Securities Regulation Daily Wrap Up,TOP STORY—Agencies propose rule to rein in bonuses,(Apr. 21, 2016)

By Anne Sherry, J.D.

A rule put out by the SEC and five other agencies would restrict bonuses at large financial institutions, including investment advisers and registered broker-dealers. One of the agencies, the National Credit Union Administration (NCUA), approved the rule's preamble and its portion of the rule text, revealing a widely applicable regulatory scheme that would govern how financial firms with over $1 billion in assets pay bonuses to their employees and disclose those arrangements.

Section 956 of Dodd-Frank directed the agencies to work together on a rule on risky compensation arrangements, which the statute considers to be "excessive" compensation, fees, or benefits, or arrangements that could lead to material financial loss to the institution. The regulators were given nine months to adopt the rules. They met that deadline with a 2011 proposal, but it languished on criticisms that it did not go far enough to change Wall Street pay practices.

Agencies and covered institutions. The rule is a joint effort among the Office of the Comptroller of the Currency, Treasury, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Credit Union Administration, and the SEC. The agencies' separate efforts were combined into the 280-page rule, and they suggest that interested parties send comments to the agency that regulates the covered institution addressed in the comments.

In the case of the SEC, the rule applies to brokers and dealers registered under Section 15 of the Exchange Act and to investment advisers as defined in Section 202(a)(11) of the Investment Advisers Act, whether or not they are registered under the Advisers Act.

Stricter standards for larger institutions. All covered institutions will be subject to a basic set of prohibitions and disclosure requirements, but further restrictions and requirements will apply to larger institutions. The rulemaking breaks institutions into three tiers: those

with average total consolidated assets between $1 billion and $50 billion (Level 3), those with between $50 billion and $250 billion (Level 2), and those with greater than $250 billion average total consolidated assets (Level 1). Even though Level 3 institutions generally need comply only with the basic rule requirements, an agency may require a covered institution with assets between $10 billion and $50 billion to comply with some or all of the rule's stricter provisions, if the agency determines that the institution's activities, complexity of operations, risk profile, or compensation practices look like those of a Level 1 or 2 institution.

Subsidiaries. The rule's treatment of subsidiaries of covered institutions varies by regulator. According to the NCUA, the SEC is not contemplating that a subsidiary institution will be subject to the same requirements as its parent. The Commission expects that brokers and advisers, which do not typically operate through subsidiaries, will derive their compensation arrangements from the activities of the broker-dealers and investment advisers themselves. But individuals that are employed by subsidiaries may be considered a "significant risk-taker" subject to the rule. A covered person may be a significant risk-taker based on either compensation or degree of authority over the firm's capital.

Prohibitions and requirements. All covered institutions under the rule would be barred from establishing or maintaining incentive-based compensation arrangements, or features of such arrangement, that encourage inappropriate risks in one of two ways. First, by providing covered persons with excessive compensation, fees, or benefits; and second, by having the potential to lead to material financial loss to the covered institution. The rule includes considerations for making a determination on the first point and requirements to prevent risks leading to material financial loss. The structure of compensation arrangements would be tailored to the size, complexity, risk tolerance, and business model of the covered institution, rather than following a one-size-fits-all approach.

Excessive compensation. The proposed factors for determining whether compensation is risky because it is excessive include: (1) the combined value of all compensation,

fees, or benefits provided to the covered person; (2) the compensation history of the covered person and other individuals with comparable expertise at the covered institution; (3) the financial condition of the covered institution; (4) compensation practices at comparable covered institutions, based upon such factors as asset size, geographic location, and the complexity of the covered institution's operations and assets; (5) for post-employment benefits, the projected total cost and benefit to the covered institution; and (6) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered institution. This list is not exclusive.

Level 1 or 2 institutions would be prohibited from awarding incentive-based compensation exceeding 125 percent of the target amount (in the case of a senior executive officer) or 150 percent of the target (for a significant risk-taker). Performance measures may not be based solely on industry peer performance comparisons. Institutions may use relative performance measures in combination with absolute performance measures, but not in isolation.

Material financial loss. An incentive-based arrangement could encourage inappropriate risks leading to material financial loss unless the arrangement (1) appropriately balances risk and reward; (2) is compatible with effective risk management and controls; and (3) is supported by effective governance. The rule would also require certain features in incentive-based compensation arrangements to help balance risk and reward, such as deferring a certain percentage of the award. Furthermore, all covered institutions would have to have appropriate controls to ensure the risk-reward balance is followed.

Disclosure and recordkeeping. Under the proposed rule, each covered institution would be required to create—and maintain for at least seven years—records that document the structure of all of the institution's incentive-based compensation arrangements and demonstrate compliance with the proposed rule, and to disclose these records to the appropriate regulator upon request. Level 1 and 2 institutions would also need to document their senior executive officers and significant risk-takers and the

compensation arrangements for those individuals, any forfeiture, downward adjustment, or clawback reviews and decisions, and any material changes to the covered institution's incentive-based arrangements and policies.

The SEC would amend Rule 17a-4(e) under the Exchange Act and Rule 204-2 under the Advisers Act to implement the recordkeeping requirements for broker-dealers and investment advisers, respectively.

Clawbacks and hedging. The rule also contains provisions regarding clawbacks and hedging that go beyond the SEC's recent rulemaking in those areas. Clawbacks will be required where a senior executive officer or significant risk-taker engaged in (1) misconduct resulting in significant financial or reputational harm to the firm; (2) fraud; or (3) intentional misrepresentation of information used to determine the individual's compensation. As to hedging, Level 1 and 2 covered institutions will be prohibited from purchasing hedging instruments on behalf of all covered persons—not just senior executive officers and significant risk-takers. Dodd-Frank Section 956 is silent on hedging, and the agencies request comment on whether the hedging prohibition is appropriate to implement the law.

Proposal status. The preamble and proposed rule will not be published in the Federal Register until all the agencies have acted, and the published version may differ from the draft published by the NCUA.

MainStory: TopStory BrokerDealers DoddFrankAct ExecutiveCompensation InvestmentAdvisers RiskManagement