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The Volcker Rule's Impact on Incentive Compensation

BY BONNIE J. ROE

The Volcker Rule[1] is designed to prohibit banks and bank affiliates from engaging in two types of behavior that are thought to expose them to inappropriate levels of risk: proprietary trading and the ownership of interests in high-risk investment funds. Restrictions on incentive compensation are a small but critical part of the edifice of compliance rules and exceptions surrounding both of these general prohibitions. The idea is to ensure that employees of "banking entities" (as defined in the rule)[2] are not improperly incentivized through compensation arrangements to implement high-risk investment strategies for their organizations.

Over the course of the next year, banking entities must review their operations and determine how to comply with the complex set of requirements contained in the Volcker Rule, promulgated by five federal agencies in December 2013 and accompanied by over 200 pages of attached commentary, explaining the rule and decisions made in the rule-making process.[3] As part of the required compliance process, banking entities will need to identify the employees covered by the restrictions, review their existing incentive compensation arrangements and determine what changes need to be made before the revised July 21, 2015 implementation date of the Volcker Rule.[4]

In general, the Volcker Rule takes a principles-based approach in identifying prohibited activities; this principles-based approach extends to the restrictions on incentive compensation. While this approach may provide needed flexibility to banking entities in structuring their compliance programs overall, the vagueness of the requirements may pose challenges in designing effective incentive compensation plans or ensuring that the plans, once designed, will conform to the requirements.

Permissible Activities

The Volcker Rule exempts certain underwriting, market-making and risk-mitigating hedging activities from the prohibition on proprietary trading. In each case, the Volcker Rule sets forth complex requirements for the permissible activities. Among these requirements are that the compensation arrangements for the employees involved in these activities be "designed not to reward or incentivize prohibited proprietary trading."[5] No other guidance is offered in the Volcker Rule itself with respect to incentive compensation for employees engaged in underwriting, market-making or hedging activities. The commentary, however, explains that the language of the rule is intended to establish an objective standard, focusing on the design of the compensation arrangement, rather than the motivations of any individual employee. In order to comply with the basic requirement and come up with effective incentives

BONNIE J. ROE *is a partner in Cohen & Gresser's corporate group.*

for the affected employees, banking entities must analyze the scope of the permissible and non-permissible activities to determine what can and cannot be incentivized or rewarded. The commentary does not shed much additional light.

For example, the Volcker Rule generally permits banking entities to serve as underwriters in securities offerings, but requires (among other things) that the amount and type of securities underwritten not exceed the amount expected to be needed to satisfy the near-term customer demand, in order to limit the exposure of the banking entity to price fluctuations in unsold allotments and to ensure that the underwriting exemption is not used as a back door into proprietary trading. In the commentary to the Volcker Rule, the agencies promulgating the rule note that compensation arrangements for employees engaged in underwriting activities could take into account profits from price increases in securities held for sale in underwriting arrangements only to the extent that such profits reflect the effective management of underwriting risk. The commentary states that the principal focus of incentive compensation for employees involved in the underwriting function should be client revenues and client service. A compensation plan that was purely focused on net profit and loss with no consideration of either the management of inventory (i.e., the amount held for sale at any time) or the level of risk would be inconsistent with the underwriting exemption. Nonetheless, the agencies rejected proposals that would have called for requiring incentive compensation to vest over time before payout or that would have permitted banking entities to pay annual bonus compensation only after all securities from the year's underwriting transactions had been sold, two proposals that might encourage longer-term thinking and thereby limit risk-taking activities. Instead, the commentary to the Volcker Rule stresses that compliance with the requirements of the exemption for underwriting activity should provide assurance that inappropriate risks are not undertaken.

A similar approach is taken in the commentary with respect to incentive compensation for employees involved in market-making. According to the commentary, incentive compensation for such employees is inappropriate to the extent that it rewards speculation in, or appreciation in the value of, financial instrument positions held in inventory, rather than effective and timely intermediation and liquidity services to customers. Incentive compensation could take into account appreciation in the value of financial instrument positions held in inventory only to the extent that such increases reflect the effectiveness with which the personnel have managed the risks of holding such positions. As in the case of the underwriting exemption, the appropriate focus for incentive compensation should be client revenues and client service, and a compensation plan that was focused solely on net profit and loss would not comply with the exemption. In adopting the final rule, however, the agencies rejected proposals that would have imposed vesting requirements, limited compensation to specific sources of market-making revenue, such as fees or spreads, or mandated that gains be risk-adjusted.

The Volcker Rule commentary on incentive compensation for employees engaged in risk-mitigating hedging activities is sparse, despite many pages of commentary devoted to hedging activities as a whole. The commentary indicates that an incentive compensation scheme that rewards speculation in, or appreciation in the value of, the financial positions held by the banking entity would not be consistent with the Volcker Rule. Instead, compensation should be tied to efforts to mitigate risk. The commentary also mentions to the need to refer to guidance, yet to come, under §956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), discussed below.

Restrictions on Equity Ownership

Under the Volcker Rule, banking entities generally may not invest in or sponsor "covered funds," such as hedge funds or private equity funds, but certain activities are permitted. Restrictions on compensatory arrangements using equity interests in such funds are woven into the exceptions. For example, a banking entity may acquire and retain an equity interest in a fund that it or an affiliate organizes and offers for the purpose of providing sufficient seed capital to permit the fund to attract other investors. After the initial seeding period, the ownership interest of the banking entity and its affiliates may not exceed 3 percent of the outstanding ownership interests in the fund. In addition, the aggregate ownership interests of the banking entity and its affiliates in all covered funds may not exceed 3 percent of the tier 1 capital of the banking entity. In calculating the per-fund limit, the ownership interests of employees and directors must be taken into account if the banking entity has provided financing to the employee or director for the purpose of acquiring the interests. Excluded from the calculation of both per-fund and tier 1 capital limits are "restricted profits interests," or carried interests, which compensate investment management and advisory activities provided by the banking entity or affiliate. In order to qualify as a restricted profits interest, undistributed profits of the fund relating to the interest may not be retained in the fund except as a reserve to satisfy contractual "clawback" obligations with respect to subsequent losses. Only employees involved in the investment management and advisory activities with respect to the fund may receive restricted profits interests.

