

Federal Reserve Issues Proposed Incentive Compensation Guidance

On October 22, the Board of Governors of the Federal Reserve System issued proposed guidance (the “Guidance”) establishing a new regulatory framework for the review of incentive compensation policies of banking organizations. The Guidance applies to all banking organizations supervised by the Federal Reserve, including U.S. bank holding companies, state member banks, and U.S. operations of foreign banks. The Guidance may also impact U.S. banking organizations that are not directly regulated by the Federal Reserve if other banking regulators adopt similar proposals, and is likely to influence the emerging best practices of companies outside the banking sphere.

Although the Federal Reserve is soliciting comments on the proposed Guidance, it expects institutions that are subject to the Guidance to immediately begin reviewing their compensation arrangements – and related risk management, control, and corporate governance processes – for compliance with the Guidance, and to implement corrective programs where necessary.

The Guidance does not adopt bright-line substantive requirements for incentive compensation, but instead establishes a principles-based framework for evaluating compensation practices and programs. The Guidance is based on three key principles, namely that incentive compensation arrangements should:

- Provide employees incentives that do not encourage excessive risk-taking beyond the organization’s ability to effectively identify and manage risk.
- Be compatible with effective controls and risk management.
- Be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

These principles are fleshed out in the Guidance, with the recognition that the specific actions taken by an institution to implement the Guidance will vary based on the institution’s size and complexity and the prevalence and scope of its incentive compensation programs.

The Federal Reserve also announced the establishment of two supervisory initiatives – one for large complex banking organizations (“LCBOs”) and the other for all other banking organizations. LCBOs will be subject to a special coordinated review of their incentive compensation practices, and will be required to provide specified information and documentation about those practices, together with plans and timetables for improving them. Non-LCBOs will have their incentive compensation practices reviewed as part of the regular risk-focused examination process. For both types of organizations, the results of these reviews will be included in the organization’s supervisory ratings, and may, where appropriate, result in an enforcement action.

Arrangements Subject to the Guidance. The overall purpose of the Guidance is to require banking institutions to design and implement compensation arrangements and procedures that “take account of potential risks and risk outcomes.” Improperly designed incentive arrangements are thought to pose a risk to the institution’s safety and soundness. As a result, the Guidance applies to compensation arrangements covering a broader group of employees than just key executives. Specifically, the Guidance applies to compensation arrangements for three categories of employees:

- Senior executives and others who are responsible for oversight of the organization’s firm-wide

activities or material business lines.

- Individual employees whose activities may expose the firm to material amounts of risk (such as traders with large position limits relative to the firm's overall risk tolerance).
- Groups of employees who are subject to similar incentives and who, in the aggregate, may expose the firm to material amounts of risk (such as loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

The Guidance does not apply to job categories that are not likely to expose the organization to material risk. The Guidance states that such job categories "may include" tellers, bookkeepers, couriers, and data processing personnel.

Elaboration of the Three Key Principles

Principle 1: Balanced Risk-Taking Initiatives.

The basic point of this principle is that incentive compensation arrangements should balance risk and financial results so that employees do not have incentives to take excessive risk. Thus, the amount paid to an employee should reflect not only the short-term revenue or profit resulting from that employee's activities, but should also reflect the risks associated with those activities. This principle is fleshed out with the following guidelines:

Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which the risks may be realized. The risks to be considered include credit, market, liquidity, operational, legal, compliance, and reputational risks, including those which may have a low probability of being realized but if realized would have highly adverse effects (so-called "bad-tail" risks). While quantitative measures of risk may be useful, organizations should also consider risks that cannot be quantified. One suggested approach is scenario analysis, in which payout levels are projected based on a range of potential performance levels and risk outcomes, to evaluate whether compensation payments are likely to be reduced appropriately as the risks to the organization increase.

