

US Compensation Reform Efforts: A Brief Overview

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The Legislative and Regulatory Landscape

- **The financial crisis has resulted in significantly increased attention to risk assessment and in particular the relationship between incentive compensation and “excessive” risk-taking:**
 - **Regulatory proposals:**
 - **US:** FRB’s Proposed Guidance on Sound Incentive Compensation Policies
 - **G-20:** Financial Stability Board’s Principles for Sound Compensation Practices
 - **UK:** Financial Services Authority’s Code of Practice on Remuneration Policies
 - France, Switzerland, Hong Kong, Germany, Italy, the Netherlands and Sweden have all proposed or implemented new compensation regulations within recent months as well
 - **US Legislative proposals:**
 - **Frank Bill:** Passed by House in July 2009
 - **Dodd Bill:** Discussion draft introduced in November 2009
 - **Peters Bill:** Introduced in House in June 2009
 - **Schumer Bill:** Introduced in Senate in May 2009

The Legislative and Regulatory Landscape

- **Compensation reform efforts in the wake of the financial crisis have been largely driven by two distinct motives:**
 - 1) De-incentivizing excessive risk-taking at systemically important financial institutions
 - *Examples: G-20 and FSB Compensation Reforms; FRB's Proposed Guidance*
 - 2) Providing investors with increased information regarding compensation structures and a more prominent voice in compensation decisions
 - *Examples: Frank Bill; Dodd Bill*
- **Additionally, several other themes seem to have played a role in the motivations underlying reform efforts in various jurisdictions:**
 - How to reflect compensation decisions (both individual and structural) in Board governance decisions
 - “Social policy issues” (e.g., what constitutes “excessive” compensation; compression ratios between highest and lowest paid employees; political intervention in compensation structures of entities receiving significant taxpayer assistance)

3

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FRB Executive Compensation Proposal

- **FRB Proposed Guidance on Sound Incentive Compensation Policies (the “Proposed Guidance”) (October 2009)**
 - Stated goal: “[T]o help ensure that incentive compensation policies at banking organizations do not encourage excessive risk-taking and are consistent with the safety and soundness of the organization”
 - Not “social policy issues” or aligning executive and shareholder interest
 - Proposed Guidance is benchmarked off the FSB’s Principles for Sound Compensation Practices, issued in April 2009 (the “April Principles”)
 - The April Principles emphasized that they were “intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. They are *not* intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm.”
 - Other jurisdictions (UK, France, etc.) have taken a more formulaic rule-based approach in line with the FSB’s Implementation Standards for the April Principles released in September 2009 – the Implementation Standards used illustrative examples to provide detailed guidance on appropriate types and forms of compensation and also included specific prescriptions on percentages of deferred compensation and stock-based compensation, vesting periods, and clawbacks

4

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FRB Proposed Guidance: Which Entities are Regulated?

- **Two aspects to the question of which entities are regulated:**
 - Which type of entity?
 - What geographical operations of that entity?
- **Which type of entity?**
 - Proposed Guidance states that it applies to “banking organizations including US bank holding companies, state member banks, Edge and agreement corporations and the US operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the United States”
 - Regulation appears to extend to broker dealer subsidiaries of bank holding companies
 - Proposed Guidance does not extend to standalone hedge fund managers, private equity fund managers or broker dealers not part of a bank holding company controlled group
 - While Proposed Guidance does not currently cover national banks regulated by the Comptroller of the Currency, it is likely that all bank regulators will adopt similar guidance

5

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FRB Proposed Guidance: Which Entities are Regulated?

- **What geographical operations of that entity?**
 - For US institutions, Proposed Guidance appears to apply worldwide
 - For foreign institutions, Proposed Guidance applies only to institutions' US operations
 - FRB directs each foreign organization to coordinate the policies of its US branch with its group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and ensure that its US policies are consistent with the foreign bank's overall corporate and management structure as well as the framework for risk management and internal controls
 - FRB's deference to home country regulator contrasts with recent developments in UK (e.g., City Minister Paul Myners' demand that US institutions with a UK presence agree to the UK FSA rules for their UK operations)
 - FRB Guidance stated that FRB will continue to work with representatives of other nations to achieve a level playing field

6

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FRB Proposed Guidance: Which Employees are Covered?

