



SEC Issues Proposed Rules on Incentive-Based Compensation Practices for Larger Broker-Dealers and Investment Advisers

On March 2, 2011, the SEC released a proposed rule regarding incentive-based compensation arrangements at “covered financial institutions” with \$1 billion or more in assets. The proposed rules are the product of a joint rulemaking effort undertaken by the SEC and other financial regulators pursuant to section 956 of the Dodd-Frank Act. Section 956 of Dodd-Frank requires the SEC and certain other agencies with regulatory authority over financial institutions to prescribe rules or guidelines that prohibit incentive-based compensation arrangements which encourage inappropriate risk-taking. The SEC and other agencies chose to enact rules rather than promulgate guidelines. While the rules are substantially similar from agency to agency, they are specifically tailored to address differences among the entities subject to regulation by the respective agencies. There will be a 45-day period for public comment on the proposed rules after publication in the Federal Register.

Summary of the Proposed Rules

The proposed rules would prohibit “covered financial institutions” with \$1 billion or more in assets from establishing or maintaining incentive-based compensation arrangements that would encourage “covered persons” from exposing the financial institution to inappropriate risks by providing “excessive compensation” or that “could lead to material financial loss” to the institution. Covered broker-dealers and investment advisers would be required to file a report with the SEC on an annual basis describing the institution’s incentive-based compensation arrangements in sufficient detail to enable the SEC to identify areas of concern. In addition, such institutions would be required to establish policies and procedures to ensure that incentive-based compensation arrangements do not encourage inappropriate risk.

Larger financial institutions with \$50 billion or more in assets would be subjected to a requirement that at least 50% of any incentive-based compensation award to an executive officer be deferred over a period of at least three years, and the deferred amounts would be subject to a claw-back in the event of losses. In addition, incentive-based compensation arrangements for executive officers and certain other employees at such larger financial institutions would have to be approved by the board of directors or an appropriate committee.

Which Broker-Dealers and Investment Advisers Are Covered?

The SEC proposes that (i) broker-dealers with total consolidated assets of at least \$1 billion reported in the firm's most recent-year end audited Consolidated Statement of Financial Condition filed pursuant to the Rule 17a-5 under the Exchange Act and (ii) investment advisers with total assets of at least \$1 billion shown on the balance sheet for the adviser's most recent fiscal year end be subject to the proposed rules. The SEC estimates that proposed rules would cover 132 registered broker-dealers and 68 investment advisers.

Whose Incentive-Based Compensation Arrangements are Covered?

Covered persons include executive officers, employees, directors, and principal shareholders.

Executive officers would include individuals holding the following roles: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, and any head of a major business line.

Directors would include members of the board of directors or a committee performing a similar function to a board of directors.

Principal shareholder would mean an individual who directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote ten percent or more of any class of voting securities of the institution.

With respect to employees, no specific categories of employees would be excluded, but the purpose of the proposed rule is to address the arrangements for employees who would be in a position to expose the institution to material financial loss. Traders with large position limits are an example of the type of non-executive employees who would be deemed "covered persons."

Which Incentive-Based Compensation Arrangements Would Be Prohibited?

The rule would prohibit incentive-based compensation arrangements that encourage inappropriate risk by providing for "excessive compensation" or that "could lead to material financial loss." The proposed rule sets forth broad standards as to what constitutes "excessive compensation," drawn largely from the standards set forth under the Federal Deposit Insurance Act. Compensation would be considered "excessive" if the amounts payable are "unreasonable" or "disproportionate" to the amount, nature, quality and scope of services performed for such compensation. Factors that may be considered in evaluating the reasonableness of compensation include (i) the combined cash value of all cash and non-cash benefits to the covered person, (ii) the compensation history of the covered person or other individuals with comparable experience at the covered financial institution, (iii) financial condition of the covered financial institution, (iv) comparable compensation practices of other comparable institutions, (v) for post-employment benefits, the projected total cost and benefit to the covered financial institution, (vi) any connection to fraud against or breach of trust or fiduciary duty to the covered financial institution, and (vii) any other factors deemed relevant by the SEC.

Incentive-based compensation arrangements would also be prohibited if they fail to balance risk and financial reward. The proposed rule identifies several non-exclusive methods for balancing risk and reward, including deferral of payments significantly beyond the end of the performance period, risk adjustment of awards, utilizing longer performance periods to determine the amount of any award and reducing the sensitivity of award amounts to short-term performance metrics. Incentive-based compensation arrangements would be deemed inappropriate if they are not compatible with effective controls or risk management and are not supported by strong corporate governance, including active and effective oversight by the board of directors or an appropriate committee.