Arrangements can be modified to make compensation more sensitive to risk. The Guidance identifies four methods which are commonly used, individually or in combination, to enhance risk sensitivity in incentive compensation programs:

- Adjusting the amount of the incentive award to take into account the risk posed by the employee's activities. The size of a risk-based adjustment may be determined on either a quantitative or judgmental basis.
- Deferring the payout until significantly beyond the end of the performance period, and adjusting the payout to reflect losses and risk outcomes from the employee's activities that become clear during the deferral period.
- Increasing the length of the performance period.
- Reducing the rate at which award payouts increase as higher levels of performance are attained, which may reduce the magnitude of the incentive to take increased risk in order to reach "stretch" goals.

The most appropriate method(s) in any situation may depend on the nature of the risks involved, such as their expected time horizon and difficulty of being measured at the outset.

The way in which incentive compensation is balanced to consider risk should be tailored to account for differences between employees. Compensation programs need to reflect the differences in the risks associated with the activities of different groups of employees, as well as the size and complexity of the organization. For example, long-term equity awards are more likely to affect the risk-taking incentives of senior management than of lower-level employees who do not believe their activities will materially affect the organization's stock price. The Guidance suggests that senior executives at LCBOs

should have a significant amount of their incentive compensation paid in the form of equity-based instruments that vest over multiple years, with the number of shares ultimately received dependent on the organization's performance over the extended period.

Termination payments have potential to encourage undue risk-taking behavior. Arrangements under which employees receive additional payments upon termination of employment (such as severance or change of control payments) or under which termination of employment triggers accelerated payment of deferred compensation generally do not contain adjustments that reflect risk outcomes, and thus may encourage excessive risk-taking. The Guidance contemplates that other features of the employee's compensation arrangements may need to be designed to prevent the termination provisions from encouraging excessive risk, but does not provide examples of features that may accomplish this. The Guidance also discourages companies from offering sign-on bonuses that make up for deferred amounts forfeited upon termination of employment since such bonuses undercut the prior employer's efforts to use deferral as a method of balancing risk.

The organization should effectively communicate to employees how their compensation will be reduced as risks increase. Employees must understand how their risk-taking will affect the amount of their compensation in order for the risk-sensitive plan design provisions to have the greatest effect on employee behavior.

Principle 2: Compatibility with Effective Controls and Risk Management.

A banking organization's risk-management and internal controls should reinforce and support the maintenance of balanced incentive compensation arrangements. This principle is fleshed out with the following guidelines:

The organization should have appropriate controls to ensure that its compensation processes are being followed and to maintain integrity of its risk management and other functions. This guideline seeks to deal with two concerns. First, that an employee may try to evade the compensation-setting process or to influence the risk measures used in that process in order to increase his or her pay, which would weaken the effectiveness of the arrangements in reducing excessive risk-taking. Second, that the effects of the employee's actions would go beyond the compensation-setting process and also taint the measures used by the institution for broader risk management, internal control, or financial purposes. As an example of the kind of controls envisioned, the Guidance states that an organization's policies and procedures should:

- Identify and describe the role(s) of the personnel, business units, and control units involved in the design, implementation, and monitoring of incentive compensation arrangements.
- Identify the source of significant risk-related inputs into these processes and establish appropriate controls over the development and approval of these inputs to help ensure their integrity.
- Identify the individual(s) and control unit(s) whose approval is necessary for the establishment or modification of incentive compensation arrangements.

The organization should also maintain sufficient documentation to permit an audit of these processes, and these processes should be regularly reviewed as part of the organization's internal audit or compliance function. The results of these reviews should be reported to appropriate levels of management and, where appropriate, the board of directors. The Guidance recognizes, however, that the scope of appropriate procedures and reviews will depend on the size and complexity of the institution.

