



Regulatory Reform

SEC Proposes Rules for Incentive-Based Pay At Brokers, Advisers With Over \$1B in Assets

The Securities and Exchange Commission March 2 voted 3-2 to propose enhanced disclosure requirements for incentive-based compensation practices at broker-dealers and investment advisers with over \$1 billion in assets, and to bar pay structures that encourage “inappropriate” risk-taking.

The proposed rulemaking—required under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act—was undertaken in conjunction with actions taken by the Federal Reserve, the Federal Deposit Insurance Corporation, and four other federal agencies with respect to financial institutions under their purview.

The commission's proposal further would impose additional requirements for broker-dealers and investment advisers with over \$50 billion in assets, which is not specifically required under Section 956.

At the same meeting, the SEC also unanimously proposed rule amendments to remove credit rating references from 1940 Investment Company Act rules and forms, and unanimously proposed operation and governance standards for clearing agencies [see *related report in this issue*]. Moreover, the commissioners unanimously agreed to reopen the comment period relating to proposed Regulation MC, which was proposed in October to mitigate conflicts of interest for swaps market participants (42 SRLR 1934, 10/18/10).

Compensation Proposal

The SEC's proposed compensation rule has three main components. It would: require broker-dealers and investment advisers with over \$1 billion in assets to disclose to the SEC their incentive-based compensation arrangements; bar arrangements that could lead to undue risky practices by covered persons; and require firms to establish and maintain policies and procedures for such arrangements.

More specifically, the proposal would require such firms to file annual reports describing their incentive-based compensation structures. The report would include a narrative description of the components of such arrangements, and a statement explaining why the firm believes its pay structure will not cause it material economic harm, or why it does not believe covered persons are over-paid. Covered persons include employees, directors, and principal shareholders.

The proposal also would bar firms from establishing or maintaining incentive-based pay arrangements that encourage excessive risk taking through over-paying executives, or that could lead to “material financial loss.”

The SEC, consistent with its directive under Dodd-Frank Section 956, proposes to use standards comparable to those developed under Section 39 of the Federal Deposit Insurance Act to determine whether compensation is “excessive.” The FDIA currently states that compensation is deemed excessive when amounts paid are “unreasonable or disproportionate” to the services performed after consideration of certain factors.

The proposal further would establish heightened requirements for broker-dealers and investment advisers with more than \$50 billion in assets. Such firms would have to defer, for three years, at least 50 percent of any incentive-based pay for executive officers, and to award such pay on a pro rata basis. Under the proposal, the pay arrangements would have to be adjusted to reflect losses suffered by the firm after the pay was initially awarded.

Moreover, the proposal would require the firms' board of directors or a board committee to identify employees outside of executive officers who could expose the firm to material losses. Once identified, any incentive-based pay awarded to such persons would have to be approved by the board or committee.

Current Pay Practices

The proposal seeks to mimic pay practices at large financial institutions, many of which currently require deferral of compensation over a three-year period. However, what is new is the commission's proposed requirement that the incentive-based compensations be adjusted for losses incurred by the firm.

It is estimated that about 132 broker-dealers, and about 70 investment advisers, have assets of over \$1 billion, and that about 17 broker-dealers, and fewer than 10 investment advisers, have assets of over \$50 billion.

It is difficult for the SEC to provide accurate figures for how many investment advisers will be impacted by the proposal because most advisers measure their assets by assets under management, rather than proprietary assets as referenced in the proposal. However, the SEC will have access to that information next year if it finalizes a proposal issued in January that would require large fund advisers to report detailed information about their asset holdings (43 SRLR 198, 1/31/11). In addition, many advisers are dually registered as broker-dealers.

In recommending the heightened requirements for firms with at least \$50 billion in assets, John Ramsay, deputy director of the SEC's Division of Trading and Markets, told the commissioners that staff was "sensitive" to the fact that deferral of compensation may not be appropriate for all firms. The proposing release asks for comment on this issue, he said.

In her opening remarks, SEC Chairman Mary Schapiro called the joint rulemaking a "challenge," given the need to find commonality, and to work out compromises, with the other federal regulators. She called for comments to aid the commission, asking especially for commenters' views on how assets should be calculated to determine if firms fall within the required \$1 billion and \$50 billion thresholds. Schapiro said she also was interested to hear how the proposed requirements would impact the covered firms, most particularly private fund advisers. "This is an area where we want to be very attuned to unintended consequences," she said.

Objections

Commissioners Kathleen Casey and Troy Paredes voted against the proposal. Casey objected to what she described as "very particularized and prescriptive requirements" for firms of over \$50 billion in assets to defer their incentive-based pay. Among other problems, there is little discussion in the proposing release of whether this is "relevant or appropriate" for the firms, she said.

Further, it is not clear how the requirements fulfill the mandate of Section 956, Casey continued. "Given the fact that under Section 956 covered financial institutions and their regulators will be reviewing incentive-based compensation practices regularly, this additional provision is wholly unnecessary and without any demonstrable corresponding benefit."

Similarly, Paredes called the proposed requirement for firms of \$50 billion and more a "prescriptive regulatory approach" that was ill-advised. He said his core concerns were that pay arrangements vary from firm to firm, and the SEC was not equipped to determine how pay should be awarded. In addition, the commissioner said the heightened requirements could make it difficult for the firms to recruit qualified personnel, and could lead to employees and executives avoiding even the necessary risks. "In sum, the risk of unintended consequences is considerable when regulators try to micromanage individuals' incentives to the degree and in the way that this rulemaking does," he said.

The SEC's incentive-based pay proposal will be published in the *Federal Register* as part of a proposed joint rule comprising the proposals approved by all the relevant federal agencies. The comment period for the proposed rule is open for 45 days after publication.

Increased Risk

Meanwhile, speaking to BNA March 4, Ford Ladd, of counsel in DiMuro Ginsberg PC, Alexandria, Va., warned that the SEC's proposed amendments—in authorizing more accelerated payment of incentive-based pay to covered employees than might otherwise result under the requirements of Dodd-Frank Section 954—inadvertently could increase systemic risk by financial institutions. Section 954—the reform act's clawback provision—requires issuers to recover erroneously awarded pay in the event of an accounting restatement due to "material noncompliance" with reporting requirements.

"By authorizing larger covered financial institutions to disburse up to 50 percent of any incentive-based compensation in the year awarded, and to pay out one-third of the retained amount over the next three years, the proposed regulations may cause entities that present the greatest systemic risk to authorize earlier disbursement of their incentive-based income than may otherwise result under Section 954, which requires issuers to recover 100 percent of incentive-based compensation over a full three-year period if an accounting restatement is required," Ladd said.

By Yin Wilczek

Further details of the proposal are available at <http://www.sec.gov/news/press/2011/2011-57.htm>, and a draft of the proposing release is available at <http://www.sec.gov/spotlight/dodd-frank/956-proposedrule-draft.pdf>.

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