Background

Covered Financial Institution

Individuals Affected Under the Proposed Rule

Proposed Rule

Conclusion

The Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Office of Thrift Supervision, Treasury; National Credit Union Administration ("NCUA"); U.S. Securities and Exchange Commission ("SEC"); and the Federal Housing Finance Agency ("FHFA") (collectively, the "Agencies") issued a joint proposed rule (the "Proposed Rule") on February 7, 2011 to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which generally prohibits incentive-based compensation practices at "covered financial institutions" (as defined below) which encourages inappropriate risk-taking. The Proposed Rule would require the reporting of incentive-based compensation arrangements by a covered financial institution and prohibit incentive-based compensation arrangements at the covered financial institution that are deemed to be excessive, or that may expose the institution to inappropriate risks that could lead to a material financial loss. In addition, the Proposed Rule would establish standards for determining whether an incentive-based compensation arrangement violates the above prohibitions.

Background

The Act, signed into law by President Obama on July 21, 2010, contains a number of significant new executive compensation and corporate governance requirements generally applicable to publicly traded companies, or issuers, in the United States (unlike other of the executive compensation and corporate governance provisions of the Act, Section 956 may apply to certain agencies, branches or subsidiaries of certain foreign institutions).

Specifically, Section 956 of the Act requires that the Agencies prohibit incentive-based payment arrangements (or any feature of such arrangement) at a covered financial institution that the Agencies determine encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to a material financial loss. The Act also requires each covered financial institution to disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements that is sufficient to allow the regulator to make such a determination, however it does not require a covered financial institution to report the actual compensation of particular individuals.

Covered Financial Institution

Under the Act, a "covered financial institution" is generally defined as an entity that has $1 billion or more in total consolidated assets, and that is either a depository institution or depository holding company, broker-dealer, credit union, investment adviser, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation or any other financial institution that the appropriate Federal regulators determine should be covered.

The Proposed Rule generally expands the definition of a covered financial institution beyond those entities specifically listed in the Act by proposing to also include as covered financial institutions the (i) uninsured branches and agencies of a foreign bank, as well as other U.S. operations of foreign banking organizations that are treated as bank holding companies pursuant to Section 8(a) of the International Banking Act of 1978, (ii) Federal Home Loan Banks, and (iii) Office of Finance (an agent of the Federal Home Loan Banks). In addition, the Proposed Rule proposes additional requirements (as discussed below) that would generally apply to covered financial institutions with $50 billion or more in total consolidated assets.

If you would like to know more about the subjects covered in this publication or our services, please contact:

Jeffrey A. Lieberman +1 212 878 8013

Robert A. Stone +1 212 878 8144

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA
www.cliffordchance.com

Individuals Affected Under the Proposed Rule

- The requirements of the Proposed Rule would only apply to an "incentive-based compensation" arrangement that is paid to a "covered person" in exchange for services rendered to a covered financial institution (each term, as defined below).
  - The term "incentive-based compensation" generally means any variable compensation that serves as an incentive for performance (regardless of the form of payment (i.e., whether it is in the form of cash, equity award or other property)), but does not generally include, for example, compensation payable solely for continued service.
  - A "covered person" is generally defined as any executive officer, employee, director or principal shareholder of a covered financial institution.
    - A "principle shareholder" is generally defined as an individual that directly or indirectly owns, controls or has the power to vote 10% or more of any class of voting securities of a covered financial institution.

Proposed Rule

The Proposed Rule establishes general requirements applicable to incentive-based compensation arrangements of all covered financial institutions. It is intended to supplement existing rules, guidance, and ongoing supervisory efforts of the Agencies. As a general matter, the Proposed Rule has three main components: required disclosure, prohibitions on incentive arrangements which encourage excessive risk, and policies and procedures, some of the more notable provisions of which are highlighted below.

Required Reports to Regulators

The Act requires a covered financial institution to submit an annual report to its appropriate Federal regulator disclosing the structure of its incentive-based compensation arrangements that is sufficient to determine whether such compensation structure provides covered persons with excessive compensation, fees, or benefits, or could lead to material financial loss to the covered financial institution. To implement this requirement, covered financial institutions would be required to submit an annual report to the appropriate Federal regulator in a specified format, the contents of which must include the following:

- a clear narrative description of the components of the incentive-based compensation applicable to covered persons, and the types of covered persons to which they apply;
- a succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements;
- for "larger covered financial institutions",[1] a description of any specific incentive compensation policies and procedures for its' executive officers, and other covered persons who the board of directors, or committee thereof, determines individually to 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;
- any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report was submitted; and
- the specific reasons the covered financial institution believes the structure of its incentive-based compensation does not provide covered persons with incentives to engage in behavior that is likely to cause it to suffer a material financial loss, and is not excessive.

Prohibitions

The Proposed Rule prohibits a covered financial institution from maintaining incentive-based compensation arrangements that may encourage inappropriate risk-taking by providing excessive compensation or that could lead to a material financial loss, and establishes standards for determining whether an incentive-based compensation arrangement violates these prohibitions.

Excessive Compensation. In general, under the Proposed Rule, a covered financial institution may not establish or maintain any incentive-based compensation arrangement, or feature thereof, that encourages a covered person to expose the institution to inappropriate risks by providing that person with "excessive compensation." Required by the Act to use

[1] Generally, "larger covered financial institutions" means (i) for the Federal banking agencies and SEC, covered financial institutions with total consolidated assets of $50 billion or more; (ii) for NCUA, all credit unions with total consolidated assets of $1 billion or more; (iii) and for FHFA, all Federal Home Loan Banks with total consolidated assets of $1 billion or more.

