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Dodd-Frank Proposed Rule for Incentive-Based Compensation: Impact on Foreign Banking Organizations

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On April 14, 2011, seven federal agencies – namely, the Federal Deposit Insurance Corporation ("FDIC"), Securities and Exchange Commission ("SEC"), Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System (the "Board"), Office of Thrift Supervision Treasury, National Credit Union Administration, and Federal Housing Finance Agency (collectively, the "Agencies") – jointly issued a proposed rule (the "Proposed Rule") to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). Section 956 of the Act requires that the Agencies jointly issue regulations or guidelines prohibiting incentive-based compensation at covered financial institutions that encourage inappropriate risk-taking by providing excessive compensation or that could result in a material financial loss. The Act also requires covered financial institutions to disclose to their applicable Agency the structure of their incentive-based compensation arrangements so that the Agency can determine whether the structure is consistent with the Proposed Rule. The Proposed Rule is intended to supplement existing rules and guidance adopted by the Agencies relating to incentive-based compensation and to be consistent with international standards.

U.S. Branches of Foreign Banking Organizations

The Proposed Rule makes clear that the Agencies intend for the Act to apply to foreign banking organizations ("FBOs") with U.S. operations. Under the Proposed Rule, a "covered financial institution" is generally defined as a financial organization with $1 billion or more in total consolidated assets. Included in this definition are the federal branch and agency of a foreign bank and the insured U.S. branch of a foreign bank. Under the Proposed Rule, the Agencies also have proposed to expand the definition of a "covered financial institution" to include uninsured branches and agencies of a foreign bank, as well as other U.S. operations of FBOs, and have specified how total consolidated assets should be determined in their Agency-specific rules. For example, according to the Board, for a state-licensed uninsured branch or agency of a foreign bank, total consolidated assets would be calculated based on the average of the branch or agency's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, and for the U.S. operations of a foreign bank, total consolidated assets would be the U.S. assets, as determined by the Board. Per the

FDIC, for an insured U.S. branch of a foreign bank, the total consolidated assets would be the average of the total assets reported in the branch's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks.

Proposed Rule and International Standards

The underlying principles of the Proposed Rule for determining whether incentive-based compensation encourages excessive risk-taking by covered persons (such as executive officers, employees, directors, or principal shareholders) embrace the international standards developed by the Financial Stability Board ("FSB")[1] and endorsed by the G-20 leaders at their summits in London in April 2009 and Pittsburgh in September 2009. The Principles for Sound Compensation Practices (the "Principles"), which were issued by the FSB, encourage large financial institutions to prohibit compensation schemes that incentivize excessive risk-taking. Specifically, the Principles require that compensation be aligned with long-term value creation by avoiding multi-year guaranteed bonuses. The Principles also require a significant portion of variable compensation to be deferred for not less than three years, tied to performance and subject to clawback. In addition, severance payouts pursuant to a contractual agreement should be examined and retained only if aligned with long-term value creation and prudent risk-taking.[2]

The Proposed Rule includes certain prohibitions and rules. A covered financial institution is prohibited from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the institution that could lead to a material financial loss. Covered financial institutions are required to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based pay arrangements. Further, a covered financial institution is required to provide annual reports disclosing the structure of its incentive-based compensation scheme to federal regulators. Large covered financial institutions with consolidated assets of $50 billion or more[3] are subject to additional rules. For example, at least 50 percent of any incentive-based compensation of an executive officer is to be deferred over a period of at least three years. Further, such institutions are to "claw back" deferred amounts paid based on "actual losses or other measures or aspects or performance that are realized or become better known during the deferral period."

Moreover, the Proposed Rule defines certain terms and outlines the actions that FBOs must take to comply with the new requirements. For example, the Proposed Rule defines the "board of directors" of an FBO to mean the relevant oversight body for the U.S. operations, consistent with the FBO's overall corporate and management structure.

[1] The FSB was established by the G-20 to coordinate at the international level the work of national financial authorities and international bodies that develop and promote the implementation of regulatory, supervisory, and other financial sector policies.

[2] Financial Stability Board, "FSF Principles for Sound Compensation Practices" (April 2009); Financial Stability Board, "FSF Principles for Sound Compensation Practices: Implementation Standards" (Sept. 2009).

[3] This definition of "larger covered financial institution" applies for the federal banking agencies and the SEC; other Agencies define it differently.

Additionally, FBOs will be required to develop policies and procedures for their U.S. operations that are coordinated with firm-wide policies and in accordance with the FBO's overall corporate and management structure.

According to a peer review conducted in March 2010 on the progress of implementing the Principles, the FSB noted that many jurisdictions have adopted regulations relating to compensation structures.[4] Although the approaches differ for each jurisdiction, many countries have taken active measures to ensure that the financial organizations develop compensation policies consistent with prudent risk-taking. For example, the peer review notes that many firms have redesigned their deferral arrangements to increase deferral amounts, extended the deferral period, and enlarged the scope of employees eligible for deferrals. The FSB is expected to conduct a second peer review by the second quarter of 2011.[5]

Several European countries have enacted laws to implement the FSB recommendations, and many of these laws apply to all worldwide branches of a financial institution.[6] This raises the question of whether those laws will be enforceable in the United States or meet an exception under the rules of the applicable European jurisdiction. Of course, U.S. federal, state, and local laws generally govern, but the extraterritorial reach of the laws implementing the FSB recommendations raises complex issues for FBOs.

What FBOs Should Do Now

The Proposed Rule is a part of the complex global reform of the financial industry, and is expected to apply to FBOs operating in the United States. The comment period of the Proposed Rule extends through May 31, 2011. The Proposed Rule, if adopted, will be effective six months after publication of the final rule in the *Federal Register* (the "Final Rule"), unless the Agencies extend the effective date.

Accordingly, FBOs should do the following:

- Consider that the Proposed Rule may be applicable to them as they examine and implement their incentive compensation structures and the policies of their U.S. operations and globally.
- Review their existing incentive compensation programs and individual incentive and employment agreements to determine whether they may be impacted by the Proposed Rule.
- Monitor the publication of the Final Rule and any additional guidance that may be issued by the Agencies.

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[4] Financial Stability Board, "Thematic Review on Compensation, Peer Review Report" (March 2010).
[5] The Conference Board, Governance Center Blog at http://tcbblogs.org/governance/2010/01/12/fdic-takes-page-out-of-g-20-executive-compensation-task-force-playbooks/.
[6] The U.K. revised the Financial Services Authority Remuneration Code because new compensation practices similar to those established in Europe needed to be in place effective Jan. 1, 2011.

Attorneys at EpsteinBeckerGreen regularly assist financial institutions in the development and implementation of incentive-based compensation programs, and provide advice and counsel to those institutions undergoing compensation arrangement compliance reviews. For more information about this Advisory, please contact:

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