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Financial Regulatory Agencies Issue Joint Proposed Rules on Compensation

On March 30, 2011, seven U.S. Federal financial agencies (the "*Agencies*")[1] announced a joint proposed rule to implement the provisions of Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "*Dodd-Frank Act*") relating to payment of incentive compensation at covered financial institutions with at least $1 billion in assets (the "*Proposed Rule*").[2] The Agencies are seeking public comment on the Proposed Rule for 45 days following its publication in the Federal Register, which is expected soon. The final version of the Proposed Rule will become effective six months after its publication in the Federal Register. The annual report required of covered financial institutions by the Proposed Rule will be due within 90 days following the end of each covered financial institution's fiscal year.

After the Proposed Rule becomes final, each Agency will codify its own version of the rules. Agency rules will vary to accommodate differences between regulated entities, as well as varying statutory and regulatory requirements.

1 The "***Agencies***" are the Office of the Comptroller of the Currency, Treasury ("***OCC***"); the Board of Governors of the Federal Reserve System (the "***Fed***"); the Federal Deposit Insurance Corporation ("***FDIC***"); the Office of Thrift Supervision, Treasury ("***OTS***"); the National Credit Union Administration ("***NCUA***"); the Securities and Exchange Commission ("***SEC***"); and the Federal Housing Finance Agency ("***FHFA***").

2 The Proposed Rule is available at http://www.sec.gov/rules/proposed/2011/34-64140.pdf.

Highlights

- ***Deferral Requirement for Executive Officers***. In a shift from current principles-based regulation, with the Proposed Rule, the Agencies would regulate the structure of incentive-based compensation. At least 50% of the incentive-based compensation of executive officers (as defined by the Proposed Rule) at the largest covered financial institutions (those with at least $50 billion in assets) must be deferred for at least three years, with vesting occurring no more rapidly than ratably over the deferral period. During the deferral period, the amount of compensation deferred is subject to downward adjustment to reflect the actual losses of the covered financial institution or other aspects of performance that are realized or become better known during that period.

- ***Flexible Approach Outside of Deferral Requirement***. With the exception of the executive officer deferral requirement, the Proposed Rule gives each institution the flexibility to fashion its own incentive-based compensation arrangements in a manner that is consistent with the purposes of the Proposed Rule. The Proposed Rule allows each Agency to enforce the rules as appropriate, and to recognize the differences in the size and scope of the covered institutions.

- ***Expanded Scope of Regulatory Oversight***. The incentive-based compensation arrangements at many financial institutions are already subject to regulatory oversight. The Proposed Rule, however, would extend compensation restrictions to certain or other institutions, including SEC regulated broker-dealers and investment advisers. Moreover, the Agencies propose to exercise their discretion to cover certain other financial institutions (including the U.S. operations of non-U.S. banks with U.S. banking offices) beyond those specifically identified as covered financial institutions in the Dodd-Frank Act.

- ***Multijurisdictional Reach***. Because the financial institutions covered by the Proposed Rule include sufficiently large U.S. branches of non-U.S. banks and non-U.S. subsidiaries of U.S. covered financial institutions, the possibility exists for potentially conflicting regulation of incentive-based compensation paid to employees of multinational institutions.

- ***Expanded Board Role in Compensation***. Perhaps most importantly, the Proposed Rule would expand the burdens and responsibilities of the boards of directors and board committees of covered financial institutions. In particular, the boards or applicable board committees of each of the largest covered financial institutions would be required to review and approve compensation arrangements for the individuals beyond the executive officer group whose compensation arrangements represent the greatest potential risk to an institution, and the board or applicable board committee would ultimately be responsible for ensuring those arrangements comply with the Proposed Rule.

Purpose

The Proposed Rule implements Section 956 of the Dodd-Frank Act[3] and reflects the Financial Stability Board's recommendations, which were endorsed by Basel and the G20.[4] It supplements, but does not supplant, other existing compensation-related rules.[5] Section 956 of the Dodd-Frank Act requires the Agencies to prohibit incentive-based compensation arrangements of covered financial institutions that provide a covered person with excessive compensation or that could lead to a material financial loss to a covered financial institution. It also calls for sufficient disclosure to enable regulators to evaluate the incentive-based compensation structures at covered financial institutions.

In the supplementary information published with the Proposed Rule, the Agencies assert that flawed incentive compensation practices in the financial industry were one of the factors contributing to the recent financial crisis, and that the Proposed Rule can play an important role in helping to ensure compensation structures do not undermine the safety and soundness of covered financial institutions.

