation or that could lead to material financial loss to the adviser;
2. Have a governing body that oversees compensation; and

3. Keep records on compensation and disclose those records to regulators upon request.
 - *Excessive Compensation.* An employee's compensation would be considered "excessive" when the amounts paid are unreasonable or disproportionate to the value of the services performed, taking into consideration all relevant factors, including:
 1. The combined value of all compensation, fees and benefits provided to the employee;
 2. The compensation history of the covered person and other individuals with comparable expertise at the adviser;
 3. The financial condition of the adviser;
 4. The compensation practices at comparable advisers (based on factors like asset size, geographic location and complexity of operations);
 5. For post-employment benefits, the projected total cost and benefit to the adviser; and
 6. Any connection between the employee and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse with regard to the adviser.
 - *Material Financial Loss.* As noted above, incentive-based compensation must not encourage inappropriate risks that could lead to material financial loss to the adviser. To comply with this requirement, incentive compensation must (1) appropriately balance risk and reward; (2) be compatible with effective risk management and controls; and (3) be supported by effective governance. The arrangement must include both financial and non-financial measures of performance and allow the latter to override the former when appropriate. Any amounts to be awarded must be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures and aspects of financial and non-financial performance.

What Is and Is Not Incentive Compensation

Under the Proposed Rule, "incentive compensation" is any variable compensation, fees or benefits that serve as incentive or reward for performance, whether in the form of cash, equity-like instruments or any other form of payment. Typically, incentive compensation covers incentive plans, annual bonuses and discretionary awards.

The SEC explained that compensation paid for reasons other than to induce performance would not be affected by the Proposed Rule and provided the following examples of such compensation: (i) compensation provided solely for continued employment (e.g., salary or a retention award); (ii) signing or hiring bonuses not conditioned on performance; (iii) payments for achieving or maintaining a professional certification or higher level of education; (iv) employer contributions to a 401(k) retirement savings plan computed as a fixed percentage of salary; and (v) dividends paid or appreciation realized on equity instruments that a covered person owns outright.

- *Carried interest.* There is a question as to whether carried interest would be subject to the Proposed Rule. While the SEC stated in the release that realized appreciation on instruments held outright was not subject to the rule, it is unclear whether that exclusion would apply to either (i) the award of carried interest participation in the first instance or (ii) subsequent payouts of carry, which would generally be tied to assets not held by the employee and which could be based on unrealized gains.

The Governing Body

The Proposed Rule will require a Level 3 adviser to designate a governing body to oversee the adviser's incentive compensation program. Oversight should be with respect to all employees and the governing body should ensure that incentive-based compensation arrangements do not encourage inappropriate risks (1) by providing excessive compensation, fees or benefits to an employee, or (2) that could lead to material financial loss to the adviser. The governing body must also approve incentive based compensation arrangements for the adviser's senior executive officers.

New Record-Keeping Requirements

The Proposed Rule imposes significant documentation and recordkeeping requirements for investment advisers that are covered institutions. These include the creation and maintenance for seven years of records that document the

structure of incentive compensation arrangements and demonstrate compliance with the final rules, which records must be disclosed to the SEC upon request. The SEC has specified that, at a minimum, the records must include copies of all incentive-based compensation plans, a record of who is subject to each plan and a description of how the incentive-based compensation program is compatible with effective risk management and controls. However, advisers would not be required to provide the actual amount of a covered person's compensation, fees or benefits.

Extraterritorial Application

The Proposed Rule raises difficult questions of extraterritorial application to non-U.S. investment advisers. In particular, the class of investment advisers potentially subject to the Proposed Rule is defined by reference to the term "investment adviser" as defined in Section 202(a)(11) of the Advisers Act, which would include both registered and unregistered investment advisers. Further, the Advisers Act definition of "investment adviser" does not include any geographic limitation. As such, it is unclear to what extent the SEC intends the Proposed Rule to apply to non-U.S. investment advisers. We are hopeful that the SEC will clarify the intended territorial scope of the Proposed Rule in finalizing the proposal.

Comment Period and Implementation

If adopted in its proposed form, many commentators are predicting that the rule will have the effect of giving stand-alone advisers that are not covered institutions a competitive advantage over advisers that are part of large banks and other financial institutions in hiring and retaining talent.

The comment period runs through July 22, 2016. If the rule is adopted as proposed, covered institutions must comply no later than the beginning of the first calendar quarter that begins at least 540 days after the final rule is published in the Federal Registrar. We estimate that the earliest the rules will apply to compensation programs is 2019.

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