What Must be Reported to the SEC?

Under the proposed rules, covered broker-dealers and investment advisers would be required to report annually to the SEC about their incentive-based compensation arrangements. The proposed rule requires reports that are succinct but that would include sufficient detail to enable the SEC to determine if there are areas of concern that need to be addressed. Information about incentive-based compensation need not be reported at an individual level. Rather, the report would contain a clear narrative description of the components of incentive-based compensation arrangements, a description of the types of covered persons eligible to participate in such compensation arrangements and a description of the policies and procedures governing the incentive-based compensation arrangements. The reports would describe any material changes in incentive-based compensation arrangements from the prior report and would include an explanation of the reasons the covered financial institution believes its incentive-based compensation arrangements do not encourage excessive risk-taking. Such reports would generally be treated as confidential and not available to the public.

What Policies and Procedures Must be Adopted?

Covered broker-dealers and investment advisers would be required to develop and maintain policies and procedures reasonably designed to ensure and monitor compliance with the new rules regarding incentive-based compensation. Such policies and procedures must be commensurate with the size and complexity of the institution, as well as the scope and nature of its use of incentive-based compensation. At a minimum, the policies and procedures would be required to (i) ensure that appropriate risk-management and oversight personnel have a role in designing incentive-based compensation arrangements and assessing the effectiveness of such arrangements in restraining inappropriate risk-taking; (ii) provide for monitoring by an independent body of risks taken and actual risk outcomes to determine whether incentive-based compensation arrangements should be reduced; (iii) provide for the board of directors or an appropriate committee to receive data and analysis from appropriate sources sufficient to determine whether the institution's incentive-based compensation arrangements are consistent with the proposed rules; (iv) ensure that the institution's documentation of its processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements are sufficient for the SEC to determine compliance with the proposed rules; and (v) subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing board or committee oversight, including approval, by the board or an appropriate committee, of such arrangements for executive officers.

Special Rules Applicable to Institutions with \$50 Billion or More in Assets

Covered financial institutions with \$50 billion or more in assets would be subject to additional requirements. The SEC estimates that the additional requirements would be applicable to 18 broker-dealers and 7 investment advisers. The additional requirements applicable to such institutions provide that at least fifty percent (50%) of any incentive-based compensation arrangement for an executive officer must be deferred over a three-year period. Deferred amounts could not be paid out any faster than on a pro-rata basis over the deferral period (e.g., for a three year deferral, no more than 1/3 of the deferred amount may be paid in any year). The deferred amounts would be subject to adjustment, or a clawback, to reflect actual losses that are realized or become known during the deferral period. Larger financial institutions would be required to establish policies and procedures to ensure that appropriate adjustments are made to any incentive-based compensation which has been deferred. The board of directors or an appropriate committee would also be required to identify individuals in addition to executive officers who have the ability to expose the institution to material financial loss (e.g., traders with large position limits) and specifically approve incentive-based compensation arrangements for such individuals, documenting the board or committee's consideration of potential methods to balance the benefits of the arrangement with the potential risks.

Dissenting View at the SEC

The SEC voted to release the proposed rules by a 3-2 vote, with Commissioners Casey and Paredes dissenting. In their comments, the dissenting commissioners expressed concerns about the prescriptive nature of the rules, in particular with respect to the minimum three-year deferral for executives of larger covered financial institutions. They also questioned the wisdom of the SEC passing on compensation arrangements given the diverse range of financial institutions covered by the proposed rules and the varied and complex issues that must be weighed in establishing executive compensation arrangements. The dissenters noted the risk of unintended consequences and expressed concern that excessive regulation of compensation arrangements might stifle innovation and appropriate risk-taking.

SEC Chairman Mary Schapiro noted that the SEC wants to be “very attuned to unintended consequences” to broker-dealers and investment advisers,¹ and that the SEC has therefore requested comment on, among other things, (i) the potential impact on broker-dealer and investment manager business models and the variety of services offered by such institutions and (ii) the impact on the ability of such institutions to retain talent.

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¹ Speech by SEC Chairman: Opening Statement - SEC Open Meeting: Proposed Rules on Incentive-Based Compensation, March 2, 2011, available at <http://www.sec.gov/news/speech/2011/spch030211mls-icomp.htm>.