Covered Financial Institutions

Only "covered financial institutions" that have total consolidated assets of $1 billion or more, determined using a rolling average to minimize the number of institutions dropping in and out of coverage, are subject to the Proposed Rule. The chart below names each Agency and the types of covered financial institutions for which it has regulatory responsibility:

AGENCY	COVERED FINANCIAL INSTITUTIONS INCLUDE:
OCC	A national bank and Federal branch and agency of a non-U.S. bank.
The Fed	A state member bank, a bank holding company, a state licensed uninsured branch or agency of a non-U.S. bank, and the U.S. operations of a non-U.S. bank with more than $1 billion of U.S. assets that is treated as a bank holding company. A covered financial institution includes the subsidiaries of the institution.
FDIC	A state nonmember bank and an insured U.S. branch of a non-U.S. bank.
OTS[6]	A savings association (including any operating subsidiary) and a savings and loan holding company.
NCUA	An insured credit union or credit union eligible to make application to become an insured credit union.

3 Earlier drafts of the Proposed Rule were released by the individual Agencies in February and March of 2011 and were not open to public comment or published in the Federal Register. The joint version of the Proposed Rule, to be codified in the Federal Register, was released on March 30, 2011.

4 For additional information regarding new rules on remuneration in the United Kingdom, you may refer to our client publication entitled, "The UK's Financial Services Authority Issues the Final Form Remuneration Code" (Dec. 28, 2010), available at http://www.shearman.com/the-uks-financial-services-authority-issues-the-final-form-remuneration-code-12-28-2010/.

5 Existing compensation-related guidance includes the Banking Agency Guidance, the Standards for Safety and Soundness adopted by the Federal banking agencies, the compensation-related disclosure requirements adopted by the SEC for public companies, the rules and guidance adopted by the FHFA for regulatory oversight of the executive compensation practices of its regulated entities and the compensation rules adopted by the NCUA for institutions under its supervision.

6 The Fed, the OCC, and/or the FDIC will assume supervisory and rulemaking responsibility for those entities in July 2011, in accordance with Title III of the Dodd-Frank Act, in connection with the elimination of the OTS in October 2011.

AGENCY	COVERED FINANCIAL INSTITUTIONS INCLUDE:
SEC	An SEC-registered broker-dealer and investment adviser.
FHFA	Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Federal Home Loan Bank System's Office of Finance.

The Proposed Rule also sets heightened standards for "larger covered financial institutions," which are generally covered financial institutions with $50 billion or more in total consolidated assets.[7] These heightened standards will be discussed later in this publication.

The Proposed Rule does not establish procedures for regulatory oversight when multiple Agencies have jurisdiction over a particular covered financial institution, such as when a large bank holding company owns an SEC-registered broker-dealer that is a covered financial institution. It remains to be seen whether enforcement of a final version of the Proposed Rule will lead to varied application and different design requirements in compensation structures depending on the Agency responsible for oversight.

Incentive-based Compensation

"Incentive-based compensation" includes any variable compensation that serves as an incentive for performance, irrespective of the form of payment. The term "compensation" is defined broadly to include all direct and indirect payments, including perquisites, benefits and post-employment payments or benefits. Under the proposed definition, salary stock and any equity (such as restricted stock) that is awarded solely for continued employment would appear not to be considered incentive-based compensation.

Covered Persons; Board of Directors

Only incentive-based compensation paid to "covered persons" is subject to the requirements of the Proposed Rule. In the Proposed Rule, a covered person includes any executive officer, employee, director or principal shareholder[8] of a covered financial institution. An "executive officer" is a person who holds the title or performs the functions of president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief lending officer, chief legal officer, chief risk officer or head of a major business line.

Under the Proposed Rule, the "board of directors" is the governing body of any covered financial institution performing functions similar to a board of directors. The Proposed Rule does not specify whether the parent company's board of directors is responsible for incentive-based compensation paid to covered persons by a subsidiary which is also a covered financial institution, or whether the subsidiary's board of directors is responsible. For non-U.S. banking organizations, the Proposed Rule clarifies that "board of directors" refers to the relevant senior management or oversight body for the firm's

7 For purposes of credit unions, the larger covered financial institutions would be defined as those with $10 billion or more in assets. Entities regulated by the FHFA (e.g., Fannie Mae/Freddie Mac and the Federal Home Loan Banks) are subject to the income-deferral rules regardless of size.

8 A "principal shareholder" means an individual who, acting directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote ten percent or more of any class of voting securities of a covered financial institution.

