

Client Alert

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FDIC Approves Rules to Implement Dodd-Frank Limits on Incentive Pay Risk at Financial Institutions

New Mandatory Deferrals for Executive Officers of Biggest Institutions

Moving the U.S. closer to some international pay standards, the Federal Deposit Insurance Corporation has approved Proposed Rules¹ to more closely regulate the use of incentive compensation arrangements (ICAs) at certain financial institutions with consolidated assets of at least \$1 billion.

The new regulations create a framework for implementing and enforcing Section 956 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. The other regulators² co-issuing the Proposed Rules are expected to formally approve the text within the next several weeks, after which the rules will be published in the *Federal Register*. There will then be a 45-day comment period.

In a nutshell, the Proposed Rules would provide for:

- **Prohibition of ICAs to covered individuals that encourage inappropriate risk by:**
 - Providing excessive compensation; or
 - Creating a potential for material financial loss
- **Special rules for institutions with assets greater than \$50 billion**
 - Mandatory deferral of a substantial portion of ICAs to executive officers
 - Enhanced internal review and approval of ICAs for other individuals who have the ability to expose the CFI to significant loss
- **Annual reporting of the structure of ICAs**
 - Requires annual reports to the appropriate regulator
- **Policies and procedures to enforce Section 956**
 - Requires policies and procedures for ICAs that are commensurate with the size and complexity of the institution

¹ For complete text of this release, see: <http://www.fdic.gov/news/board/2011rule2.pdf>

² Prior to their publication in the *Federal Register*, the Proposed Rules also must be separately approved by the five federal members of the Federal Financial Institutions Examination Council (FFIEC); the Securities Exchange Commission (SEC); and the Federal Housing Finance Agency (FHFA).

Scope and Definitions

It is important to understand that the Proposed Rules only apply to incentive compensation paid to certain individuals at certain regulated institutions. They are defined as follows:

- **Covered Financial Institutions** (CFIs): Institutions with consolidated assets of at least \$1 billion that are overseen by Appropriate Federal Regulators. They are defined as banking organizations (including national banks and branches of certain foreign banks); credit unions; broker-dealers; investment advisors; Fannie Mae; Freddie Mac; the Office of Finance; and the Federal Home Loan Banks.
- **Larger Covered Financial Institutions** (Larger Institutions): CFIs with consolidated assets of at least \$50 billion.
- **Appropriate Federal Regulators** (Regulator): Those responsible for overseeing these rules at each CFI, including the OCC, Federal Reserve, FDIC, OTS, NCUA, SEC and FHFA.
- **Incentive-Based Compensation** (ICA): Broadly defined as any variable payments provided as an incentive for performance. It *excludes* payments tied solely to continued employment such as salary, 401k contributions, or dividends and appreciation realized on stock or other equity instruments owned outright.
- **Covered Persons**³: Executive Officers, employees, Directors or principal shareholders (10% owners). Some of the Proposed Rules apply only to Executive Officers and/or certain other subsets of Covered Persons, as discussed elsewhere in this Alert.
- **Executive Officers**: Those with the title or function of any of the following positions: President, CEO, Executive Chairman, COO, CFO, CIO, Chief Lending Officer, Chief Legal Officer, Chief Risk Officer, or head of a major business line.

Rule #1: Prohibitions

The Proposed Rules prohibit ICAs that encourage inappropriate risk: (i) by providing “Excessive Compensation” or (ii) that could lead to a “Material Financial Loss.”

Excessive Compensation is defined as payments to any Covered Persons that are unreasonable or disproportionate to the amount, nature, quality, and scope of services performed. In making that determination, Regulators will consider the following factors:

- The combined value of all cash and non-cash benefits provided to the Covered Persons;
- The compensation history of the Covered Person and other individuals with comparable expertise at the CFI;
- The financial condition of the CFI;
- Comparable pay practices at comparable CFIs, based upon factors such as asset size, geographic location, and the complexity of their operations and assets;
- The projected total cost and benefit to the CFI of any post-employment payments;
- Any connection between the individual and a fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse regarding the CFI; and
- Any other factors considered relevant.

³ The Proposed Rules also contain an anti-abuse section that prohibits evasion of the rule by outsourcing for the sole purpose of classifying individuals as consultants who would ordinarily be Covered Persons.

PM&P Observation: Information regarding comparable pay practices will be difficult to obtain for non-public CFIs, and may in fact only be accessible by the Regulator. As a result, many private CFIs may have little opportunity to understand in advance what their respective Regulator considers to be appropriate.

Material Financial Loss: This term is not specifically defined. However, the Proposed Rules are clear that ICAs will be assumed to promote inappropriate risk that could lead to Material Financial Loss unless they meet the following three standards, which are consistent with the Guidance on Sound Incentive Compensation Policies issued by the Regulators in 2010⁴:

- A balance between risk and financial rewards (e.g., through deferral, risk adjustment of awards, longer performance periods, or reduced sensitivity to short-term performance);
- Compatibility with effective controls and risk management; and
- Strong corporate governance.

It is important to note that unlike the Excessive Compensation standard, the Material Financial Loss standard does not apply to all Covered Persons, but only to:

- Executive Officers;
- Non-executive employees whose activities could expose the CFI to Material Financial Loss (e.g., traders); and
- Groups of Covered Persons subject to the same or similar ICAs and who, in the aggregate, could expose the CFI to a Material Financial Loss (even if acting alone they would not create that level of risk).

