A Closer Look

The Dodd-Frank
Wall Street Reform and
Consumer Protection Act

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Part of an ongoing series

Incentive-Based Compensation Requirements for Certain Firms

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or "the Act") requires enhanced disclosure of incentive-based compensation arrangements by certain banks, credit unions, investment advisers, brokerage firms, and other financial institutions. It also prohibits any type of incentive-based compensation that, in the regulators determination, encourages inappropriate risks by providing excessive compensation, or has the potential to cause material financial loss to the covered firm. Regulators are directed to jointly adopt rules and guidelines to implement this provision. This *A Closer Look* provides a description of the incentive-based compensation restrictions and describes the proposed rule and its impacts, should the rule become final in its present form.

Background

Section 956 of Dodd-Frank requires the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Depository Insurance Corporation (FDIC), the Treasury Department's Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), and the Federal Housing Finance Agency (FHFA) (collectively, "the Agencies") to prescribe rules that would prohibit covered financial institutions from offering any type of incentive-based compensation that, in the regulators' determination, provides excessive compensation or could expose the institution to inappropriate risks that could lead to material financial loss.

On March 30, 2011, the Agencies issued a joint proposed rule, which was published in the Federal Register on April 14. The public has an opportunity to comment on the proposal until May 31, 2011. If adopted, the final rules would become effective six months after they are published in the Federal Register. The proposed rule is available at http://www.gpo.gov/fdsys/pkg/FR-2011-04-14/pdf/2011-7937.pdf

Summary of proposed rule

The proposed rule would:

- Prohibit a covered financial institution from offering incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risks by providing the covered persons excessive compensation.
- Require that any standards adopted with regard to excessive compensation are comparable to the compensation-related safety and soundness standards applicable to insured depository institutions under Section 39 of the Federal Deposit Insurance Act (FDIA).[1]
- Prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the covered financial institution that could lead to material financial loss. The Agencies propose to adopt standards for determining whether an incentive-based compensation arrangement may encourage inappropriate risk-taking. These standards would be consistent with the key principles established for incentive compensation in the interagency *Guidance on Sound Incentive Compensation Policies* ("Banking Agency Guidance") adopted by the federal banking agencies.[2]
- Impose additional requirements on larger covered financial institutions relating to the deferral of incentive-based compensation for executive officers and the review and approval of incentive-based compensation for those covered persons that 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. Specifically, the rule would require at least 50 percent of executive officers' incentive-based compensation be deferred on a

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[1] The federal banking agencies (OCC, the Federal Reserve, FDIC, OTS) each have adopted guidelines implementing the compensation-related and other safety and soundness standards in Section 39 of the FDIA.

[2] *Guidance on Sound Incentive Compensation Policies*, 75 FR 36395 (June 25, 2010), adopted by the OCC, the Federal Reserve, FDIC, and OTS.

pro rata basis over a period of at least three years, and be adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

- Require covered financial institutions to provide certain information to their appropriate federal regulator concerning their incentive-based compensation arrangements for covered persons.
- Require covered financial institutions to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based compensation to help ensure compliance with these requirements and prohibitions.

What is incentive-based compensation?

The proposed rule defines "incentive-based compensation" to mean any variable compensation that serves as an incentive for performance. Compensation is defined in the proposal as:

> [A]ll direct and indirect payments, fees or benefits, both cash and 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 of compensation specifically excludes 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.

The form of such compensation—including cash, an equity award, or other property—does not affect whether compensation meets the definition of "incentive-based compensation."

Certain types of compensation *would not* be considered incentive-based compensation, including:

- Compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary);
- Compensation arrangements that provide rewards solely for activities or behaviors that do not involve risk-taking (e.g., payments solely made for achieving or maintaining a professional certification or higher level of educational achievement);
- Compensation arrangements that are determined based solely on the covered person's level of fixed compensation and do not vary based on one or more performance metrics (e.g., employer contributions to a 401(k) retirement savings plan that is based on a fixed percentage of an employee's salary); and
- Dividends paid and appreciation realized on stock or other equity instruments that are owned outright by a covered person.[3]

[3] However, the proposal states that stock or equity instruments awarded to a covered person under a contract, arrangement, plan, or benefit would not be considered owned outright while subject to any vesting or deferral arrangement (irrespective of whether such deferral is mandatory).

