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Legal Counsel

Client Alert

Proposed Rules Issued on Incentive Compensation of Financial Institutions

Prohibits Excessive Compensation and Excessive Risk-Taking Incentives; Includes Enhanced Reporting and Governance Obligations

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On February 7, 2011, federal regulators of financial institutions jointly issued proposed rulemaking ("Joint Proposed Rules") on Incentive-Based Compensation Arrangements under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Joint Proposed Rules generally apply to financial institutions with $1 billion or more in assets ("covered financial institutions") that maintain incentive-based compensation arrangements for certain executive officers, employees, directors and principal shareholders ("covered persons").

New Requirements

The Joint Proposed Rules:

- *Prohibit Payment of Excessive Compensation:* Covered financial institutions will be prohibited from maintaining incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risk by providing the covered person with "excessive" compensation;
- *Prohibit Excessive Risk-Taking Incentives:* Covered financial institutions will be prohibited from establishing or maintaining incentive-based compensation arrangements for covered persons that encourage inappropriate risks that could lead to a material financial loss;
- *Require Adoption of Appropriate Compensation Policies and Procedures:* Covered financial institutions will be required to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with the Joint Proposed Rules; and
- *Require Enhanced Regulatory Disclosure:* Covered financial institutions will be required to provide enhanced disclosure to regulators regarding their incentive-based compensation arrangements for covered persons within 90 days following the end of the fiscal year.

Observations

- The Joint Proposed Rules supplement all other compensation-related guidance applicable to a covered financial institution, including the Interagency Guidance on Sound Incentive Compensation Policies finalized in June, 2010.
- Covered financial institutions should be prepared to justify why their incentive-based compensation arrangements do not provide covered persons with excessive compensation or create excessive risk-taking incentives.
- Covered financial institutions should be prepared to develop written policies and procedures describing the process for establishing, implementing, modifying and monitoring incentive-based compensation arrangements. These procedures should involve the active involvement of the board of directors (or a committee) and appropriate risk-personnel.

- Covered financial institutions with assets of $50 billion or more will be required to defer at least 50 percent of the incentive-based compensation paid to executive officers for a period of at least three years. The amount deferred must be adjusted to reflect actual losses realized and performance measure that become known during the deferral period.
- All financial institutions, including those with $1 billion or less in assets, should be prepared for aspects of the Joint Proposed Rules to become "best practices" and be made applicable to them through regulators' periodic examinations and other reviews.

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