



Regulatory Developments Affecting Compensation at Financial Institutions: A Comparative Perspective

In the aftermath of the financial crisis, regulators in the United States and in Europe have focused on modifying compensation practices at financial institutions. In prior alerts, we have provided an overview of the regulations in the UK and in the EU affecting compensation at financial institutions. Please see <http://www.mofo.com/files/Uploads/Images/110124-Financial-Sector-Remuneration-in-the-UK-and-the-EU.pdf>. Likewise, we have discussed the initiatives in the United States affecting compensation policies and compensation instruments <http://www.mofo.com/files/Uploads/Images/101019-Incentive-Compensation-for-Financial-Institutions.pdf>. Most recently, on February 7, 2011, the FDIC approved an interagency notice of proposed rulemaking regarding incentive-based compensation arrangements by “covered financial institutions.” A covered financial institution is a bank that has total consolidated assets of more than \$1 billion. Incentive-based compensation arrangements at covered financial institutions that provide for excessive compensation would be prohibited. Arrangements that encourage or expose the institution to inappropriate risk also would be prohibited. These institutions would be required to file regular reports detailing the design and structure of their incentive-based compensation plans and arrangements and explaining how these plans and arrangements are intended to mitigate excessive risk-taking. In addition, institutions that have total consolidated assets of more than \$50 billion are subject to other restrictions and must detail the compensation policies applicable to senior executives and others that may expose the institution to substantial risk of losses (based on the institution’s business). The rule requires that at least 50% of incentive-based compensation payments be deferred over a period of not less than three years for designated executives at these larger institutions. In many respects, this rule moves the compensation policies applicable to U.S. financial institutions more in line with those applicable to financial institutions in the UK and EU.

The following table summarises and compares the principal legislation relating to remuneration in each of the EU, the UK and the proposed rule recently published in the U.S. with regard to financial institutions:

	EU Rules	UK Rules ¹	U.S. Proposed Rule
Implementation	On 7 July, 2010, the European Parliament approved a final draft of the EU Directive (2010/76/EU, also known as “ CRD 3 ”), amending the Capital Requirements Directive (2006/48/EC and 2006/49/EC). The CRD 3 measures relating to remuneration policies in the financial sector were required to be implemented by member states (as CRD 3 does not have direct effect in Member States) by 1 January 2011.	On 17 December, 2010, the UK Financial Services Authority (“ FSA ”) published a policy statement adopting a revised remuneration code that came into force on 1 January 2011 (the “ FSA Code ”). For institutions now falling within the scope of the FSA Code for the first time, transitional rules will be applied. These institutions must comply as soon as reasonably possible, and by 31 July 2011 at the latest.	On 9 February, 2011, the Federal Deposit Insurance Corporation (“ FDIC ”) approved an Interagency Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements (“ Proposed Rule ”). ² The Proposed Rule will be published in the Federal Register for a 45-day comment period. A final rule is expected later this year and the Federal regulators propose to make such final rule effective six month after its publication in the Federal Register. ³
Scope – Institutions	All EU credit institutions (comprising banks and building societies) and investment firms (incorporating other financial institutions including certain funds and investment management firms) as defined by the Markets in Financial Instruments Directive.	All UK credit institutions and investment firms within the scope of CRD 3. It also applies to overseas branches of certain UK institutions; however it will not apply to UK branches of EEA institutions, which will instead be subject to the provisions of CRD 3 as implemented in the relevant EEA home state.	U.S. “covered financial institutions,” as defined by the Proposed Rule, that have total consolidated assets of \$1 billion or more would be subject to the Proposed Rule. ⁴ Additional requirements would apply to larger covered financial institutions with total consolidated assets of \$50 billion or more. ⁵

¹ The UK Rules are based primarily upon the revised FSA Code, which serves to incorporate many of the provisions of CRD 3 into UK law, and carry over certain provisions from the existing code. In addition, it also includes rules made under powers provided to the FSA by the Financial Services Act 2010, and takes account of the principles set out in the Financial Stability Board’s “*Principles for Sound Compensation Practices*”.

² The Federal regulator, *i.e.*, the Board of Governors of the Federal Reserve System (“**Federal Reserve**”), the Office of the Comptroller of the Currency (“**OCC**”), the Office of Thrift Supervision (“**OTS**”), the FDIC, the National Credit Union Administration (“**NCUA**”), the U.S. Securities and Exchange Commission (“**SEC**”), and the Federal Housing Finance Agency (“**FHFA**”), are mandated by section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank Act**”) to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. Each Federal regulator must approve the Proposed Rule independently.

³ The Proposed Rule would supplement existing rules and guidance adopted by the Federal regulators regarding compensation and incentive-based compensation, such as the Interagency Guidance on Sound Incentive Compensation Policies and the Standards for Safety and Soundness adopted by the Federal Reserve, the OCC, the FDIC, and the OTS, the compensation related disclosure requirements for public companies adopted by the SEC, the rules and guidance adopted by the FHFA, and compensation rules adopted by the NCUA.

