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October 20, 2010

## Incentive Compensation for Financial Institutions: Balancing Business Drivers and New Regulatory Oversight

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### INTRODUCTION

Recent economic turmoil has brought unprecedented attention to the incentive compensation practices of financial institutions. In addition to the pervasive media coverage and public scrutiny of compensation arrangements, these concerns have given rise to new federal oversight of financial institutions' compensation arrangements. Enforcement action may be taken by a financial institution's federal supervisor if its incentive compensation arrangements are considered to create a risk to the safety and financial soundness of the organization. In addition, the Dodd-Frank Act requires disclosures of incentive compensation arrangements that may increase a company's exposure to risk.

### DODD-FRANK ACT

President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") on July 21, 2010. The Act contains amendments to the Securities Exchange Act of 1934 that impose new executive compensation requirements for public companies. Among other new rules, the Act requires companies to disclose to shareholders whether they permit any employee or board member to purchase financial instruments that are designed to hedge or offset any decrease in the market value of their equity-related compensation. In addition, regulations will be promulgated under the Act requiring disclosure of any incentive-based compensation arrangements that could lead to material financial loss to the company. Thus, the Act seeks to encourage risk mitigation for all public companies.

### THE FEDERAL RESERVE GUIDANCE

On June 21, 2010, the Federal Reserve, the Department of the Treasury, and the FDIC issued final guidance (the "Federal Reserve Guidance" or the "Guidance") regarding incentive compensation policies.<sup>1</sup> The Guidance is applicable to the incentive compensation of any bank employees whose activities on an individual or aggregate level may expose the institution to material amounts of risk, and it notably concludes with the admonition that the authoring agencies intend to monitor banks' compensation practices and progress in adhering to the Guidance, and where appropriate "will take supervisory or enforcement action" to ensure that these practices are implemented. Thus, banks must carefully consider compensation practices in light of the Federal Reserve Guidance in order to steer clear of potential government intervention.

The Federal Reserve Guidance is based on three primary principles: (i) balanced risk-taking incentives, (ii) compatibility with effective controls and risk-management, and (iii) strong corporate governance. With respect to the first principle, the

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<sup>1</sup> Full text available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20100621a1.pdf>

# Client Alert.

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Guidance states that compensation practices should not encourage employees to expose institutions to imprudent risks (taking into account the full range of risks associated with an employee's activities and the timeline over which such risks might be realized) and should be appropriately modified such that compensation amounts are reflective of risk and long-term outcomes. In this respect, the Guidance specifically suggests making compensation more sensitive to risk by including features for risk adjustment of awards based on the risks an employee's activities pose to the organization, deferring payment for a sufficient period to allow for the realization of a substantial portion of the risks created by the employee's activities, providing for longer performance periods, and/or limiting awards that are based on short-term performance. The Guidance also indicates that compensation arrangements must take into account differences among categories of employees (with particular attention to employees whose risk-taking activities may have a material effect on the organization) and institutions, that banks should limit severance and vesting arrangements that encourage imprudent risk-taking, and that employees should receive clear information indicating the manner in which risk-taking will be taken into account in determining compensation amounts. The Guidance specifically discourages employee incentive awards based solely on overall organization-wide performance, except for awards to senior executives with the ability to affect the organization's overall performance and risk profile.

In addressing the second principle, institutional structures and procedures for minimizing risk, the Guidance indicates that banks must implement internal controls to ensure that employees may not circumvent incentive compensation procedures designed to control risk, must implement appropriate processes (such as maintaining documentation to enable internal audits) to maintain the integrity of compensation arrangements, and must involve risk-management personnel (with appropriate skills and compensation) in the design and implementation of compensation arrangements intended to minimize imprudent risk-taking. In addition, the Guidance requires that banks monitor the performance of their incentive compensation arrangements through substantial reporting to various levels of management, including boards of directors where appropriate, and should engage in ongoing assessments and revisions (as needed) to ensure that the incentive compensation arrangements in place appropriately reflect risk outcomes.