- **The scope of employees regulated by the FRB Proposed Guidance is directly tied to the notion of managing risk:**
 - **Senior executives** and others who are responsible for oversight of the organization's firm-wide activities or material business lines
 - **Individual employees**, including non-executive employees, whose activities may expose the firm to material amounts of risk (e.g., traders with large position limits relative to the firm's overall risk tolerance)
 - **Groups of employees** who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the firm to material amounts of risk, even if no individual employee is likely to expose the firm to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk)
 - **Risk-management personnel** should receive compensation sufficient to attract talent and structured to avoid conflicts of interest (e.g., compensation should not be based on the profits of the business that risk-management personnel oversee)

7

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FRB Proposed Guidance: Three Key Principles

- **What does the FRB Proposed Guidance require?**
 - Three key principles – Incentive compensation arrangements should:
 - 1) Provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk;
 - 2) Be compatible with effective controls and risk management; and
 - 3) Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors
 - Proposed Guidance contains a number of suggested methods for achieving these principles:
 - Compensation should be risk-adjusted (e.g., an employee who achieves a higher return with less risk should get more compensation)
 - Compensation should vary based on risk outcomes (e.g., when risk outcomes are materially worse than expected, employees should receive substantially less than the full amount of potential incentive compensation)
 - Incentive compensation arrangements should consider the full range of risks associated with the employee's activities and the time horizon over which the risks may be realized
 - Focus on "bad tail risk" (low probability event with disastrous outcomes)

8

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FRB Proposed Guidance: How Does it Compare?

■ FRB Proposed Guidance vs. International Efforts

- The Proposed Guidance has the singular focus of protecting safety and soundness. Proposed Guidance focuses on both individual employees and groups of employees who might together have a material impact on a banking organization's risk profile; FSB Implementation Standards and UK FSA's remuneration code focus only on individual employees
- While the FSB Implementation Standards are highly prescriptive, the Proposed Guidance does not impose any formulaic restrictions on incentive compensation arrangements. Instead, the Proposed Guidance encourages firms to improve processes such that they ensure that compensation is substantively adjusted based on actual risk outcomes – in other words, do not “set and forget”
- The Proposed Guidance encourages management to work together with the Board (and thus take responsibility) to determine an appropriate balance in incentive compensation arrangements that does not promote excessive risk-taking; the Implementation Standards ask the Board to work independently of management to annually review compensation

9

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US Legislative Proposals

■ The Corporate and Financial Institution Fairness Act of 2009 (Frank Bill)

- **Current status:**
 - Passed by the House of Representatives in July 2009
 - Currently in committee in Senate
- **Key compensation-related provisions:**
 - Mandatory advisory say on pay vote (annual vote on disclosed executive compensation; vote on golden parachutes at shareholder meeting to approve transaction)
 - Compensation committee independence
 - Regulatory review and oversight of executive compensation plan design at financial institutions
 - Compensation structure aligned with sound risk management
 - Compensation structure structured to account for time horizon of risks
 - Compensation structure reduces unreasonable incentives to take undue risks that could threaten safety and soundness of institution, or could have serious adverse effects on economic conditions or financial stability
- Advisory vote requirements do not apply to foreign private issuers; unclear at this time whether any other provisions would apply to foreign institutions

10

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US Legislative Proposals

■ Restoring Financial Stability Act of 2009 (Dodd Bill)

- **Current status:**
 - Introduced for discussion in Senate on November 10, 2009 but further progress not expected until mid-December at the earliest
- **Key compensation-related provisions:**
 - Mandatory advisory say on pay vote (annual vote on disclosed executive compensation; vote on golden parachutes at shareholder meeting to approve transaction)
 - Compensation committee independence
 - Clawbacks for public company executive officers, triggered by restatement
 - Directs SEC to issue rules requiring:
 - “Clear description” of compensation
 - Relationship between executive compensation and performance
 - Five-year graph showing compensation and financial performance / return to shareholders

11

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US Legislative Proposals

■ Dodd Bill – Key compensation-related provisions (cont'd.):

- Disclosure of whether employees permitted to hedge
- Compensation standards for banks and their holding companies:
 - No excessive compensation
 - No compensation plans that could lead to material financial loss
 - Higher capital requirements if a bank's compensation practices pose a risk of harm
- **Several of the Dodd Bill's provisions are likely to apply to foreign private issuers:**
 - Safety and soundness standards for excessive compensation applicable to bank holding companies and depository institution holding companies
 - Higher capital charges for depository institutions with harmful compensation practices
 - Prompt corrective action for undercapitalized financial companies (bonus limitations, removal of officers and/or directors, etc.)
 - Increased disclosure for issuers of asset-backed securities relating to compensation of broker or originator of assets backing security and amount of risk retention by originator/secrurizer of such assets

12

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US Legislative Proposals

- **Shareholder Empowerment Act of 2009 (Peters Bill)**
 - Introduced in House by Rep. Gary Peters in June; no further action
 - Say on pay, independent compensation committee advisors, clawbacks, limits on severance agreements, heightened disclosure requirements for performance targets
- **Shareholder Bill of Rights Act of 2009 (Schumer Bill)**
 - Introduced in Senate by Sen. Charles Schumer in May; no further action
 - Provisions similar to Peters bill, but does not include performance target disclosure

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