⁴ Covered financial institutions include: depository institutions or depository holding institutions (including branches and agencies of foreign banking organizations), broker-dealers, credit unions, investment advisers, the Federal National Mortgage Association (“**Fannie Mae**”), the Federal Home Loan Mortgage Association (“**Freddie Mac**”), and any other financial institution that the appropriate Federal regulators determine should be treated as a covered financial institution. For a branch or agency of a foreign banking organization the consolidated assets would be determined based on their U.S. assets.

⁵ For covered financial institutions supervised by the NCUA or the FHFA, the threshold remains at \$1 billion in total consolidated assets.

	EU Rules	UK Rules ¹	U.S. Proposed Rule
Scope - Employees	Institutions must take responsibility for identification of relevant employees, and must be able to demonstrate to supervisors how they have been assessed and selected. Such employees should include, at least, senior management and executive board members, risk-takers whose professional activities can influence the institution's risk profile, senior staff engaged in control functions (such as compliance or risk management), as well as any employee whose total remuneration takes them into the same remuneration category as senior management and risk-takers	Special provision is made for "Code staff", a new definition introduced by the FSA Code that includes: senior management, risk-takers, staff engaged in control functions and any employee whose total remuneration takes them into the same remuneration bracket as senior management and risk-takers who have a material impact on the institution's risk profile.	"Covered persons" subject to the Proposed Rule would be any executive officer, employee, director, or principal shareholder of a covered financial institution. No specific categories of employees are excluded, however, certain prohibitions in the Proposed Rule would apply only to a subset of covered persons.
Primary Requirement	Credit institutions must have " <i>robust governance arrangements, which include...remuneration policies and practices which are consistent with and promote sound and effective risk management.</i> " (Article 22 – CRD, as amended by CRD 3)	The primary requirement of the CRD 3 rules is mirrored in the FSA Code, being that an institution: " <i>must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management</i> ".	A covered financial institution " <i>must not establish or maintain any types of incentive-based compensation arrangements, or any feature of such arrangements, that encourage inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.</i> "

Proportionality

EU Rules

Institutions should apply the remuneration provisions “*in different ways according to their size, internal organisation and the nature, scope and complexity of their activities*”. ‘Limited licence’ and ‘limited activity’ institutions may be given certain flexibility in their application of the requirements. Certain requirements may be ‘neutralised’ by decision of the institution if this is reconcilable with the risk profile, risk appetite and the strategy of the institution.

UK Rules¹

The FSA Code develops the CRD 3 principles by identifying four tiers of institutions, with varying standards of compliance resulting from falling within each one. Tiers are determined according to the type of institution and level of capital resources held at the last accounting reference date.⁶

U.S. Proposed Rule

The policies and procedures developed by each covered financial institution regarding incentive-based compensation arrangements should be appropriately tailored to balance risk and reward for an institution of its size, complexity, and business activity, as well as the scope and nature of the incentive-based compensation arrangements.

In order to determine whether a incentive-based compensation arrangement is excessive, the Federal regulators will consider the following factors:

- The combined value of all cash and non-cash benefits provided to the covered person;
- The compensation history of the covered person and other individuals with comparable expertise;
- The financial condition of the covered financial institution;
- Comparable compensation practices at comparable institutions, based upon asset size, geographic location, and the complexity of the institution’s operations and assets;
- Projected total benefits to the covered financial institution for post-employment benefits;
- Other factors that the Federal regulators deem appropriate.

⁶ Tier 1 comprises UK banks and building societies with capital resources in excess of £1 billion, BIPRU 730k firms which are full-scope BIPRU investment firms (all as defined in the FSA Handbook) with capital resources in excess of £750 million and third country BIPRU firms with assets exceeding £25 billion. Tier 2 comprises UK banks and building societies with capital resources between £50 million and £1 billion, BIPRU 730k firms which are full-scope BIPRU

	EU Rules	UK Rules ¹	U.S. Proposed Rule
Supervision	Each institution’s management body (acting in a supervisory function) must be responsible for approving, maintaining and implementing all remuneration policies in order to ensure that they are consistent with, and promote, sound and effective risk management. Further, each institution that is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities must establish a remuneration committee.	As per EU Rules.	Each covered financial institution’s board of directors ⁷ or a committee thereof is ultimately responsible for a covered financial institution’s incentive-based compensation arrangements and must approve policies and procedures to adopt incentive-based compensation arrangements and to ensure monitoring and compliance with the Proposed Rule. The board of directors or a committee thereof of a covered financial institution with \$50 billion in total consolidated assets must identify those covered persons (other than executive officers) that have the ability to expose the institution to substantial losses and must approve of such covered person’s incentive-based compensation arrangement.
Risk Alignment	Remuneration systems must be structured so as take account of long term risk and be capable of adjustment. The variable components of any remuneration policy are required to be fully flexible, and must therefore be allowed to decrease following negative performance.	As per EU Rules.	Incentive-based compensation must balance risk and financial rewards, must be compatible with effective controls and risk management, and must be supported by strong corporate governance.
Malus & Claw-Back?	EU rules envisage the use by institutions of performance adjustment techniques including ‘malus’ (operating to reduce the value of any deferred remuneration prior to vesting) and / or ‘claw-back’ (entitling the institution to claim-back some or all of the amounts already accrued, i.e., after vesting) arrangements. These techniques adjust the variable component of an employee’s remuneration and are intended to achieve effective risk alignment.	As per EU Rules.	The payment of the deferred amount of the incentive-based compensation to an executive officer of a covered financial institution with \$50 billion or more in total consolidated assets (see below) must be adjusted for actual losses or other measures or aspects or performance that are realized or become better known during the deferral period.