Special Prohibitions and Requirements for Larger CFIs with at least \$50 billion in total consolidated assets:

- Mandatory Deferral for Executive Officers:
 - At least 50% of ICAs for Executive Officers must be deferred over at least three years, although pro-rata payments are permitted during that period.
 - Any payouts must be adjusted for actual losses, or for other measures, aspects, or performance that are realized or become better known during the deferral period.

PM&P Observation: While at first blush this new rule seems onerous, in practice it may have minimal impact, depending on the total compensation package. For example, a typical pay structure for an Executive Officer may consist of 30% fixed pay (i.e., salary), and 70% incentive pay (usually split between annual bonus and long-term incentives). Many long-term incentive programs consist of options or restricted stock that already vest over a 3-year period, in which case 50% of the ICA inherently complies with the new deferral mandate. However, vested payments would still be subject to recoupment if other losses become apparent over the subsequent three years.

⁴ For a more detailed explanation of this Guidance, see our Client Alert dated June 30, 2010 at <http://pearlmeyer.com/Pearl/media/PearlMeyer/PDF/PMP-CA-FederalReserveJoinsForces-6-10.pdf>.

- Special Review and Approval for Designated Covered Persons
 - The Board or Committee must identify Covered Persons (other than Executive Officers) who could expose the institution to substantial losses relative to the Larger CFI's size, capital or overall risk tolerance (e.g., traders with large position limits).
 - The Board or Committee must document its approval of ICAs to such individuals, based on its determination that the financial rewards are balanced with the range and time horizon of the risks associated with the employee's activities.
 - Evidence of such balance could include deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or extended performance periods.
 - The Board or Committee must evaluate the overall effectiveness of the balancing methods used in the ICA in reducing incentives for inappropriate risk taking, as well the ability of the methods used to make payments sensitive to all the risks arising from the employee's activities, including those that may be difficult to predict, measure or model.

PM&P Observation: While mandatory deferral applies only to Executive Officers, some CFIs may choose to reinforce the balancing mandate under the Proposed Rules by including other groups of Covered Persons in the three-year deferral program.

Rule #2: Annual Reporting

CFIs must submit annual reports to their Regulator that describe the structure of the ICA for the Covered Persons that demonstrates whether it provides Excessive Compensation or promotes inappropriate risk-taking that could result in Material Financial Loss. Those reports will be kept confidential.

The format must be succinct, but include:

- A clear narrative description of the components of the applicable ICAs and Covered Persons to which they apply.
 - Individual compensation does **not** need to be provided;
- A brief description of the ICA policies and procedures;
- Any material changes made to those policies and procedures since the CFI's last report was submitted; and
- The specific reasons for determining the ICA will not provide Excessive Compensation or encourage behavior likely to cause a Material Financial Loss.

The length and scope of the report should be commensurate with the size and complexity of the CFI, as well as the scope of its ICAs. Thus, the level of detail expected from a large, complex CFI that uses multiple incentive arrangements for many individuals would be substantially greater than for a smaller institution with only a limited number of ICAs or participants.

Special Reporting Rule for Larger CFIs only: Larger CFIs must include an annual description of any ICAs provided to Executive Officers or other Covered Persons that their Board or Committee determines could create exposure for substantial losses relative to its size, capital, or overall risk tolerance.

Rule #3: Policies and Procedures

CFIs must maintain policies and procedures that promote compliance under the Proposed Rules. At a minimum, they should:

- Be consistent with the reporting requirements and prohibitions in the Proposed Rules;
- Ensure the participation of risk management, risk oversight, and internal control personnel in all phases of ICA design and oversight;
- Provide for monitoring of ICAs, risks taken, and actual risk outcomes by a person or group independent of Covered Persons;
- Provide data to the CFI's Board or Committee from management or outside sources sufficient to allow the Board or Committee to assess if the overall design and performance of the ICAs are consistent with Section 956;
- Maintain sufficient documentation regarding the establishment, implementation, modification and monitoring of ICAs to determine compliance with Section 956;
- Ensure all deferral programs are appropriate to the scope and potential risk impact of the individual's duties and responsibilities, as well as the size and complexity of the CFI;
- Require the Board or Committee to provide ongoing oversight of ICAs; and
- Require the Board or Committee to approve any ICA for its Executive Officers.

Conclusion

While the Proposed Rules appear to be expansive in scope and requirements, in practice many of the mandates (with the exception of the 50% ICA deferrals for Executive Officers) duplicate the Guidance on Sound Incentive Compensation Policies issued last year.

Nevertheless, CFIs should prepare to comply with the Proposed Rules as written. While public comments will be accepted for 45 days after publication in the *Federal Register* (pending), typically few changes have been incorporated. The Final Rules are expected to become effective six months after publication in the *Federal Register*, with the first annual reports due within 90 days of each CFI's fiscal year. For most institutions, this will mean second quarter of 2012.

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**NEW YORK**

570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA

One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON

132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE

3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO

123 N. Wacker Drive, Suite 1225
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON


Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LOS ANGELES

550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN JOSE

2880 Zanker Road, Suite 203
San Jose, CA 95134
(408) 954-7399
sanjose@pearlmeyer.com



www.pearlmeyer.com