Other Regulation

The Volcker Rule is not the only Dodd-Frank provision regulating incentive compensation for employees of financial institutions. A more comprehensive regulatory scheme for incentive compensation is included in §956 of Dodd-Frank, which requires various federal agencies to develop "regulations or guidelines" that prohibit incentive compensation arrangements that:

- encourage financial institutions covered by the rule to incur inappropriate

risk by providing an executive officer, employee, director or principal shareholder of the institution with excessive compensation, fees or benefits; or

• could lead to material financial loss to the covered financial institution.

The rules to be promulgated by the federal agencies must require covered financial institutions to disclose their incentive compensation arrangements to the federal agencies on an annual basis to enable the agencies to determine whether such arrangements encourage inappropriate risk as described above or could lead to material financial loss to the covered financial institution.

Rules under §956 were proposed in the first half of 2011,[6] but they came under significant criticism and have not yet been finalized. In general the proposed rules under §956 take a principles-based approach, although there are also some more specific requirements. For example, in order to avoid "excessive" compensation, judgments would be made about, among other things, the individual's compensation history and the compensation of his or her peers, as well as the financial condition of the institution, compensation practices at similar institutions and the individual's connection to any fraudulent act or breach of trust. Incentive compensation arrangements would be required to balance risk and reward through various mechanisms such as deferral arrangements, risk adjustment of reward, or longer-term performance periods. Incentive compensation would also be required to be structured so as to be compatible with effective internal control and risk management, and be supported by strong corporate governance and oversight by the board or board committee. For officers at covered financial institutions having at least $50 billion in consolidated assets, at least 50 percent of their incentive compensation for any year must be deferred for payout over a period of no less than three years. For all executive officers at covered financial institutions, if a portion of their incentive compensation is deferred, the deferral period must be appropriate to the duties of such executive officer. Deferred amounts must also be adjusted for losses or other elements of performance that become known after the award is made.

Incentive compensation also must be viewed under the light of §39(c) of the Federal Deposit Insurance Act, enacted in 1991, which prohibits excessive compensation at banking institutions. In addition, the Interagency Guidance on Sound Incentive Compensation Policies, published in the Federal Register on June 25, 2010, sets forth some general principles for incentive compensation offered by banking institutions.[7] Thus incentive compensation must: reflect an appropriate balance of risks and rewards; be consistent with effective controls and risk management; and be supported by strong corporate governance and active and effective oversight by the organization's board of directors. While these are nice-sounding principles, they offer little practical guidance for entities trying to devise a compliant incentive compensation plan. It is possible, however, that more specific guidance will come as a result of future rule-making or oversight under §956 of Dodd-Frank.

What Should Banking Entities Do?

Designing a compliant incentive compensation plan for any banking entity requires a thoughtful analysis of the entity's activities and the actual incentives of the employees engaged in activities that are covered by the Volcker Rule. This analysis is an integral part of the development of the compliance programs that banking entities are required to adopt pursuant to the Volcker Rule. A rigorous and well-articulated overall compliance program will make it easier to design and implement compliant employee incentives and help employees understand what they may and may not do. Given the minimal guidance in the Volcker Rule commentary, banking entities must rely on their own analysis and the strength of their compliance systems as a whole in order to ensure that they do not offer inappropriate incentive compensation.

1. Section 619 of Dodd-Frank generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. The regulations adopted pursuant to §619 of Dodd-Frank, described in more detail in footnote 3 below, are referred to in this article as the "Volcker Rule."

2. A "banking entity" is defined in §_.2(c) of the Volcker Rule as, subject to certain exceptions, (i) any insured depository institution; (ii) any company that controls an insured depository institution; (iii) any company that is treated as a bank holding company for purposes of §8 of the International Banking Act of 1978 (12 U.S.C. 3106); and (iv) any affiliate or subsidiary of any entity described in (i), (ii), or (iii).

3. "Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds," 79 FR No. 21 at 5536 (Jan. 31, 2014), Office of the Comptroller of the Currency, Treasury, 12 CFR Part 44, Board of Governors of the Federal Reserve System, 12 CFR Part 248, Federal Deposit Insurance Corporation, 12 CFR Part 351, Securities and Exchange Commission, 17 CFR Part 255, Commodity Futures Trading Commission, 17 CFR Part 75.

4. The original implementation date was set for July 21, 2014 before the Federal Reserve exercised its independent authority to grant a one-year extension of the conformance period for all banking organizations.

5. Section _.4(a)(2)(iv) of the Volcker Rule (underwriting); section _.4(b)(2)(v) of the Volcker Rule (market-making); section _.5(b)(3) (risk-mitigating hedging activities).

6. "Incentive-based Compensation Arrangements," 76 FR No. 72 at 21170 (April 14, 2011), Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 42, Federal Reserve System, 12 CFR Part 236, Federal Deposit Insurance Corporation, 12 CFR Part 372, Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 563h, National Credit Union Administration, 12 CFR Parts 741 and 751, Securities and Exchange Commission, 17 CFR Part 248, Federal Housing Finance Agency, 12 CFR Part 1232.

7. "Guidance on Sound Incentive Compensation Policies," Department of the Treasury, Office of the Comptroller of the Currency; Federal Reserve System; Federal Deposit Insurance Corporation; Department of the Treasury, Office of Thrift Supervision.

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