investment firms with capital resources between £100 million and £750 million and third country BIPRU firms (other than limited licence/limited activity firms) with assets between £2 billion and £25 billion. Tier 3 comprises UK banks and building societies and full-scope BIPRU firms not within tiers 1 and 2, and third country BIPRU firms not within tiers 1, 2 and 4. Tier 4 comprises limited licence and limited activity firms.

⁷ The FDIC Proposed Rule defines the board of directors of an insured U.S. branch of a foreign bank as the “senior management of [the] parent bank.”

	EU Rules	UK Rules ¹	U.S. Proposed Rule
Deferral Requirement	Between 40% and 60% of a staff member's variable remuneration must be deferred, depending on the impact that the relevant staff member may have on the institution's risk profile and the amount of the total variable remuneration (the higher the total amount, the higher the minimum deferred percentage).	As per EU Rules.	At least 50% of the annual incentive-based compensation for an executive officer of a covered financial institution with \$50 billion or more in total consolidated assets must be deferred over a period of not less than 3 years and payout cannot be faster than a pro rata equal-annual-increments distribution.
Deferral Period	A minimum period of 3 to 5 years, depending on the impact that the relevant staff member may have on the institution's risk profile and the amount of the total variable remuneration (the higher the total amount, the higher the minimum deferral period).	As per EU Rules.	Over a period of not less than 3 years (see above).
Payment in cash or other instruments	At least 50% of any variable remuneration element shall consist of an appropriate balance of shares (or equivalent ownership interests), share-linked instruments, equivalent non-cash instruments (in the case of non-listed institutions), or if appropriate, any instruments that (i) convert to equity in emergency situations or at a regulator's instigation and (ii) "adequately reflect the credit quality of the institution as a going concern". This requirement is applied equally to both the deferred and non-deferred component of variable remuneration.	As per EU Rules.	n/a
Guaranteed Bonuses	'Guaranteed variable remuneration' should be "exceptional" and only arise under the condition of hiring new staff and during the first year of employment. This type of benefit may include a bonus payment under a number of descriptions including a guaranteed / welcome / sign-on or minimum bonus.	As per EU Rules.	n/a

	EU Rules	UK Rules ¹	U.S. Proposed Rule
Personal Hedging	Staff must undertake not to employ hedging strategies or contracts of insurance which are intended to undermine the risk alignment effects of their remuneration package.	As per EU Rules.	The Proposed Rule does not contain a provision regarding personal hedging strategies, however, the Federal regulators specifically ask for comments whether the final rule should contain a provision limiting personal hedging strategies in connection with incentive-based compensation arrangements.
Disclosure Requirements	All institutions must publicly disclose detailed information with respect to any remuneration policies relating to staff whose activities have a material impact on their risk profiles. This information might include, amongst other things, information on the link between pay and performance, information on the performance criteria on which entitlement to shares is based, and / or aggregate quantitative information on remuneration. Disclosure requirements are subject to the principles of proportionality, such that small or non-complex institutions are only expected to provide “ <i>some qualitative information and very basic quantitative information where appropriate</i> ”. Certain types of information may also be exempt from disclosure on the basis of materiality, their proprietary nature or confidentiality.	There are no specific disclosure requirements referred to in the FSA Code. Instead, the CRD 3 requirements have been implemented through the FSA’s Prudential Sourcebook for Bank, Building Societies and Investment Firms (BIPRU). Disclosure requirements have been applied proportionately, in accordance with the categorisation (ie., Tier 1 to Tier 4) of the relevant institution. Each of the largest (Tier 1) firms is expected to disclose all relevant information identified by CRD 3.	Each covered financial institution must submit an annual report to its Federal regulator, describing the structure of the covered financial institution’s incentive-based compensation arrangement for covered persons. The report must be sufficient to allow an assessment whether such compensation is excessive or could lead to material financial loss to the covered financial institution. A covered financial institution is not required to report the actual compensation of a particular covered person.
Method of Disclosure	There are presently no specific requirements as to how such information is to be disclosed, although the CEBS Guidelines make it clear that the information must be “easily accessible”.	Disclosures must be made “ <i>as soon as practicable</i> ” after 1 January 2011, although it is expected that the FSA will impose a deadline of 31 December 2011. Disclosure may be made in the form of a stand-alone report, or alternatively can be included in the institution’s annual report.	Annual report to the appropriate Federal regulator according to rules to be established by each Federal regulator. The Federal regulators will maintain the confidentiality of the information and such information will be nonpublic to the extent permitted by law.