U.S. branch, agency or operations, consistent with the non-U.S. banking organization's overall corporate and management structure.

Prohibitions

The Proposed Rule prohibits covered financial institutions from maintaining incentive-based compensation arrangements (i) that provide a covered person with "excessive compensation" or (ii) that could lead to material financial loss to the covered financial institution.

Excessive Compensation. The Proposed Rule prohibits a covered financial institution from establishing or maintaining any incentive-based compensation arrangement that encourages any covered person to expose the institution to inappropriate risks by providing that person with excessive compensation. In evaluating whether incentive-based compensation is excessive, the Agencies will consider whether the amounts paid are either unreasonable or disproportionate to the services performed by a covered person. The Proposed Rule sets out several criteria that the Agencies will consider when making this determination, including:

- The combined value of all amounts provided to the individual;
- The compensation history of the individual and other individuals with comparable expertise at the covered financial institution;
- The financial condition of the covered financial institution;
- Comparable compensation practices at comparable covered financial institutions, taking into consideration factors such as asset size, geographic location and the complexity of the operations and assets;
- Post-employment benefits and their cost and benefit to the covered financial institution; and
- Any connection between the individual and any fraudulent act or omission or any breach of trust or fiduciary duty.

These standards suggest the Agencies will use, among other things, benchmarking to measure whether compensation is "excessive." These standards are comparable to, and based on, the existing standards established for FDIC insured banking institutions under Section 39 of Federal Deposit Insurance Act.

Incentive-Based Compensation for Risk Takers That May Lead to Material Financial Loss. The Proposed Rule also focuses on incentive-based compensation arrangements that encourage inappropriate risk-taking and could consequently lead to a material financial loss to the covered financial institution. To address this issue, the Agencies apply an additional requirement to incentive-based compensation arrangements for those covered persons who may subject the covered financial institution to the most risk: specifically, executive officers, non-executive individuals whose activities may expose covered financial institutions to a material financial loss (such as traders with large position limits) and groups of individuals with the same incentive-based compensation arrangements who could collectively expose the covered financial institution to a material financial loss. An incentive-based compensation arrangement does not comply with this requirement of the Proposed Rule unless it (i) balances risk involved against the financial reward paid, (ii) is compatible with effective controls and risk management and (iii) is supported by strong corporate governance.

- ***Suggested Compensation Structures***. The Proposed Rule does not set out specific compensation plan designs that satisfy the requirement that risk and reward be balanced appropriately. However, the Proposed Rule references four methods that are commonly used to make compensation more sensitive to risk:
  - Risk adjustment of awards, so that the amount of incentive-based compensation is adjusted based on measures that take into account the risk the covered person's activities pose;

  - Deferral of payment, in which the actual payout of the award is delayed significantly beyond the end of the performance period to allow for the adjustment of the payout based on the actual losses realized by the financial institution or other aspects of performance that become clear only during the deferral period;
  - Longer performance periods, extending the time period on which performance measures are based to allow awards or payments to be made after some or all of the risk outcomes are realized or better known; and
  - Reduced sensitivity to short-term performance, in which the amount of incentive-based compensation paid in connection with short-term performance measures is reduced.

  While the suggested structures for balancing risk and reward are neither mandatory nor exhaustive, they provide insight into the expectations of the Agencies in the design of compensation structures and may ultimately serve as guidelines or best practices depending on how the Agencies apply the Proposed Rule.

- ***Effective Controls and Strong Corporate Governance***. Covered financial institutions must have strong controls surrounding the design and implementation of incentive-based compensation arrangements and must involve risk-management personnel in the compensation process. In addition, the board of directors of a covered financial institution, or the appropriate board committee, is required to actively oversee compensation programs and ensure that incentive compensation arrangements are appropriately balanced. The Proposed Rule tasks boards and committees with reviewing and approving the goals and purposes of the compensation structure and aligning the arrangements with the institution's overall risk tolerance profile.
- ***Deferral Rule and Other Requirements for Larger Financial Institutions***. At larger covered financial institutions (in general, institutions with $50 billion or more in total consolidated assets), executive officers are required to defer at least 50% of their incentive-based compensation over a period of at least three years, with vesting occurring no more rapidly than ratably over the deferral period. Deferred incentive-based compensation must be adjusted downward for actual losses of the covered financial institution or other aspects of performance that are realized or become better known during the deferral period.

Board Oversight

The Proposed Rule recognizes that for these measures to be successful, they must be accompanied by strong corporate governance practices. Boards of directors or board committees are ultimately responsible for ensuring the incentive-based compensation structures are appropriately balanced and effective.

