

**MEMO# 25004**

March 4, 2011

# **SEC Proposes Rules on Incentive-Based Compensation Arrangements; Conference Call on Friday, March 11**

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TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 6-11  
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 14-11  
RISK MANAGEMENT COMMITTEE No. 3-11  
SEC RULES COMMITTEE No. 20-11 RE: SEC PROPOSES RULES ON INCENTIVE-BASED  
COMPENSATION ARRANGEMENTS; CONFERENCE CALL ON FRIDAY, MARCH 11

The Securities and Exchange Commission, jointly with six other federal financial regulators, has proposed a rule relating to incentive-based compensation practices at certain covered financial institutions, including investment advisers. [\[1\]](#) The rule implements Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

As explained more fully below, the proposed rule would: 1) prohibit incentive-based compensation arrangements that encourage inappropriate risks; 2) require covered financial institutions to make annual non-public reports to their primary regulators describing their incentive-based compensation arrangements; and 3) require the institutions to implement related policies and procedures. “Covered financial institutions” include, among others, broker-dealers and investment advisers with more than \$1 billion in total consolidated assets. Additional requirements apply to “larger covered financial institutions” with total consolidated assets of \$50 billion or more.

Comments on the proposal will be due 45 days after its publication in the Federal Register. We will have a conference call to discuss the proposal at 2:00 Eastern time on Friday, March 11. If you would like to participate in the call, please RSVP via email to Gwen Kelly at [gwen.kelly@ici.org](mailto:gwen.kelly@ici.org).

# Background

Dodd-Frank Section 956 requires seven financial regulators (the “Agencies”) [\[2\]](#) to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. The statute requires the Agencies to prohibit incentive-based payment arrangements, or any feature of any such arrangement, that the Agencies determine encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss. The statute also requires covered financial institutions to disclose to its appropriate regulator the structure of its incentive-based compensation arrangements.

## Main Components of the Proposed Rule

The proposed rule has three main components:

- **Prohibitions.** The proposed rule would prohibit incentive-based compensation arrangements that encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss.
- **Policies and Procedures.** The proposed rule would require covered financial institutions to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based compensation.
- **Non-public Reporting.** The proposed rule would require covered financial institutions to provide certain information to their appropriate Federal regulator concerning their incentive-based compensation arrangements.

Each of these is described more fully below.

## Key Definitions

There are a number of defined terms in the proposed rule, including:

- **“Covered Financial Institution.”** Only covered financial institutions that have total consolidated assets of \$1 billion or more would be subject to the proposed rule. Covered financial institutions include certain banking institutions, broker-dealers, and investment advisers. The proposing release explains that for investment advisers, asset size would be determined not by assets under management, but rather by the adviser’s total assets shown on the balance sheet for the adviser’s most recent fiscal year end.
- **“Covered Person.”** Only incentive-based compensation paid to “covered persons” would be subject to the requirements of this proposed rule. A “covered person” includes any executive officer, employee, director, or principal shareholder of a covered financial institution.
- **“Executive Officer.”** Certain of the additional restrictions on larger covered financial institutions apply to “executive officers.” The proposed rule defines “executive

officer” of a covered financial institution 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 lending officer, chief legal officer, chief risk officer, or head of a major business line.

- “Incentive-based Compensation.” The proposed rule defines “incentive-based compensation” to mean any variable compensation that serves as an incentive for performance. The form of payment, whether it is cash, an equity award, or other property, does not affect whether compensation meets this definition.

## Prohibitions

The proposed rule contains two express prohibitions. First, “a covered financial institution must not establish or maintain any types of incentive-based compensation arrangements, or any feature of any such arrangements, that encourage inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.” The proposed rule contains implementing standards that provide that compensation is “excessive” when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration six specific factors, such as the total compensation package, the financial condition of the covered financial institution, and comparable packages at comparable institutions, plus “any other factors the [SEC] determines to be relevant.”

The second prohibition prohibits a covered financial institution from establishing or maintaining any incentive-based compensation arrangements for covered persons that “encourage inappropriate risks...that could lead to a material financial loss to the covered financial institution.” To comply, an arrangement must: 1) balance risk and financial rewards; 2) be compatible with effective controls and risk management; and 3) be supported by strong corporate governance, including active and effective oversight by the institution’s board. The proposed rule includes a list of specific, non-exclusive, methods that may be used to “balance” risk and reward, such as risk-adjusting rewards and using longer performance periods.

Larger covered financial institutions (those with \$50 billion or more in assets) are subject to two additional requirements:

- **Mandatory Bonus Deferrals for Executive Officers.** The proposed rule would require that at least 50 percent of the annual incentive-based compensation of an executive officer must be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis. Deferred amounts must be adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.
- **Identification of Other Risk-Takers.** The proposed rule would require that the board (or a committee) identify those 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. The board must approve the incentive-based compensation for these individuals.

## **Policies and Procedures**

The proposed rule would require covered financial institutions to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based compensation. At a minimum, these policies must:

- Ensure that risk-management, risk-oversight, and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;
- Provide for the monitoring of incentive-based compensation awards and payments, risks taken, and actual risk outcomes by an independent [\[3\]](#) group or person;
- Provide for the covered financial institution's board (or committee) to receive data and analysis from management and other sources; and
- Ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained.

## **Non-Public Reporting**

The proposed rule would require covered financial institutions to submit a report annually to the SEC that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons. 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, specifying 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;
- 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 plan does not provide covered persons incentives to engage in behavior that is likely to cause the covered financial institution to suffer a material financial loss, and does not provide covered persons with excessive compensation.

For larger covered financial institutions, the report must also contain a succinct description of any specific incentive compensation policies and procedures for the institution's executive officers, and other covered persons who the board or a committee thereof 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.

The proposing release notes that "the volume and detail of information provided annually by a covered financial institution should be commensurate with the size and complexity of the institution, as well as the scope and nature of its incentive-based compensation arrangements. As such, the Agencies expect that the volume and detail of information provided by a large, complex institution that uses incentive-based arrangements to a significant degree would be substantially greater than that submitted by a smaller institution that has only a few incentive-based compensation arrangements or arrangements that affect only a limited number of covered persons."

## **Next Steps; Proposed Effective Date**

When all of the federal agencies involved in the rulemaking approve their version of the proposed incentive-based compensation rule for public comment, the proposed rule will be published in the Federal Register. Once published, the public will be given 45 days to comment on the joint proposal.

The Agencies propose to make the rule effective six months after publication of the final rule in the Federal Register, with annual reports due within 90 days of the end of each covered financial institution's fiscal year.

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### **endnotes**

[1] SEC Release No. XXX (March 3, 2011). The release can be found on the SEC's website at <http://sec.gov/spotlight/dodd-frank/956-proposedrule-draft.pdf>.

[2] The seven regulators are the SEC, Office of the Comptroller of the Currency (OCC), Federal Reserve System (Fed), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), and the Federal Housing Finance Agency (FHFA).

[3] To be considered independent under the proposed rule, the group or person at the covered financial institution monitoring or assessing incentive-based compensation awards must have a separate reporting line to senior management from the covered person who is creating the risks.