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The SEC has released proposed rules that would implement the Dodd-Frank Act's requirements for certain regulated financial institutions, including mandating periodic disclosure of the institution's incentive compensation arrangements and imposing restrictions on such arrangements in an attempt to avoid excessive compensation and material losses.

SEC Issues Proposed Rules Regarding Incentive-Based Compensation Arrangements for Certain Financial Institutions

By Warren Fusfeld

The Securities and Exchange Commission (SEC) released proposed rules on March 2, 2011, in connection with provisions of the Dodd-Frank Act that prohibit "covered financial institutions" from providing incentive-based compensation that encourages inappropriate risks, by providing either excessive compensation or incentives that could lead to material financial loss to the institution. The Dodd-Frank Act requires that the SEC and other regulatory agencies jointly establish rules that would require each "covered financial institution" to disclose to the applicable regulatory agency the structure of its incentive-based compensation arrangements so the regulator can determine whether such compensation is excessive or could lead to material financial loss to the firm. To the extent the agency determines that the arrangement encourages inappropriate risks (by providing excessive compensation or because it could lead to material financial loss to the institution), the arrangement would be prohibited.

The proposed rules, once finalized, will apply to any entity considered to be a "covered financial institution," which is defined as all institutions that have $1 billion or more in assets, including: depository institutions or depository institution holding companies; broker-dealers; credit unions; investment advisors; Fannie Mae; Freddie Mac; and any other financial institution that the relevant regulatory agencies determine should be treated as a covered financial institution. For purposes of the proposed rules, incentive-based compensation is any variable compensation that serves as an incentive for performance, other than base pay. Incentive awards may include awards paid in cash, equity or other property.

The proposed rules would apply the following to brokers, dealers and investment advisors (*i.e.*, firms subject to SEC regulation):

1. Require reporting of incentive-based compensation arrangements (to be filed annually with the SEC);
2. Prohibit incentive-based compensation arrangements that encourage inappropriate risk-taking by providing excessive compensation or incentives that could lead to material financial loss to the firm;
3. With respect to firms with $50 billion or more in assets, a significant portion of

incentive-based compensation payable to executive officers will be required to be deferred. In addition, board of directors' approval will be required with respect to the compensation of employees who could expose the firm to a substantial amount of risk in the course of performing their job duties (these requirements are further described below); and

4. Require institutions to develop policies and procedures that ensure and monitor compliance with requirements related to incentive-based compensation arrangements.

Annual Reporting. The annual reporting requirements would include that, within 90 days of the end of the firm's fiscal year, a report be submitted to the relevant regulatory agency providing a narrative description of the firm's incentive-based compensation arrangements, a succinct description of the firm's policies and procedures governing its incentive-based compensation arrangements, and a statement of the specific reasons why the firm believes its incentive-based compensation arrangement(s) will help prevent it from suffering a material financial loss or does not provide covered persons with excessive compensation.

Prohibition on Excess Compensation and Inappropriate Risk. The prohibition against encouraging inappropriate risk will apply to all individuals who are "covered persons" at the firm and will bar the firm from paying excessive compensation to such covered persons through an incentive-based compensation arrangement and from structuring its incentive-based compensation arrangement in a manner that could lead to material financial loss to the firm. For these purposes, the term "covered person" includes each executive officer, employee, director and principal shareholder of the firm.

Special Rules for Larger Institutions. The additional rules for larger financial institutions (with $50 billion or more in assets) will require that an incentive-based compensation arrangement for any executive officer include a deferral mechanism in which at least half of the incentive compensation is paid on a pro rata basis over a period of three years, with a provision for an adjustment to such payments in the event of firm losses after the compensation is awarded. For these purposes, the term executive officer will include the firm's president, CEO, executive chairman, COO, CFO, chief investment officer, chief legal officer, chief lending officer, chief risk officer and head of a major business line. The SEC is seeking comment regarding whether the list of persons covered should be modified.

In addition to a firm's executive officers (as defined above), a firm's board of directors (or a subcommittee) will be charged with identifying employees whose job functions include the establishment of policies that could expose the firm to possible substantial losses. The SEC provided as an example traders with large position limits (relative to the firm's risk tolerance). Once identified, any incentive-based compensation arrangement for such individuals would require board of directors' approval.

Policies and Procedures. Under the proposed rules, a covered financial institution would be barred from establishing an incentive-based compensation arrangement unless the arrangement has been adopted under policies and procedures developed and maintained by the institution and approved by its board of directors.

The proposed rules recognize the diversity of institutions covered by the rules and explicitly state that the policies and procedures should be commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation.

Effective Date. The SEC is seeking public comment on the proposed rule during the 45-day period following its publication. After comments are reviewed and a final version has been approved by the SEC and the other agencies charged with responsibility for these rules under the Dodd-Frank Act, the rule (in its final version) will be published in the Federal Register and is proposed to become effective six months after the date of publication.

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