Updated June 29, 2010

Bank Supervisory Agencies' Final Guidance: Aligning Incentive Compensation with Safety and Soundness Concerns

This memorandum has been updated to reflect changes made to the text of the financial reform bill after our original posting on June 28. We will continue to monitor developments relating to the bill and will issue a memorandum summarizing the bill when it is finalized.

On June 22, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS) issued final guidance[1] intended to help ensure that incentive compensation paid by banking organizations does not encourage imprudent risk taking that threatens the organizations' safety and soundness. The final guidance makes generally modest changes to the guidance proposed by the Federal Reserve on October 22, 2009,[2] which is described in our previous memorandum. This memorandum briefly summarizes the more significant of these changes.

Significant Changes in the Final Guidance

Covered Banking Organizations. The proposed incentive compensation guidance applied only to those banking organizations supervised by the Federal Reserve, which include U.S. bank holding companies, state member banks, Edge and agreement corporations and U.S. operations of foreign banks with a branch, agency or commercial lending company in the U.S. The final guidance applies also to those banking organizations supervised by the OCC, the FDIC and the OTS, which include national banks, state nonmember banks, savings associations and savings and loan holding companies.

The final guidance, like the proposed guidance, applies to incentive compensation arrangements. "Incentive compensation" includes, for purposes of the final guidance, the "portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics," and excludes salary and compensation based solely on an employee's level of compensation, such as employer contributions to a 401(k) plan based on a specified percentage of an employee's salary. The final guidance does not supersede long-standing safety and soundness standards of the Federal Reserve, the OCC, the FDIC and the OTS, applicable to insured depository institutions, prohibiting excessive compensation. The agencies' prohibition on excessive compensation pursuant to these safety and soundness standards is not limited to incentive compensation. Therefore, organizations that find that they must impose limitations on their incentive compensation on account of the final guidance may not be able to respond to such limitations simply by increasing base compensation or post-employment benefits.

Board Oversight of Compensation Practices. The final guidance provides additional advice on the actions that boards of directors (including board committees) should take in overseeing compensation practices. The proposed guidance provided that boards should directly approve incentive compensation

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[1] The final guidance is available at http://edocket.access.gpo.gov/2010/pdf/2010-15435.pdf.

[2] The proposed guidance is available at http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf.

arrangements for senior executives. The final guidance clarifies that boards ultimately are responsible for ensuring that the incentive compensation of *all* employees whose activities, individually or as a group, may expose their organizations to material risk does not endanger the organizations' safety and soundness.

The proposed guidance advised that boards stay informed of significant emerging trends in compensation plan mechanisms and market incentives. The final guidance expands on the proposed guidance by advising that boards also stay informed of developments in academic research and regulatory guidance on incentive compensation policies.

Under the proposed guidance, the board of each banking organization was required to have sufficient expertise and experience in risk management and compensation practices in the financial services industry in light of the nature, scope and complexity of the organization's activities. The final guidance clarifies that a board need not itself have such expertise and experience, so long as it has access to such expertise and experience (*e.g.*, by consulting with outside counsel, consultants or others with expertise in incentive compensation and risk management).

The final guidance also clarifies that, to ensure that its incentive compensation program is consistent with safety and soundness, the board of a large banking organization or other organization that uses significant amounts of incentive compensation generally will need to be more involved in overseeing compensation practices than will the board of a smaller organization that uses less incentive compensation. Examples of such greater board involvement include:

- reviewing and approving the overall goals and purposes of the incentive compensation program and providing clear direction to management to ensure that the goals and policies that it establishes are appropriately implemented; and
- reviewing at least annually management's assessment, with input from risk management personnel, as to whether the design and operation of the program are providing appropriate risk-taking incentives.

Continuing Supervisory Initiatives

The Federal Reserve, the OCC, the FDIC and the OTS intend to update the final guidance to incorporate best practices that emerge as banking organizations revise their incentive compensation practices to reflect the guidance. In addition, after the end of 2010, the Federal Reserve will prepare a report, in consultation with the other agencies, on trends and developments in banking organizations' compensation practices.

The Final Guidance and Other Efforts to Regulate Compensation

The final guidance constitutes one of a number of legislative and regulatory efforts to curb perceived abuses relating to the compensation of banking and other organizations undertaken since the onset of the financial crisis in the fall of 2008. One such effort was the stimulus bill and implementing regulations, which imposed on companies (primarily financial institutions) that received assistance under TARP compensation-related requirements such as:

- restrictions on bonuses, retention awards and incentive compensation;
- prohibitions on severance, change in control and tax gross-up payments;
- clawback of bonus payments based on materially inaccurate information;
- mandatory "say on pay";
- disclosure regarding perquisites and compensation consultants; and
- Special Master oversight, in exceptional cases.

Another such effort is nearly complete: Congressional negotiators last week completed the reconciliation of the differences between the House and Senate versions of the financial reform bill, and Congress is aiming to pass the bill this week. The reconciled bill includes a modified form of a provision in the House version that would require federal regulators jointly to prescribe regulations or guidelines to require covered financial institutions to disclose to their regulators their incentive compensation structures to permit the regulators to determine whether the structures:

- provide executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits; or
- could lead to material financial loss to the institutions.

The bill defines “covered financial institutions” to include the following financial institutions with at least $1 billion in assets: depository institutions and depository institution holding companies, broker dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac and any other financial institution determined jointly by the appropriate federal regulators. “Federal regulators” for this purpose include not only the banking regulators who issued the joint guidance discussed above, but also the SEC.

The financial reform bill also contains the following compensation-related provisions, which would apply to all public companies:

- disclosure in public filings of:
  - whether employees and directors are allowed to hedge the value of equity securities;
  - the relationship between a company’s executive compensation actually paid and the company’s financial performance;
  - internal pay equity, including the ratio of the median employee annual total compensation to that of the CEO;
- independence requirements for compensation committee members;
- prohibition of broker discretionary voting in connection with a shareholder vote on significant matters, including executive compensation;
- mandatory “say on pay” and “say on golden parachutes”; and
- clawback of incentive compensation from current or former executive officers following any accounting restatement.

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