New Federal Initiatives Project

Federal Agencies Propose Rules on Incentive-Based Compensation at Financial Institutions

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August 9, 2011

The Federalist Society
for Law and Public Policy Studies

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Federal Agencies Propose Rules on Incentive-Based Compensation at Financial Institutions

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") requires seven federal agencies, including the FDIC and the SEC,[1] to jointly adopt rules regulating incentive-based compensation arrangements at "covered financial institutions" that are excessive or that could lead to material financial loss.

On April 14, 2011, these agencies published a proposed rule implementing Section 956 of Dodd-Frank,[2] kicking off a 45-day comment period that expired on May 31, 2011. The regulators are now in the process of jointly reviewing the comments submitted. They are expected to make the terms of the proposed rule, if adopted, effective six months from publication of the final rule in the Federal Register. Given the current timeframe, the final rule may become effective in the first quarter of 2012.

In general, the proposed rule:

- Prohibits "covered financial institutions" (generally, regulated entities with consolidated assets of $1 billion or more)[3] from maintaining incentive-based compensation arrangements that:
    - encourage "inappropriate risks" that could lead to "material financial loss" at such institution, or
    - encourage "inappropriate risks" by providing "excessive compensation."

  It is important to note that "incentive-based compensation" is defined broadly to include any variable compensation that serves as an incentive for performance.

- Requires executive officers at larger covered financial institutions (those with consolidated assets of $50 billion or more) to defer at least 50% of their incentive-based compensation for a period of at least three years. Deferred amounts must be subject to adjustment for actual losses of the covered financial institution, or based on other measures of performance, during the deferral period.
- Requires boards of larger covered financial institutions to approve all incentive-based compensation arrangement for certain designated employees that the board determines 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."
    - In approving these arrangements, the board must determine that the arrangement effectively balances (through methods such as deferral, risk-weighting and longer performance periods) the financial rewards to the individual with the range and time horizons of risks associated with the individual's activities.

- Requires covered financial institutions to provide, within 90 days of the end of their fiscal year, an annual report to the appropriate federal agency to determine compliance with the rule requirements.
  - Among other things, the annual report must detail the components of incentive arrangements and provide a description of the reasons why the covered financial institution believes that the incentive arrangements do not provide excessive compensation and do not provide incentive to engage in actions leading to a material financial loss.

The proposed rule adopts a principles-based approach, reflecting a view that "supervision and regulation of incentive compensation, as with other aspects of financial oversight, can play an important role in helping ensure that incentive compensation practices at covered financial institutions do not threaten their safety and soundness." The proposed rule is broad in scope and lacks specificity as to how certain terms should be applied.

The agencies have received hundreds of comments on the proposed rule.[4] Below is a summary of some of the significant comments and criticisms:

- *First*, critics of the proposed rule have argued that it is problematically vague and contains little guidance on its application. For example, terms such as "inappropriate risk" are not defined. Other concepts, such as "excessive compensation," are defined in terms of principles, such as whether the compensation is "unreasonable or disproportionate to" the services performed by the person. However, notwithstanding factors set forth in the proposed rule, little guidance is given as to how to apply the concept of "excessive compensation" to specific situations.[5] Thus, some have argued that "[r]esponsibility for confronting the operational issues embedded in the rule is punted to covered institutions and their boards of directors without offering much constructive guidance."[6]

- *Second*, it is unclear whether existing entitlements to incentive-based compensation arrangements would be grandfathered under the proposed rule. Without such grandfathering treatment, the proposed rule could potentially result in the impairment of existing contractual obligations, which raises a number of legal and policy questions.

- *Third*, critics have argued that the proposed rule would lead to unintended consequences. For example, it is possible that, to comply with limits on incentive-based compensation, institutions will increase the amount of fixed compensation (such as salary). Some may question whether institutions and their stakeholders would really benefit from shifting significant amounts of compensation *from* types that incentivize, and are linked to, performance *to* non-performance-based compensation.

- *Fourth*, questions have been raised as to whether the proposed rule would have an adverse competitive impact on covered institutions. For example, would the rule adversely impact their ability to attract and retain talented executives? Would institutions take action to avoid application of the rule? (For example, would a

foreign bank with a U.S. subsidiary move assets out of the U.S. to avoid being a covered financial institution?) Further, are some of the provisions (such as the deferral requirement at larger institutions) too prescriptive and, by being "one-size-fits-all", not flexible enough to allow institutions to best tailor compensation to meet their specific circumstances?

- *Finally*, some may question the extent to which the proposed rule would lead to second guessing of boards and increased risk of litigation. As a general matter, compensation decisions at companies traditionally have been made by boards, with courts generally giving deference to their business judgments. Arguably, the proposed rule invites regulators to second-guess decisions made under the broad and vague standards imposed.

In short, the proposed rule responds to a legislative concern that executive compensation at financial institutions has sometimes been misaligned with long-term performance and risk management. Critics raise questions as to whether the proposed rule achieves or undermines the intended policy goals.

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[1] The federal agencies include the Securities and Exchange Commission, National Credit Union Administration, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Office of Thrift Supervision, and Federal Housing Finance Agency.

[2] 76 Fed. Reg. 21170 (Apr. 14, 2011), *available at* http://edocket.access.gpo.gov/2011/pdf/2011-7937.pdf.

[3] The proposed rules apply to the following "covered financial institutions," among others, with consolidated assets of $1 billion or more.

- Banking organizations (*e.g.*, state banks, federally-chartered banks and savings associations, bank holding companies, thrift holding companies, and credit unions).
- Registered brokers or dealers.
- Investment advisors.
- Fannie Mae and Freddie Mac.
- Any other financial institution that the appropriate federal regulators jointly by rule determine should be treated as a covered financial institution.

[4] Letters commenting on the proposal can be found here: http://www.sec.gov/comments/s7-12-11/s71211.shtml.

[5] The rules provide factors to be considered when making a determination regarding possible "excessive compensation," including:

- The combined value of all cash and non-cash benefits provided to a covered person.
- Historical compensation of the covered person in comparison to other individuals with comparable expertise at the covered financial institution.

- The institution's financial condition.
- Comparable compensation practices at comparable institutions (based upon such factors as asset size, geographic location, complexity of operations and assets).
- Projected total cost and benefit of post-employment benefits.
- Any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse.
- Any other factors the federal agencies determine relevant.

[6] Statement of the Shadow Financial Regulatory Committee (Feb. 14, 2011), *available at* http://fic.wharton.upenn.edu/fic/policy%20page/Statement%20No.%20305.pdf.

Related Links:

Section 956 of the Dodd-Frank Act can be found here: http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/content-detail.html.

Section 956 requires that regulators, in adopting the implementing rule, take into consideration compensation standards that already apply to insured depository institutions under Section 39(c) of the Federal Deposit Insurance Act. Thus, entities that are not subject to the FDIA standards (such as investment advisers and brokers) may be impacted by the proposed rules more than other entities. Section 39 can be found here: http://www.fdic.gov/regulations/laws/rules/1000-4100.html.

The SEC voted to propose the rules with two dissenting votes. Commissioner Troy Paredes' statement against the rule can be found here: http://www.sec.gov/news/speech/2011/spch030211tap-icomp.htm, and Commissioner Kathleen Casey's statement can be found here: http://www.sec.gov/news/speech/2011/spch030211klc-icomp.htm.

For an additional discussion of execution compensation issues, including compensation at financial institutions, see postings at the The Harvard Law School Forum on Corporate Governance and Financial Regulation, which can be found here: http://blogs.law.harvard.edu/corpgov/category/executive-compensation/.