Finally, with respect to its third principle the Guidance provides that financial institutions must have strong and effective corporate governance to ensure sound incentive compensation practices. This necessarily entails substantial involvement by an institution's board of directors (particularly with respect to the compensation of senior management), which should be made up of parties with an appropriate level of expertise in risk-management, and in some cases by a committee of primarily non-executive directors devoted to compensation issues.

The Guidance also indicates that institutions should disclose sufficient information to restrain imprudent risk-taking (including, but not limited to, compliance with applicable securities law disclosure requirements). Under the Guidance, large banks should develop incentive compensation arrangements systematically, using formal policies, procedures, and systems that mitigate and monitor appropriately all forms of risk (taking into account various types of employees, performance measures, timelines, and methods of imposing checks on imprudent risk-taking).

## CHECKS ON INCENTIVE COMPENSATION: A EUROPEAN MODEL

Europe has recently begun developing its own solutions to the perceived adverse impact of existing incentive compensation practices. In July 2010, the European Parliament approved a variety of sweeping restrictions ("CRD3") that constitute some of the world's strictest limits on financial institutions' incentive compensation practices.<sup>2</sup> These rules are

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<sup>2</sup> Subsequently, the Basel Committee on Banking Supervision published its "Principles for enhancing corporate governance" and its "Range of

## Client Alert.

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applicable to U.S. (and other non-European) banks operating in the EU, so it will be critical for institutions with operations in Europe to understand the limits (which become effective in January 2011) and adapt applicable compensation arrangements appropriately. Moreover, since the Federal Reserve Guidance provides few specific limits, some may view the European CRD3 rules as establishing “bright-line” limits for incentive compensation at U.S. financial institutions, at least those with operations in the EU. Also, in the event that additional, more stringent U.S. compensation restrictions are added, they may be similar to the EU’s limits; therefore, conforming compensation to those limits now could reduce the need for more extensive changes in the future.

Although some of the details of the European CRD3 rules are still being developed, these rules already prescribe a number of specific limits. These include 20 to 30 percent, depending on the size of the bonus, that may be paid up-front, in cash; a requirement that 40 to 60 percent of bonuses must be deferred for at least three years; and a requirement that bonuses include clawback provisions so that they may be recovered if investment performance is weaker than expected over longer periods. In addition, at least 50 percent of incentive compensation amounts must be paid as contingent capital<sup>3</sup> (such that the amounts may be called upon first in the event that the institution experiences financial difficulties) and shares or equivalent ownership interests.

In addition to the above restrictions, the European CRD3 rules will prescribe caps (to be established by the Committee of European Banking Supervisors) on the proportion of total compensation that may be paid as bonuses. Moreover, all of these rules will apply to pensions that are structured similarly to bonuses, as well as deferred compensation. Banks that have received so-called “bail-out” funds will also be subject to absolute caps on bonus amounts and will be prohibited from granting bonuses to directors except where “duly justified.”

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Methodologies for Risk and Performance Alignment of Remuneration” (consultative document) in October 2010. The Basel principles regarding executive compensation state:

[A] bank should ensure that variable compensation is adjusted to take into account the risks an employee takes. This should consider all types of risk over a timeframe sufficient for risk outcomes to be revealed. It is appropriate to use both quantitative risk measurements and human judgment in determining risk adjustments...all material risks should be taken into account, including difficult-to-measure risks (e.g. reputational risk) and potentially severe risk outcomes...

Compensation should be sensitive to risk outcomes over a multi-year horizon [including claw-backs] ... ‘Golden parachute’ arrangements under which terminated executives or staff receive large payouts irrespective of performance are generally not consistent with sound compensation practice.

The consultative document also emphasizes the importance of implementing sound incentive compensation practices for any employees (rather than just executives) whose activities on an individual or collective level may present risks to the institution, linking remuneration with performance and risk outcomes, as well as structuring total compensation packages appropriately such that variable compensation may realistically be reduced to very low levels depending on performance outcomes. In addition, the Basel Committee notes the importance of clearly defining performance measures at the beginning of a performance period, implementing clear rules and procedures governing any annual bonuses, and taking into account a broad range of risks, often with an approach including both ex ante (risks estimated) and ex post (risk outcomes observed) measurements and adjustments.