Additional Review and Certification of Individual Compensation. As an additional requirement for larger covered financial institutions, the board of directors or applicable board committee must identify any covered persons other than executive officers who have the ability to expose the covered financial institution to possible substantial losses. The board (or committee) must then determine that the incentive-based arrangements for these identified individuals effectively balance the financial rewards in light of the time horizon and the range of associated risks.

This requirement will significantly increase the workload for the board, or more likely, the compensation committee, which would now be required to review the individual compensation structure for each identified person in addition to reviewing the structure and effectiveness of the overall program. Depending on the current level of authority provided to the board or applicable board committee, larger financial institutions may need to amend their charters to account for the increased oversight responsibilities.

Policies and Procedures. The Agencies believe the incentive-based compensation practices of covered financial institutions should be subject to internal policies and procedures that are appropriate to the size and complexity of the institution. Accordingly, risk-management personnel must be involved with the creation and oversight of the internal policies and procedures, and boards of directors (or committees) are required to review the data used to create and administer the policies to ensure they comply with the requirements of the Proposed Rule.

Additionally, sufficient documentation of the institution's processes for establishing, implementing, modifying and monitoring incentive-based compensation arrangements must be maintained. The documentation should include copies of the arrangements or plans, the names and titles of the individuals covered by the arrangements, a list of the awards made, and records reflecting the persons or units involved in the approval of, and ongoing monitoring of, the arrangements or plans.

The Agencies are also considering limiting personal hedging strategies by covered persons, and they have requested comments on this topic in the Proposed Rule.

Required Reports

The Proposed Rule also implements the reporting requirements of Section 956 of the Dodd-Frank Act. Each covered financial institution would be required to file a report with its governing Agency on an annual basis. The format of the annual report will be specified by the governing Agency, but under the Proposed Rule, it must contain the following information:

- A clear narrative description of the components of the incentive-based compensation arrangements and the classes of covered persons to which they apply;
- A succinct description of the policies and procedures governing the incentive-based compensation arrangements;
- For larger covered financial institutions, a succinct description of any specific incentive-based compensation policies and procedures for executive officers and other individuals who have the ability to expose the institution to possible substantial losses;
- Any material changes from the previous report; and
- The specific reasons the covered financial institution believes the structure of its incentive-based compensation does not provide incentives to engage in behavior that is likely to cause material financial loss.

The Proposed Rule confirms that actual compensation information for individuals is not required to be filed. It also recognizes that the materials provided will be sensitive, and therefore the Agencies generally will maintain confidentiality of the information submitted, and the information will be not be public to the extent permitted by law.[9] The Agencies also recognize that the volume and detail of the information provided in the annual reports will vary with the size and complexity of the institution.

[9] The Freedom of Information Act provides at least two exemptions under which the regulatory agencies have the authority to withhold certain information (FOIA Exemption 4 relating to trade secrets and commercial or financial information, and FOIA Exemption 8 for matters that are contained in, or related to, reports to regulatory agencies).

Evasion

The Proposed Rule prohibits covered financial institutions from evading the proposed requirements by effecting measures counter to the Proposed Rule indirectly or through another entity. For example, covered financial institutions would not be permitted to classify substantial numbers of employees as independent contractors for purposes of evading the requirements of the Proposed Rule.

Points of Note

As described above, the Proposed Rule represents a shift away from principles-based guidance to a more specific approach, which is a change in the philosophy of U.S. regulation and oversight of compensation more in line with the approach currently being taken in the European Union. Importantly, the Proposed Rule is likely to increase significantly the burden on boards of directors and compensation committees. Boards and committees would be ultimately responsible for the compliance of incentive-based compensation structures with the Proposed Rule, and would have the added duty to review the structure and compliance, along with the risk profile, of all incentive-based compensation arrangements for a broad group of covered persons. For larger covered financial institutions, boards or committees would be required to review the individual arrangements of all the largest risk takers, which will require preparation of the appropriate data by management prior to review by the board or committee. The oversight and reporting requirements for boards of directors, compensation committees and risk-management personnel will only add to a workload that has significantly increased in the past few years.

It will be interesting to see whether differing implementation of the Proposed Rules by the Agencies will result in disparate practices among the Agencies. A similar area to watch is the application of the Proposed Rule to U.S. branches of non-U.S. institutions as well as non-U.S. subsidiaries of U.S. institutions. It is likely these institutions will be subject to multijurisdictional regulation depending on their organizational structures. It is expected that ongoing discussions will attempt to resolve these jurisdictional overlaps.

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This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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