Which firms are covered?

The proposed rule would apply to "covered financial institutions" that have total consolidated assets of $1 billion or more, including:

- National banks and federal branches and agencies of foreign banks;
- State member banks, bank holding companies, state-licensed uninsured branches or agencies of foreign banks, and the US operations of any foreign bank with more than $1 billion of US assets that is treated as a bank holding company;
- State non-member banks and insured US branches of foreign banks;
- Savings associations and savings and loan holding companies;
- Credit unions;
- Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Federal Home Loan Banks system's Office of Finance; and
- Broker-dealers and investment advisers.

Which persons are covered?

A "covered person" is defined in the proposed rule as any executive officer, employee, director, or principal shareholder of a covered financial institution.

The proposed rule further defines "executive officer" as a person who holds the title or performs the function (regardless of title, salary, or compensation) of one or more of the following positions: 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.

No specific category of employee is excluded as a covered person. In considering coverage of the proposed rule, firms should bear in mind that the underlying purpose of the rulemaking is to address incentive compensation paid to individuals or groups of individuals that encourages inappropriate risk because they provide excessive compensation or pose a risk of material financial loss to the institution.

How to calculate total consolidated assets

The proposed rule would apply to all covered financial institutions that have total consolidated assets of $1 billion or more. With the exception of the FHFA, the Agencies have specified how total consolidated assets should be calculated in their agency-specific rule text:

- **OCC:** Total consolidated assets means (i) for a national bank, calculating the average of the total assets reported in the bank's four most recent Consolidated Reports of Condition and Income ("Call Reports"); and (ii) for a federal branch and agency, calculating the average of the total assets reported in the federal branch or agency's four most recent Reports of Assets and Liabilities of US Branches and Agencies of Foreign Banks (reporting form FFIEC 002).

- **Federal Reserve:** Total consolidated assets would be determined based, (i) for a state member bank, on the average of the bank's four most recent Call Reports; (ii) for a bank holding company, on the average of the company's four most recent Consolidated Financial Statements for Bank Holding Companies; (iii) for a state-licensed uninsured branch or agency of a foreign bank, on the average of the branch or agency's four most recent FFIEC 002 reports; and (iv) for the US operations of a foreign bank, total consolidated US assets would be determined by the Federal Reserve.
- **FDIC:** Asset size would be determined, (i) for state non-member banks, by calculating the average of the total assets reported in the institution's four most recent Call Reports; and (ii) for insured US branches of foreign banks, by calculating the average of the total assets reported in the branch's four most recent FFIEC 002 reports.
- **OTS:** Asset size would be determined by calculating the average of total assets reported in the institution's four most recent Thrift Financial Reports.
- **NCUA:** For credit unions, asset size would be determined by calculating the average of the total assets reported in the credit union's four most recent 5300 Call Reports.
- **FHFA:** The FHFA is not including a definition of total consolidated assets in its proposed rule because it is proposing to make all requirements of the rule applicable to all the entities it regulates without regard to asset size.
- **SEC:** Asset size would be determined, (i) for registered brokers or dealers, by the total consolidated assets reported in the firm's most recent year-end audited Consolidated Statement of Financial Condition filed pursuant to Rule 17a-5; and (ii) for investment advisers, by the adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year end.[4]

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[4] This proposed method of calculation for investment advisers is consistent with the SEC's recent proposal that each investment adviser filing Form ADV Part 1A indicate whether the adviser had $1 billion or more in "assets," defined as the total assets shown on the balance sheet for the adviser's most recent fiscal year end. See *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Rel. No. 3110 (Nov. 19, 2010), 75 FR 77052 (Dec. 10, 2010), described in *A Closer Look*, *Impact on Asset Managers* published in December 2010.