<sup>3</sup> In a contingent capital arrangement, funds are revocable under a pre-negotiated agreement if a specific contingency occurs or a threshold is crossed.

# Client Alert.

## IMPLEMENTING SOLUTIONS IN THE U.S.: POTENTIAL ALTERNATIVES

The second and third principles of the Guidance, as described previously, center on developing robust processes and strong oversight for the implementation of appropriate incentive compensation arrangements. These are institutional measures that, while not necessarily easy to implement, are relatively straightforward. Thus, it is the Guidance's first tenet—the development of actual incentive compensation arrangements that appropriately measure long-term performance and discourage imprudent risk-taking—that may pose the most significant challenge for institutions attempting to reform their compensation practices. While any number of vehicles could potentially address these concerns, two new kinds of arrangements have emerged recently that present interesting opportunities for implementing the Guidelines while furthering growth and providing attractive employee incentives.

One such arrangement is to set aside a pool of illiquid assets which relate to or originate with a specified group of employees (such as investment banking, or housing loan underwriters) (an "Asset Pool"). The relevant employee's performance awards are indexed to, on a first-loss interest basis, the Asset Pool. Assets remain on the financial institution's balance sheet, but any mark-to-market losses or gains on the assets will be offsets by identical gains or losses from the banks' liabilities to employees. The notional value of the Asset Pool is based on the fair market value of its assets as of the beginning of the arrangement. Since the assets are illiquid, the value of the assets would remain static until liquidated. The award holders will participate in gains if assets in the pool are liquidated at prices above the original fair market value, and if the assets are liquidated below fair market value, the holders of the awards will bear the first loss (i.e., like common shareholders) on the Asset Pool. Under this type of arrangement, the majority of an employee's incentive compensation (particularly for employees whose risk-taking activities may materially impact the institution) should be based on the Asset Pool. Thus, employees reap gains based on, and bear first loss on, the Asset Pools, so they share in the risk-taking directly related to the functions of their positions. Also, in order to incentivize based on long-term performance, such awards should have extended durations. For example, Credit Suisse has set up this type of arrangement with an eight-year term, with payouts starting five years after the grant date, although all awards vested within the first two years. It used leveraged loans and commercial mortgage-backed debt to fund its Asset Pool, which is then used to fund executive compensation packages. This transfers the risk of the assets from the corporation to the executives.<sup>4</sup>

From a tax perspective, this type of compensation arrangement should be relatively straightforward; as payouts occur, the employee would include amounts as ordinary income and the institution would claim a corresponding deduction. Moreover, such arrangements are unlikely to present concerns under Section 409A of the Internal Revenue Code ("Section 409A"), which governs deferred compensation, so long as payouts are to occur on set dates based on predetermined formulas. (Section 409A presents a myriad of complicated issues, however, so competent counsel should be involved in the design of any deferred compensation program.)

Perhaps the most challenging issues for banks wishing to implement this kind of arrangement would be determinations regarding the treatment of awards following termination of an employee's service with the bank. On one hand, because such awards would be made in lieu of short-term incentive compensation arrangements that would otherwise have been paid on an annual basis, banks may wish to treat such amounts as vested on an annual basis (subject to the performance of the Asset Pool) for purposes of employee satisfaction and retention. On the other hand, banks might wish to reward

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<sup>4</sup> This transfer of risk should be disclosed to the executives.

## Client Alert.

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long-term success in connection with an Asset Pool and to discourage imprudent risk-taking by employees whose tenure with the institution is limited, in which case it may be appropriate in some situations to consider requiring that employees remain in service through a payout date in order to receive such bonus amounts.

Another proposed arrangement, particularly where higher-risk investing could be occurring, is to create an Asset Pool, as described above, but place the assets into a separate entity (“AssetCo”), exchanging the assets for debt and shares of AssetCo. The financial institution can then distribute shares of AssetCo to its employees in lieu of cash compensation. (Shares of AssetCo may also be distributed to existing shareholders of the financial institution pursuant to a special dividend declaration.) In this type of arrangement, the grantees again share in the risk-reward potential, including the down-side, so it should provide an effective check if these awards make up a large portion of compensation packages.