© Clifford Chance US LLP February 2011

compensation standards comparable to those established under Section 39 of the Federal Deposit Insurance Act ("FDIA"), the Proposed Rule instructs that compensation would be considered excessive if amounts paid are disproportionate or unreasonable to the amount, nature, quality and scope of services performed by the covered person, among other factors. The following factors will be considered by the Agencies when making such a determination:

- the 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;
- the financial condition of the covered financial institution;
- comparable compensation practices at similar 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 benefits to the 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 appropriate Agency considers relevant.

Inappropriate Risks that May Lead to a Material Financial Loss. The Proposed Rule also prohibits a covered financial institution from establishing or maintaining any types of incentive compensation arrangements, or any features thereof, for covered persons or groups of covered persons, that could lead to a material financial loss to the covered financial institution. Specifically, an incentive-based compensation arrangement will not comply with the Proposed Rule unless it (i) balances the risks and financial rewards[2], (ii) is compatible with effective controls and risk management and (iii) is supported by strong corporate governance practices.

Balancing the Risks and Financial Rewards. In structuring incentive-based compensation to appropriately balance risks and financial rewards, the covered financial institution must consider the full range of risks associated with a covered person's activities (i.e., credit, market, liquidity, operational, legal, compliance, and reputational), as well as the time horizon over which those risks may be realized. The Proposed Rule identifies four methods often used to make compensation more sensitive to risk, specifically: (i) risk adjustment of awards (i.e., the amount of compensation is adjusted based on factors that take into account the risk the covered person's activities pose to the institution); (ii) deferral of payment (i.e., the actual payout of an award is delayed significantly beyond the end of the performance period, and amounts paid are adjusted for actual losses or other aspects of performance); (iii) longer performance periods (i.e., the time period covered by the performance measures in determining an award is extended); and (iv) reduced sensitivity to short-term performance (i.e., the rate at which awards increase as higher levels of the relevant performance measures are achieved is reduced).

Compatibility with Effective Controls and Risk Management. According to the Proposed Rule, the risk management processes and internal controls of a covered financial institution should reinforce and support the development and maintenance of balanced incentive-based compensation arrangements. Covered financial institutions are expected to maintain strong controls governing its processes for designing, implementing and monitoring incentive-based compensation, and for ensuring that risk-management personnel have an appropriate role in the institution's processes to further this purpose.

Strong Corporate Governance. The Proposed Rule would require the board of directors of a covered financial institution, or committee thereof, to actively oversee its incentive-based compensation arrangements to ensure that the institution's incentive compensation arrangements are appropriately balanced (i.e., the board of directors should review and approve the overall goals and purposes of its incentive-based compensation system to ensure consistency with the institution's risk tolerance level).

Specific Deferral Requirements for Larger Covered Financial Institutions. For larger covered financial institutions, the Proposed Rule would require at least 50 percent of the incentive-based compensation of an executive officer to be deferred over a period of at least three years, with deferred amounts adjusted for actual losses or other measures of performance that are realized during the deferral period. While U.S. rules have generally not required specific pay practices, this deferral requirement is consistent with international standards that establish the expectation that large interconnected firms require the deferral of a substantial portion of incentive-based compensation for certain employees for a fixed period of time not less than three years (i.e., Financial Stability Board, FSF Principles for Sound Compensation Practices, Basel, Switzerland (April 2009); Financial Stability Board, FSB Principles for Sound Compensation Practices: Implementation Standards, Basel,

[2] For example, with deferred payments, a risk adjustment of awards, longer performance periods or decreased sensitivity to short-term performance.

© Clifford Chance US LLP February 2011

Switzerland (September 2009)). In this regard, the Proposed Rule would also require that the board of directors, or committee thereof, (i) identify covered persons (other than executive officers) 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, (ii) approve the incentive-based compensation for such individuals and (iii) maintain documentation of such approval.

Policies and Procedures

According to the Proposed Rule, in order to foster transparency and promote compliance and accountability within a covered financial institution, incentive-based compensation practices must be supported by policies and procedures appropriate to the size, complexity and business activity, as well as the scope and nature of the covered financial institution's incentive-based compensation arrangements. To further this end, the Proposed Rule would require that, among other things:

- policies and procedures are designed to discourage inappropriate risks that provide covered persons with excessive compensation or that could lead to material financial losses;
- a group or person independent of the covered persons monitor incentive-based compensation awards, risks taken, and actual risk outcomes to determine whether such awards or payments are reduced to reflect adverse risk outcomes or high levels of risk taken;
- policies and procedures are developed to ensure that the board of directors, or committee thereof, receives sufficient data to enable it to assess whether the overall design and performance of incentive-based compensation are consistent with Section 956 of the Act; and
- the covered financial institution maintain sufficient documentation of its processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements sufficient to allow the institution's appropriate Federal regulator to determine whether such institution is in compliance with Section 956 of the Act and the Proposed Rule.

Conclusion

Although this is a joint-interagency rulemaking, each Agency may issue supplemental guidance specific to their regulated entities, including guidance to clarify the requirements set forth in the Proposed Rule.

Comments on the Proposed Rule will be accepted for 45 days after publication in the Federal Register.

This client memorandum does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Prague ■ Riyadh* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Tokyo ■ Warsaw ■ Washington, D.C.

* Clifford Chance also has a co-operation agreement with Al-Jadaan & Partners Law Firm in Riyadh

© Clifford Chance US LLP February 2011