In the proposal, the SEC notes that most advisers presently report assets under management and do not report the amount of their own assets to the SEC. It estimates, however, that advisers with more than $100 billion in assets under management would have total consolidated assets of more than $1 billion, and advisers with more than $500 billion in assets under management would have total consolidated assets of at least $50 billion. Based on that, it estimates that approximately 70 registered advisers would have total consolidated assets of $1 billion or more, and that 7 registered advisers would have total consolidated assets of at least $50 billion. The SEC estimates that there are 132 registered broker-dealers with assets of $1 billion or more and 18 broker-dealers with assets of at least $50 billion.

SEC Chairman Mary Schapiro specifically mentioned in her statement accompanying the rule proposal that she is particularly interested in commenters' views on how assets would be calculated for purposes of determining whether institutions would fall within the definition of a covered financial institution. She also stated she is very interested in commenters' views on how the proposal may affect the broad array of financial firms covered by Section 956—most particularly private fund advisers, given how they structure their compensation, and given the proposal's potential impact on broker-dealer and investment adviser business models and the variety of services they provide to investors.

In determining whether their assets meet the $1 billion threshold, firms should consider the application of Generally Accepted Accounting Principles related to Accounting Standards Codification 810 (previously titled FIN 46(R), as amended by FAS 167) that may require them to include on their balance sheets the consolidated net assets of certain pooled investment vehicles. Firms should continue to monitor the Agencies' proposal, and consult with their independent accountants as to whether any managed investment funds should be consolidated on the firm's balance sheet.

Requirements applicable to all covered financial institutions

Prohibition on excessive compensation: How to determine whether incentive-based compensation is excessive

The proposal would establish a general rule that covered financial institutions may not establish or maintain any type of incentive-based compensation arrangement that, by providing a covered person with excessive compensation, encourages inappropriate risks by the institution.

The proposal includes a framework for determining whether an incentive-based compensation arrangement provides excessive compensation. Incentive-based compensation for a covered person would be considered excessive when 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 this determination, the Agencies would consider the following factors:[5]

- 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 covered financial institution;
- The financial condition of the covered financial institution;
- Comparable compensation practices at comparable institutions, based upon 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 covered financial institution;
- Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and
- Any other factors the Agencies determine to be relevant.

Inappropriate risks that may lead to material financial loss

The proposed rule also would prohibit covered financial institutions from establishing or maintaining any type of incentive-based compensation arrangement for certain covered persons, or groups of covered persons, that could lead to material financial loss.

[5] As directed by Section 956 of the Act, these factors are the same as those set forth in Section 39 of the FDIA.

Covered persons include:

- Executive officers and other covered persons who are responsible for oversight of the covered financial institution's firm-wide activities or material business lines;
- Other individual covered persons, including non-executive employees, whose activities may expose the covered financial institution to material financial loss (e.g., traders with large position limits relative to the covered financial institution's overall risk tolerance);
- Groups of covered persons who are subject to the same or similar incentive-based compensation arrangements, and who, in the aggregate, could expose the covered financial institution to material loss (e.g., loan officers who, as a group, originate loans that account for a material amount of the covered financial institution's credit risk).

The proposal would deem an incentive-based compensation arrangement of any covered person as liable to encourage inappropriate risks that could lead to material financial loss *unless* the arrangement:

- Balances risk and financial results (for example, by using deferral of payments, risk adjustment of awards, longer performance periods, or reduced sensitivity to short-term performance);
- Is compatible with effective controls and risk management; and
- Is supported by strong corporate governance.[6]

Additional requirements for larger covered financial institutions

Deferral arrangements required for executive officers

The proposed rule would establish additional measures for certain covered persons working for a covered financial institution with total consolidated assets of at least $50 billion.[7] Executive officers at these firms would be required to defer at least 50 percent of their incentive-based compensation on a pro rata basis over a period of at least three years. The proposal also would require that executive officers' deferred incentive-based compensation reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