However, establishing an AssetCo involves significant administrative overhead and would likely require shareholder approval and compliance with Blue Sky laws if the company is not publicly traded. Because of the cost of overhead and significance of establishing a new entity, a bank may not wish to undertake this type of arrangement unless there is some other justification for using this structure (e.g., moving high-risk assets to a separate entity).

If shares of AssetCo that are distributed to employee grantees are issued as common shares, employees should recognize ordinary income upon the issuance (subject to payroll withholding taxes), and employees would then recognize gains or losses over time. These distributed shares would be treated as a compensation expense for the bank. The financial institution could also issue restricted shares of AssetCo to its employees, which would add a time element for vesting, or could limit sales of the shares for a specified period, to address the issue of incenting long-term performance of the assets.

Similarly, as argued by Frederick Tung, portions of the award portfolio that consist of subordinated debt securities may help constrain bank risk.<sup>5</sup> Research has purportedly shown that risk taking declines as the proportion of a CEO’s wealth held in the form of debt relative to equity holdings increases.<sup>6</sup> Subordinated debt is repaid only after all equity holders, general credit holders, and depositors have been repaid. Debt shifts the executive’s personal interests away from risky behavior that is encouraged by equity awards, to align interests more closely with those of debt holders, who are more risk-averse. This also imposes market discipline upon the issuing bank because the trading price of subordinated debt is sensitive to the issuer’s risk taking. Tung recommends that the subordinated debt awarded to bank executives “should have a maturity of at least eight to ten years...be issued relatively frequently in staggered tranches... [and] be required to [be held] for at least half of its maturity.”<sup>7</sup> Furthermore, this debt should be issued at the level of the banking subsidiary, not the bank’s holding company.

The following are additional methods of aligning incentive compensation with sensitivity to risk that are presently being used:

(1) Risk Adjustment of Awards. The amount of an incentive compensation award for an employee may be adjusted

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<sup>5</sup> See Tung, Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation, Northwestern U. L.R., Vol. 105 (2010).

<sup>6</sup> *Id.* at 24

<sup>7</sup> *Id.* at 32.

## Client Alert.

based on measures that take into account the risk the employee's activities may pose to the bank. These measures may be quantitative or set judgmentally, and result in the employee whose activities create materially larger risks for the organization receiving less than other employees, all else being equal. Therefore, two employees who generate the same amount of short-term revenue or profit would not receive the same amount of incentive compensation under risk-adjusted awards because the risks taken by the employees in generating that revenue or profit differ. However, mitigating risk by adjusting compensation commensurate with the level of risk taken is a difficult process, and if the primary focus in designing compensation arrangements is risk aversion (therefore penalizing employees who are involved in functions that inherently bear greater risk), business opportunities, innovation, and growth initiatives may be diminished.