Risk-management personnel should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk-taking. The design of the kind of balanced compensation arrangements called for by the first principle requires an understanding of the risks associated with the activities of the affected employees. Risk managers can contribute to this process by, for example, reviewing the types of risks associated with each group of employees, approving the risk measures used in risk adjustments and performance measures, and analyzing the related risk outcomes. The Guidance recognizes that other

personnel (such as those in the control, human resources, and finance areas) also play an important role in the compensation-setting process.

Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest. The incentive compensation received by such personnel should not be based on the financial performance of the business units they review, but should instead be based on achievement of their functions (such as risk-adjusted performance or adherence to internal controls).

Organizations should monitor the performance of their incentive compensation arrangements and revise them as needed if payments do not appropriately reflect risk. Payments made should be compared to risks taken and actual risk outcomes to determine whether the payments in fact are being reduced to reflect adverse risk outcomes. The results of such review should be taken into account in setting and modifying incentive compensation arrangements and related controls.

Principle 3: Strong Corporate Governance.

The Guidance states that organizations should have strong and effective corporate governance to help ensure sound compensation practices. It contemplates active board involvement in the compensation process, either by the board as a whole or by a board committee, which may, but need not be, the compensation committee. This principle is fleshed out with the following guidelines:

The board of directors should actively oversee incentive compensation arrangements and related control processes. The Guidance contemplates that the board should actively oversee the organization's systems and controls for setting incentive compensation, including the performance measures and targets for individuals and business units that can expose the organization to large amounts of risk. In addition, the board should directly approve and monitor the incentive compensation arrangements for senior executives.

The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements. In addition to the Board's role in approving incentive compensation arrangements on a going-forward basis, the Guidance contemplates a board review, at least annually, of the effectiveness of the compensation system in providing risk-taking incentives that do not encourage excessive risk-taking. These reviews would include an assessment by management, with input from risk-management personnel. As part of the process, the board should receive reports describing payments made in relation to risk outcomes on a backward-looking basis. The board should also consider reviewing scenario analysis of compensation on a forward-looking basis. The scope of such reviews and the extent of board involvement will vary based on the complexity of the institution and extent to which it uses incentive compensation.

The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation. Boards that do not already have a compensation committee should establish one or take other steps to ensure that non-employee directors are involved in the oversight of incentive compensation. Where feasible, the board should include members with risk management and compensation expertise. The board compensation committee should work closely with the board audit and risk committees where the substance of their activities overlap. The board should have authority to select, compensate, and use outside counsel, consultants, or other experts in risk management and incentive compensation, although the Guidance recognizes that smaller institutions may find it is not necessary or appropriate to do so. In selecting outside advisers, the board should consider whether their other relationships with the organization create potential conflicts of interest. The Guidance also cautions that such outside advisers should not have undue influence over board decisions, and that the board has the ultimate responsibility for its decisions.

The organization's disclosure practices should support safe and sound incentive compensation arrangements. Organizations should provide an appropriate amount of information concerning incentive compensation and related risk management, control, and governance processes to allow shareholders to monitor such processes. The Guidance states that the Federal Reserve intends to work with the Securities and Exchange Commission regarding disclosure requirements for public companies and will also consider what information it should collect and make publicly available.

Organizations should follow a systematic approach to developing a balanced compensation system.

Organizations need formalized policies, procedures, and systems to ensure that their compensation arrangements are appropriately balanced. Large organizations with employees in diverse risk-taking activities should:

- Identify the individual employees and groups of employees who may expose the organization to material amounts of risk.
- Identify the types and time horizons of the risks to the organization from the activities of these employees.
- Assess whether the performance measures applied to such employees may encourage them to take excessive risks.
- Include measures in their incentive compensation arrangements to balance the risks, such as risk adjustments or deferred payouts.
- Communicate to the employees how their incentive compensation arrangements will be adjusted to reflect the risks of their activities.
- Monitor the awards, payments, risks taken, and risk outcomes for these employees, and modify the arrangements as necessary to achieve an appropriate balance.

Smaller organizations should implement similar systems, but tailored to the organization's size and complexity.

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