[6] These three standards are consistent with the principles for sound compensation practices in the Banking Agency Guidance. The SEC states that many covered broker-dealers and investment advisers already conform to incentive-based compensation standards reflected in the Guidance because they are affiliated with banking organizations ("covered bank broker-dealers and investment advisers") supervised by the Federal Reserve, OCC, OTS, or FDIC, that have already altered their incentive-based compensation arrangements and policies and procedures following the publication of the Guidance. The SEC estimates there are 20 covered bank broker-dealers with assets of at least $50 billion and 35 covered bank broker-dealers with assets between $1 billion and $50 billion. With respect to investment advisers, the SEC estimates that there are approximately 5 covered bank investment advisers with assets of at least $50 billion and 50 covered bank investment advisers with assets between $1 billion and $50 billion.

[7] For the NCUA, all credit unions with total consolidated assets of $10 billion or more are considered larger covered financial institutions. For the FHFA, all Federal Home Loan Banks with total consolidated assets of $1 billion or more are considered larger covered financial institutions.

The required deferral of 50 percent of incentive compensation for executive officers is one of the most significant provisions of this proposed rulemaking. While most institutions have deferral mechanisms in place for senior executives and key contributors, the prescriptive nature of this rule would have an impact on the design of compensation arrangements at larger financial institutions. Note that while this requirement is consistent in principle with that prescribed by European regulators in 2010, the proposed rule is somewhat narrower than the European rules in that it applies only to executive officers, while the European equivalent applies to all "risk takers," which is generally a much broader group.

Firms should consider the proposal's deferral requirements in light of other relevant US and foreign laws, including US tax laws related to deferred compensation arrangements.

Special review and approval requirement for other designated individuals

Under the proposed rule, the board of directors or a committee thereof ("board") of a larger covered financial institution would be required to identify those covered persons (other than executive officers) that 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. These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution.

In addition, the proposal would require that the board review and approve each identified person's incentive-based compensation, and maintain documentation of such approval. Furthermore, the board may not approve an incentive-based compensation arrangement unless the board determines that the arrangement, including the method of paying the compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity.

In performing its duties in this regard, the board must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person. The board must also evaluate the ability of the methods used to make payments sensitive to the full range of risks presented by that covered person's activities, including those risks that may be difficult to predict, measure, or model.

The rigorous standards for larger covered financial institutions may be yet another means for federal agencies to assess systemic risk. The SEC states in the proposal that the heightened standards for the largest covered broker-dealers and investment advisers are particularly appropriate because decisions made by these institutions can greatly impact the fair and orderly operations of the financial markets.

Reporting requirements

According to the proposed rule, covered financial institutions must submit an annual report to their federal regulator disclosing the structure of their incentive-based compensation arrangements. This report must be of sufficient detail to allow the regulator to determine whether the incentive-based compensation structure provides persons with excessive compensation, fees, or benefits, or could lead to material financial loss.

Specifically, the report must contain:

- A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons, and an enumeration of the types of covered persons to which these arrangements apply;
- A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;
- For larger covered financial institutions, a succinct description of any specific incentive-based compensation policies and procedures for the firm's executive officers and for any other covered persons who the board or 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;
- A description of any material changes in incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report was submitted; and
- A statement specifying why the covered financial institution believes the structure of its incentive-based compensation does not provide persons with excessive compensation or incentive-based compensation that could encourage those persons to take inappropriate risks and thereby lead to material financial loss at the covered financial institution.

The annual reports would be due within 90 days of the end of a covered financial institution's fiscal year. The proposed rule does allow for some flexibility, as it provides that the volume and detail of information provided should be commensurate with the size and complexity of the institution, as well as the scope and nature of its incentive-based compensation arrangements.

While the SEC states in the proposed rule that it intends to keep the reported information confidential to the full extent it is permitted to do so under the Freedom of Information Act, it also acknowledges that firms may nonetheless have concerns about potential disclosure of this type of information, which could be competitively sensitive. The SEC is seeking comment on any specific methods that could be used to minimize these concerns.