- (2) Long Performance Periods. The time period covered by the performance measures used in determining an employee's award may be extended, because reducing the reliance of awards on short-term performance serves to increase sensitivity to risk.
- (3) Extended Deferrals. An arrangement may provide that the employee will vest in a stock award or payment, but the actual payout of the award will be delayed significantly beyond the end of the performance period, and the amounts paid will be adjusted for actual losses or other aspects of performance that are realized during the deferral period. Care should be taken that such deferrals do not violate Section 409A of the Code.
- (4) Restrictive Covenants. Contractual promises between the employees and the employer regarding matters such as confidentiality and assignment of intellectual property, in addition to non-compete and non-solicitation provisions, may help mitigate risk. They may also be used as triggers for clawbacks, discussed below.
- (5) Clawbacks. Sarbanes-Oxley imposed limited claw-back provisions, TARP requires more extensive clawbacks, and the 2009 SEC Final Rule on executive compensation instructed companies to address "clawbacks or imposing holding periods." The Frank-Dodd Act provides that if a company restates an accounting restatement due to its "material noncompliance" with any financial reporting requirement under the law, then it must recover from current and former executive officers any excess incentive-based compensation awarded in the previous three years. Clawbacks can be used both for individuals who perpetrated fraud or for compensation earned by fraud, and also can be implemented for taking unreasonable risk. Clawbacks can be applied to performance compensation including annual bonuses, options, restricted stock, and performance shares. However, clawbacks may be difficult to enforce or recoup.
- (6) Caps. Capping the upside of stock options and other awards may help avoid incentivizing risky behavior. For example, the gain on a stock option can be capped via a stock-settled automatic exercise when the stock reaches two or three times the strike price. Although the market value of capped options may be substantially lower for companies with high share price volatility, many employees do not perceive them as substantially less valuable. Alternatively, the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s) may be reduced. Also, absolute caps may be placed on bonuses.
- (7) Lower Thresholds. The threshold, target, and maximum levels of performance and payout "curves" under incentive plans should be calibrated to promote the right kind, and the right amount, of risk-taking by executives. Lower thresholds can decrease risk-taking in employees by eliminating all-or-nothing awards, while performance curves that are too steep can signal overly risky incentives.
- (8) "Second-Chance Shares." Stock awards with a "second-chance" at vesting once a first goal is missed can help

## Client Alert.

discourage risk-taking. These “second-chance,” or “catch-up” provisions can include additional service criteria (accrual over longer period of time) or performance goals. They also provide an additional retention benefit.

(9) **EPS or ROI Hurdles.** Adding EPS (earnings per share) or ROI (return on investment) hurdles to options or cash performance awards may mitigate risk because these measures tend to be more reflective of the institution’s long-term financial performance.

(10) **Additional Limits on Performance Awards.** A bank may retain discretion regarding an award in order to certify the results of performance metrics and/or adjust final payout amounts before settling such awards. Also, awards may combine service and performance requirements for vesting in lieu of a clawback. However, this type of award may raise disclosure and accounting issues.

(11) **Hold Through Retirement Requirements.** Hold through retirement requirements promote focus on long-term value creation, and reduce the mismatch between performance compensation payments and the realization of risk. These requirements are generally imposed only on very top-level executives, but may help foster a company-wide share-ownership culture if extended to other employees. Also, they can be used in conjunction with “net exercise” of options to encourage share retention among all employees. In addition to hold through retirement requirements, share retention can also be increased by adding retention ratios which may vary among classes of employees and long-term vesting for restricted shares. However, hold through retirement requirements have the disadvantage of creating an incentive for the employee to leave in order to cash in. Requirements to hold until a period after retirement may also be imposed (e.g., an award of restricted stock or options that may not be sold or exercised until two to four years after the executive leaves the company).

(12) **Anti-Hedging Policy.** An anti-hedging policy bars employees from buying company stock on margin and selling and purchasing “puts” and other derivative securities tied to the company’s securities. Some policies also prohibit forward sales contracts and options based on employer securities. However, this type of policy wouldn’t apply to the exercise of options granted as part of the employer’s incentive plan. This type of policy is an excellent risk mitigator, and the Frank-Dodd Act requires disclosure if a public company fails to have an anti-hedging policy.

### CONCLUSION

Due to increased scrutiny and regulation, banks have been left with little choice but to address their incentive compensation arrangements and in some cases to implement reforms to more adequately discourage imprudent risk-taking. Financial institutions must pay close attention to the Federal Reserve Guidelines when designing and implementing these arrangements, as well as in assessing their existing corporate governance procedures in this context. If implemented correctly, however, a number of alternatives—including the two types of arrangements discussed above—seem capable of addressing the Guidelines while allowing banks the flexibility to attract talent and encourage some degree of prudent risk-taking in order to promote healthy growth. Ultimately, particularly in the absence of strict interpretations such as those adopted in the EU, the Guidelines should present opportunities for banks to implement incentive compensation arrangements that meet strategic growth and recruiting needs while promoting the financial health and security of individual institutions as well as the larger financial system.

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