CAPflash
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FDIC and related Agencies propose rules under Dodd-Frank Reform Act relating to Incentive-based Compensation Arrangements

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On February 7th, the FDIC issued its proposed rules implementing Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed rules, which build on principles/guidance previously announced by the Financial Stability Board (in September 2009) and the Federal Reserve (in June 2010), seek to protect an institution's safety and soundness and ensure that compensation arrangements do not expose institutions to unnecessary risk and material financial loss.

The SEC announced its adoption of the rules on March 3rd. Seven other government regulators are expected to adopt substantially similar provisions, which will cover most financial institutions with assets greater than $1 billion.

The proposed rules will be effective six months after their adoption by all regulators and following a 45-day comment period. Current estimates are that the rules will go into effect sometime in late 2011. Compensation currently being determined for 2010 performance and long-term incentive awards being made now or this spring are unaffected. However, most affected institutions have not previously been subject to this level of review, therefore the process of complying and assessing the impact of the rules on compensation plan design needs to begin now.

Key Provisions

The new proposed rules:

- prohibit most financial institutions in excess of $1 billion in assets from providing incentive compensation arrangements that could encourage inappropriate risk-taking;
- prohibit any incentive arrangement or feature that is excessive or could lead to a material loss;
- require larger institutions whose assets exceed $50 billion to defer 50% of the incentive compensation of executive officers (and select individuals) over a three-year period;
- provide for additional annual reporting for all institutions over $1 billion to their respective regulators on how their incentive plans for executives and identified other individuals are structured to prevent material loss and excessive compensation;
- disclose the policies and procedures in place to monitor and evaluate these arrangements.

Covered Person

Executive officers including senior corporate executives and the heads of major business units, directors, principal shareholders and other individuals whose activities may expose the institution to significant risk.

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Definition of Compensation and Excessive Compensation

Compensation includes all direct and indirect payments, fees, and benefits received including those under employment contracts or agreements, in the form of cash or non-cash. It also includes perquisites, stock options, post-employment benefits and any other compensatory arrangement.

Excessive compensation includes amounts that are determined to be unreasonable or disproportionate to the amount, quality and scope of services performed.

Board of Directors' Role

The Board of Directors, or a designated Committee of the Board, is expected to actively oversee the institution's incentive arrangements for covered employees, including executives. For larger institutions, the Committee will also need to identify individuals who may expose the company to material risk. In support of strong corporate governance the board's (or committee) responsibilities would include:

- determining employees other than executive officers in their purview;
- reviewing and approving goals and payments;
- ensuring the alignment of goals with the institution's overall risk tolerance;
- evaluating appropriate performance periods;
- ensuring risk adjustment of awards as appropriate.

  In addition, the Committee would receive data and analyses sufficient to determine whether the arrangements are in compliance and performing in accordance with their terms.

Compensation Standards

The rule reiterates three key standards/ principles for sound compensation practices from earlier Banking Agency Guidance and the Financial Stability Board for determining whether an incentive arrangement is in compliance with the rule.

The incentive arrangement must:

- balance risk and financial rewards;
- be compatible with effective controls and risk management;
- be supported by strong corporate governance.

Deferral of Annual Incentive Compensation (Large Institutions)

The proposal mandates the deferral of 50% of incentive compensation for executive officers (and select individuals) over a three-year period. Incentive compensation is broadly defined in the proposal and would likely cover most forms of compensation other than base salary and salary-related benefits (e.g., employer contributions to a 401(k))

The deferrals may vest on a pro-rata basis, but no more than 1/3 per year. In order to recognize that an annual performance period may be too short a time to recognize the impact of actions taken, the deferred amounts are also subject to adjustment based on actual loss or other aspects of performance that are better evaluated over a longer period.

This provision places the US in closer alignment, but with greater flexibility, with the actions of the UK Financial Stability Authority (FSA) and EU remuneration guidelines.