Covered investment advisers and broker-dealers should be aware that the information may be used by the SEC in determining whether firms are fulfilling the requirements of Section 956. In the proposal, the SEC specifically states that examiners would find these descriptions a useful starting point in an examination to make a risk assessment as to which areas of a firm's incentive-based compensation arrangements merit further examination.

Required policies and procedures

Finally, the proposed rule would require covered financial institutions to adopt and maintain policies and procedures reasonably designed to address the proposal's reporting requirements and prohibitions. According to the proposal, the policies and procedures developed should be appropriately tailored to balance risk and reward, taking into account the institution's size, complexity, and business activity, as well as the scope and nature of its incentive-based compensation arrangements. The policies and procedures must, at a minimum:

- Be consistent with the disclosure requirements and prohibitions set forth in the proposed rule;
- Ensure that risk management, risk oversight, and internal control personnel have an appropriate role in designing incentive-based compensation arrangements and assessing their effectiveness in restraining inappropriate risk-taking;
- Provide for the monitoring, by a group or person independent of the covered person, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes, to determine whether incentive-based compensation payments are reduced to reflect adverse risk outcomes or high levels of risk taken;[8]
- Require that a firm's board of directors, or a committee thereof, receive data and analysis from management and other sources sufficient to allow it to assess whether the overall design and performance of the firm's incentive-based compensation arrangements are consistent with Section 956 of the Act; and
- Maintain documentation of the institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements sufficient to enable the institution's appropriate regulator to determine the firm's compliance with Section 956 of the Act and the proposed rule. Documentation would include, but would not be limited to:
    - A copy of the covered financial institution's incentive-based compensation arrangements(s) or plan(s);
    - Names and titles of individuals covered by such arrangement(s) or plan(s);
    - Records of incentive-based compensation awards made under the arrangement(s) or plan(s); and
    - Records reflecting the persons or units involved in the approval and ongoing monitoring of the arrangement(s) or plan(s).

In addition, the proposal would require that covered financial institutions' policies and procedures include certain features when they use deferral in connection with an incentive-based compensation arrangement, and that the policies and procedures subject incentive-based compensation arrangements to an appropriate corporate governance framework.[9]

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[8] To be considered independent under the proposed rule, and to ensure that their analysis of risk is unbiased, the person or group assessing incentive-based compensation awards must have a separate reporting line to senior management from the covered person who is creating the risks.

[9] The proposal does not include policies and procedures regarding personal hedging strategies. The Agencies state they are aware that covered persons may employ personal hedging strategies to lock in value for equity compensation, and are concerned that to the extent personal hedging strategies may be widespread, such

The policies and procedures an entity will establish are not meant to be "one size fits all," and the proposed rules clearly allow for consideration of the size and complexity of the organization. When determining appropriate policies and procedures, covered financial institutions should consider the underlying principles of this legislation, including the impact incentive compensation can have on inappropriate risk taking, the potential for material financial loss, etc.

If adopted as proposed, the rule would have significant impact on covered financial institutions and their covered officers, directors, and other employees. Firms should begin to assess whether they would be covered and which of their personnel would be impacted, and should start to assess their existing compensation schemes in light of the guidance provided in the proposed rule. Covered firms should also start to assess the operational, governance, and human resources impact of the requirements.

practices would serve to diminish the effectiveness of a covered financial institution's policies and procedures. Thus, the Agencies are considering whether a covered financial institution's policies and procedures should be required to specifically include limits on personal hedging strategies, and are requesting comment regarding the extent to which firms presently prohibit such practices among their covered persons.

While Dodd-Frank will have an impact on executive compensation, many implementation issues are currently unclear and the SEC will need to fully digest comments received from constituents before promulgating final rules. PwC will continue to monitor developments and provide you with updates, which will be available at www.pwcregulatory.com.

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