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SEC Proposes Incentive-Based Compensation Rules

To implement Section 956 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, the Securities and Exchange Commission (the "SEC"), working in conjunction with the Department of the Treasury, the Federal Reserve and certain other government agencies, has proposed rules that would require "covered financial institutions" to disclose the structure of their incentive-based compensation practices and prohibit such institutions from maintaining compensation arrangements that provide excessive compensation or could lead to material financial loss.

Who would be Covered?

"Covered financial institutions" would include, among others, registered brokers, registered dealers and investment advisers, in each case with "total consolidated assets" of $1 billion or more. For a broker or dealer, "total consolidated assets" would be the total consolidated assets reported in its most recent year-end audited Consolidated Statement of Financial Condition filed pursuant to the *Securities Exchange Act of 1934*. For an investment adviser, "total consolidated assets" would be the total assets shown on the investment adviser's balance sheet for its most recent fiscal year end (<u>not</u> the investment adviser's assets under management).

While one might expect the number of investment advisers with $1 billion or more of assets on their balance sheets (as opposed to assets under management) to be relatively small, the application of certain accounting rules (FIN46(R), as amended by FAS 167) may in certain instances require an investment adviser to include on its balance sheet the assets of certain pooled investment vehicles it manages. The application of those accounting rules is fact-specific and primarily qualitative in nature, focusing on whether the investment adviser has the power to direct the activities of the vehicle that most significantly effect the vehicle's economic performance and (i) the obligation to absorb losses of the vehicle or (ii) the right to receive benefits from the vehicle. Investment advisers may wish to consult with their accountants regarding the application of those rules. The proposing release requests comments on the proposed method of determining asset size for investment advisers, including specifically whether the determination of total consolidated assets should be further tailored for certain types of investment advisers, such as advisers to hedge funds or private equity funds.

Summary of Proposed Rules

The proposed rules would prohibit a covered financial institution from employing any "incentive-based compensation" arrangement (defined as any variable compensation arrangement that serves as an incentive for performance) that encourages inappropriate risk, either (i) by providing excessive compensation to an executive officer, employee, director or principal shareholder (a "covered person") or (ii) because it could lead to material financial loss to the covered financial institution. The proposed definition of "incentive-based compensation" appears sufficiently broad to capture, among other things, participation by investment adviser personnel in private fund carried interest or performance fee arrangements. Incentive-based compensation arrangements would be excessive under the proposed rules if the amounts paid were unreasonable or were disproportionate to, among other things, the amount, nature, quality and scope of services performed by the covered person. Incentive-based compensation arrangements would be deemed to encourage inappropriate risks unless they (i) balance risk and financial rewards, (ii) are compatible with effective controls and risk management and (iii) are supported by strong corporate governance. The proposed rules use a number of terms that are either undefined (*e.g.*, "inappropriate risks," "material financial loss") or defined by reference to so many factors as to make their eventual interpretation difficult to predict (*e.g.*, "excessive compensation").

The proposed rules would require covered financial institutions to maintain incentive-based compensation policies and procedures that are appropriate to their size, complexity and use of incentive-based compensation. The proposed rules also would require a covered financial institution to file annually with its appropriate federal regulator a report describing the covered financial institution's incentive-based compensation arrangements, including descriptions of (i) the components of such arrangements, (ii) any policies and procedures governing such arrangements and (iii) any material changes to such arrangements, policies or procedures since its last report, as well as an explanation of why the structure of such arrangements does not encourage inappropriate risks by providing covered persons with excessive compensation or incentive-based compensation that could lead to material financial loss. A covered financial institution is not required to report the actual compensation of any particular covered person.

The proposed rules contain additional requirements for "larger covered financial institutions" (which include covered financial institutions regulated by the SEC with total consolidated assets of $50 billion or more). The proposed rules would require that at least 50% of any incentive-based compensation of executive officers of larger covered financial institutions be deferred for at least three years, and that the deferred amounts be adjusted for actual losses incurred by the covered financial institution or other measures of performance during the deferral period. The proposed rules also would require that the board of directors (or a committee thereof) of a larger covered financial institution identify any covered persons, other than executive officers, that individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance. The board or committee would be required to approve such identified persons' incentive-based compensation arrangements and determine that such arrangements effectively balance the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities.

It is worth noting that the proposed rules are similar to draft versions of the *European Union Directive on Alternative Investment Fund Managers* (the "EU Directive"), which requires deferral of incentive compensation and potential clawbacks if incentive compensation ultimately is not earned. Significantly, the applicability of the EU Directive's compensation restrictions to alternative investment fund managers is determined by reference to assets under management (it would apply to all investment advisers other than those with a *de minimis* level of assets under management) without regard to balance sheet assets.

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The proposed rules are available here. Although the SEC already has approved the proposed rule release, certain other regulatory agencies must review and approve the proposed rules before the release can be published in the Federal Register. Once published, there will be a 45 day comment period. If you have any questions about the proposed rules, please contact the Ropes & Gray attorney who normally advises you.

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