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Annual Reporting

An annual report, filed within ninety days of the financial year, must be made to the appropriate regulator. This report discloses the structure and features of incentive compensation arrangements for covered persons in a manner sufficient to determine whether the plan(s) incents behavior that could contribute to a material financial loss or provide for excessive compensation. The guidance provides that the form of the report is expected to be a clear, succinct narrative description of the plans. Further, it requires disclosure of the policies and procedures put in place to monitor/evaluate incentive plans as well as any changes made since the last report.

Impact of the Proposed Rule on Incentive Compensation

The rule reiterates principles that have been disseminated by multiple regulators since the financial crisis. The focus remains on minimizing risk to the institution and the financial system. The inclusion of all financial institutions over $1B provides for a broader level of compensation supervision than we have seen to date, creating more complexity for smaller institutions likely lacking the infrastructure and governance larger institutions have of necessity put in place. For public companies, recent SEC requirements on risk disclosure have likely started the process and raised Board awareness.

Smaller Institutions

For institutions who have not undergone risk assessments by their regulators or were not CPP (Capital Purchase Plan) participants, the rules will require a thorough review of existing incentive arrangements relative to the principles identified. This assessment would extend to plans that cover employees other than executives, and contain potential for material loss. In addition, the institution will need to develop (with the participation of its Board, or appropriate committee) policies and procedures for monitoring and approving plans that include:

- Significant involvement by risk management in the incentive plan process;
- An assessment of plan features to ensure that they minimize risk;
- A review of payouts to confirm that they are not excessive.

Larger Institutions

Larger institutions have had significant interaction with regulators over the last two years, either as CPP participants or through regulatory reviews which have included incentive compensation**.** Much of what is required in the proposed rules is similar to the guidance they have received. The requirement for a mandatory deferral of compensation for larger institutions is new.

While initially targeted at executives, individuals and/or groups who may expose the institution to losses, it is unclear how deep this policy will be extended. Companies that have undergone regulatory review have difficulty in clearly defining or segregating individuals and groups who are in a position to expose the institution to risk from other positions within their organization. This may have the unintended consequence of leading to the greater use of deferrals throughout institutions.

Additionally, the design of deferral features, allowing for risk adjustment due to material loss or changes in performance that can be linked to actions directly taken by these individuals, is more complex than it appears. The proposal suggests that adjustments can be determined quantitatively or subjectively. It is likely that Compensation Committees will prefer quantitative criteria but will also retain some judgment. Other suggestions from the regulators (not required) for minimizing the potential for loss include lengthening performance periods overall, reducing reliance on annual incentives and de-levering incentive awards at higher levels of performance.

The guidance makes no distinction between how companies structure incentive compensation. For exam-

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ple, many Wall Street firms have a compensation model that delivers total compensation (salary plus incentive compensation) for a year based on performance in that year. The incentive compensation is delivered to executives in a mix of fixed annual cash bonus and equity (e.g., stock options, restricted stock). Other financial services companies have a different compensation model where annual cash bonuses are based on annual performance, but the amount of equity-based compensation provided to executives is not necessarily dependent on annual performance. The proposed rules seem to have been designed with the Wall Street incentive compensation model in mind.

The rule does not mandate the form of a deferral – a departure from UK and European regulations that are more prescriptive. A variety of incentive programs utilized today don't fit neatly into a "bonus deferral" and questions will be posed about how to apply the proposal to these forms of compensation. Some include:

- Stock options – does a three or four year vesting period meet the deferral requirement if the executive exercises no more than 1/3 per year of the award by the third anniversary of grant?
- Performance-based restricted stock – does a three-year cliff vest on the shares, assuming performance is met, substitute for the three-year deferral requirement?
- Performance shares or units – does the award need to be held post the three-year performance period to allow for a performance adjustment?

Boards and Committees that have been heavily involved in risk assessments over the last two years, will see the rules as confirmation of their oversight of compensation for all employees and a significant expansion of their charter. These additional responsibilities will require support from management and corporate functions – particularly risk, finance and human resources in order to meet the greater demands.

Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.