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# How Did We Get Here? Executive Compensation One Year After Dodd- Frank

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- Dodd-Frank Update

Provision	General Summary	Anticipated Date for Release of Proposed Rules	Update
Section 951	(1) Say on Pay; (2) Say When on Pay; (3) advisory vote on golden parachutes; (4) disclosure by institutional investment managers of compensation votes	Proposed rules released October 18, 2010	Final Rules Adopted
Section 952	(1) Compensation committee independence standards; (2) compensation committee advisory independence; (3) additional disclosure regarding compensation consultant conflicts	Proposed rules released March 30, 2011	Originally: April – July 2011  Final rules anticipated August- Dec 2011
Sections 953 and 955	(1) pay for performance; (2) internal pay equity information ((3) employee and director hedging policies	April – July 2011 <i>Now August-Dec 2011</i>	After July 2011
Section 954	Requirements to institute clawback policies regarding incentive compensation	April – July 2011 <i>Now August-Dec 2011</i>	After July 2011
Section 957	Broker non votes	April – July 2011	After July 2011



- **Incentive-Based Compensation**

- Required under Section 956 of the Dodd-Frank Act
- Joint rules published February 7 by OCC, Federal Reserve, FDIC, OTS, NCUA, SEC and FHFA
  - Rules on incentive compensation for broker dealers and investment advisers proposed by SEC on March 2
- The rule would apply to institutions governed by the Federal banking agencies and the SEC with assets of \$50 billion or more, to firms regulated by the NCUA with \$10 billion or more, and for the FHFA, all Federal Home Loan Banks with a \$1 billion threshold.
  - "Incentive-based compensation" includes *any variable compensation that serves as incentive for performance*
    - Base salary ordinarily not incentive-based comp
    - Equity-based awards incentive-based comp
  - "Covered person" includes any executive officer, employee, director or principal shareholder of covered financial institution
- Financial institutions with \$50 billion or more in total consolidated assets are required to defer at least 50 percent of the incentive pay of executive officers for at least three years



- **Covered Financial Institutions**

- Any of the following type of institutions that have \$1 billion or more in assets:
  - A depository institution or holding company
  - A registered broker-dealer
  - A credit union
  - A registered investment adviser
  - Fannie Mae/Freddie Mac
  - Any other financial institution that regulators determine



- **Covered Persons**

- Any executive officer, employee, director or principal shareholder of over 10%
- No categories are excluded from the proposal
- Proposals discuss excluding certain lower-level employees under adopted policies
- Proposal include anti-evasion provisions that prohibit shifting substantial numbers of covered employees to become independent contractors



- Major components:

- (1) prohibiting incentive arrangements that encourage inappropriate risks by providing excessive compensation
- (2) prohibiting incentive arrangements that encourage inappropriate risks that could lead to a material financial loss
- (3) requiring policies and procedures commensurate with the institution's size, complexity and use of incentive arrangements, and
- (4) requiring annual reports on incentive structures to the appropriate agency



- **Incentive Based Compensation**

- Any variable compensation that serves as an incentive to performance
- Form of compensation is not determinative
- Compensation that is excluded:
  - Compensation payment tied solely to continued employment (salary)
  - Compensation that does not involve risk taking (payments for achieving higher education or maintaining certifications)
  - Compensation that is determined solely on employee's level of fixed compensation and does not vary based on performance metrics (employer's contribution for 401(k))
  - Dividends paid and appreciation realized on stock owned



- **Prohibited Excessive Compensation**

- Compensation for covered persons is considered excessive when amounts are unreasonable or disproportionate to, among other things, the amount, nature, quality or scope of services performed by the covered persons
- In making a determination, the agencies will consider:
  - The combined value of all cash and non-cash benefits
  - The compensation history of the covered person and comparable individuals
  - Financial condition of CFI
  - Comparable compensation practices at comparable institutions based on asset size, geographic location, and complexity of institution
  - Post-employment benefits
  - Any connection between covered person and any fraud or abuses
  - Any other factors agencies determine appropriate



- **Complying with the proposed rules**
  - Balance of risk with financial reward
    - Risk adjustment of awards
    - Deferral of payment
    - Longer performance periods
    - Reduced sensitivity to short-term performance
  - Compatibility with effective controls and risk management (Board involvement)
  - Mandatory incentive compensation deferral
    - 50% of incentive compensation of an executive officer deferred for at least three years
    - Cliff Deferral, Ratable Deferral or Variable Deferral
    - Special review and approval requirements for other designated individuals
    - Board of Directors must identify any non-executives whose job responsibilities and impact expose CFI to material financial loss
    - Board must evaluate the effectiveness of risk-balancing
    - Board must determine the risk posed by incentive compensation arrangements
  - Policies and procedures
    - CFIs must have adopted policies and procedures
    - Documentation of process



- Methodology for compliance
  - Guidance on Sound Incentive Compensation Policies have a 3-pronged approach:
    - Incentive plan design that appropriately balances risk with rewards
      - Determine best approach for risk mitigation
    - Integrated internal controls and risk management
      - Involvement of internal advisors
    - Strong corporate governance
      - Oversight by Board or Committee
      - Regular reports
      - Education and resources



- **Compensation Committees and Consultants**

- Rules proposed March 30 (Comment period extended to May 19)
  - SEC must complete rulemaking by July 16 per Dodd-Frank
  - Exchanges have up to one year from completion of rulemaking to have revisions to listing standards approved by SEC
- Rules do not elaborate on “independence factors” specified in Dodd Frank Act (left to securities exchanges)
- Exchanges must modify listing standards to require compensation committees to consider the independence of a potential adviser to the committee before engaging advisor
- Require ALL companies to disclose in proxy the identity of any compensation consultant retained, whether engagement created a possible conflict of interest and, if so, how resolved



- What to do now?
  - Identify those who could subject the organization to excessive risk, and then benchmark their pay
    - How to determine whether individual compensation above median?
    - How to figure out who within organization are risk takers?
  - Consider whether changes to equity and other incentive-based compensation plans and arrangements necessary
  - Determine which individuals will be subject to additional board oversight
  - Although no specified format of required annual reports yet, may wish to begin to consider implementing appropriate procedures to prepare reports
  - Review responsibilities of compensation committees and of risk-management, risk-oversight and internal control personnel to ensure design, approval, monitoring and review of incentive-based compensation arrangements comply with Section 956
  - Amend compensation committee charter to ensure committee has the requisite authority to satisfy its obligations under Section 956



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Cynthia Krus, who serves as the Co-Practice Group Leader of Sutherland's Corporate Practice Group, has been involved in numerous public and private securities offerings and has advised clients in connection with a variety of corporate transactions including mergers and acquisitions, proxy contests, exchange and rights offerings, going-private transactions and reorganizations. Cynthia counsels public companies in a broad range of corporate and securities matters, such as the Sarbanes-Oxley Act of 2002, corporate governance, disclosure, executive compensation and shareholder matters. Cynthia has conducted several webinars on Dodd-Frank regulations. She also advises companies on the structure and formation of various entities and the establishment and operation of private and public venture equity, including business development companies (BDCs).



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