

**SEC APPROVES PROPOSED RULE REGARDING FINANCIAL INSTITUTIONS'
INCENTIVE-BASED COMPENSATION**

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), on March 2, 2011, the Securities and Exchange Commission (the “SEC”) became the second of several federal agencies to approve an interagency proposed rule (the “Proposed Rule”) that would regulate the incentive-based compensation arrangements of certain financial institutions. Under the SEC’s Proposed Rule, certain broker-dealers and investment advisers, including covered hedge fund investment advisers, would be required to disclose the structure of their incentive-based compensation practices and would be prohibited from maintaining compensation arrangements that provide excessive compensation to “covered persons” or encourage inappropriate risks. In addition, broker-dealers and investment advisers with \$50 billion or more in assets would be subject to additional requirements, including, most significantly, mandatory deferral of the incentive-based compensation of executive officers and heads of major business lines.

The Dodd-Frank Act, which was signed into law on July 21, 2010, requires the SEC, the Board of Governors of the Federal Reserve System (“Federal Reserve”), the Office of the Comptroller of the Currency (“OCC”), the Board of Directors of the Federal Deposit Insurance Corporation (“FDIC”),¹ the Office of Thrift Supervision (“OTS”), the Federal Housing Finance Authority (“FHFA”) and the National Credit Union Administration (“NCUA”) to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. The Proposed Rule must be approved separately by each of the agencies before it is officially published and then will be subject to a 45-day public comment period. If adopted, the final version of the Proposed Rule would become effective six months after publication of the final rule in the Federal Register, with annual reports due within 90 days of the end of each covered financial institution’s fiscal year.

1. Covered Financial Institutions

Consistent with the Dodd-Frank Act, the Proposed Rule applies to broker-dealers registered under the Securities Exchange Act of 1934 and “investment advisers,” within the meaning of the Investment Advisers Act of 1940 (whether or not registered), in each case that have total consolidated assets on their balance sheets of at least \$1 billion.² For purposes of the Proposed Rule, the amount of consolidated assets of a broker-dealer is determined based on the total assets reported in the most recent year-end audited Consolidated Statement of Financial Condition filed

¹ In February, the FDIC approved a similar version of the interagency proposed rule as it would apply to certain state non-member banks and insured U.S. branches of foreign banks.

² Investment advisers should consult with their auditors as to whether the assets of investment funds managed by them must be consolidated on the adviser’s balance sheet under applicable accounting principles, an issue beyond the scope of this memorandum.

under the Securities Exchange Act of 1934, while the amount of consolidated assets of an investment adviser is determined using the adviser's total assets shown on its balance sheet for the most recent fiscal year end.

As proposed, an investment adviser would not be treated as a covered financial institution unless assets on its own balance sheet are \$1 billion or more, regardless of whether it has assets under management of \$1 billion or more. However, public comment has been specifically requested on the proposed method of determining asset size for investment advisers and on whether the determination of total assets should be further tailored for advisers to hedge funds or private equity funds.

2. Prohibition on Excessive Compensation

The Proposed Rule prohibits incentive-based compensation arrangements that encourage executive officers, employees, directors, or principal shareholders ("covered persons") to expose the financial institution to inappropriate risks by providing the covered person excessive compensation. For purposes of the Proposed Rule, an "executive officer" is a person who holds the title or performs the function of president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer or head of a major business line. A "principal shareholder" is an individual who directly or indirectly, or acting in concert with one or more persons, owns, controls or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.

Incentive-based compensation is defined quite broadly under the Proposed Rule to include any variable compensation that serves as an incentive for performance, regardless of the form of payment (i.e., cash, equity or other property). However, compensation conditioned solely on continued employment, such as salary or retention-like awards, would not be considered incentive-based compensation. Also, compensation would not be subject to the Proposed Rule if paid solely for activities or behaviors that do not involve risk-taking or if based solely on the covered person's level of fixed compensation rather than on a performance metric. Any gain (including dividends paid) on stock or other equity instruments that are owned outright by a covered person would also be excluded from the Proposed Rule.

Under the Proposed Rule, incentive-based compensation would be considered excessive compensation if the amount paid is unreasonable or disproportionate to the services performed, taking into account, among other 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 at the financial institution;
- the financial condition of the financial institution;
- comparable compensation practices at comparable institutions;

- for post-employment benefits, the projected total cost and benefit to the financial institution; and
- any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution.

3. Prohibition on Arrangements That Could Lead to Material Financial Loss

The Proposed Rule prohibits a covered financial institution “from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the covered financial institution that could lead to material financial loss.” To comply with this prohibition, the incentive-based compensation arrangement would be expected to balance the risks against the financial rewards to the covered financial institution. Some methods by which a plan can strike this balance are deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance and longer performance periods. In some cases, two or more methods may be needed for an incentive-based compensation arrangement to be balanced. In addition to being balanced, the plan should also be compatible with effective controls and risk management and supported by strong corporate governance. Covered financial institutions should have appropriate controls to ensure that their procedures for achieving balanced and effective compensation arrangements are followed.

4. Mandatory Deferral of Incentive-Based Compensation

The Proposed Rule establishes additional requirements for covered financial institutions with total consolidated assets of \$50 billion or more. With respect to these institutions, the Proposed Rule requires that at least 50% of the incentive-based compensation for the institution’s executive officers be deferred for at least three years. Amounts deferred must be adjusted for actual losses of the covered financial institution or other measures or aspects of performance that are realized or that become better known during the deferral period.

The Proposed Rule would also require that a board of directors, or a committee of such a board, identify those covered persons (other than executive officers) who have the ability to expose the institution to substantial losses in relation to the institution’s size, capital or overall risk tolerance and approve their incentive-based compensation arrangements and maintain documentation of such approval. Under the Proposed Rule, an incentive-based compensation arrangement could not be approved unless the board or committee determined that it effectively balanced the financial rewards to the covered person and the risks associated with the covered person’s activities.

The implementation of the deferral requirements imposed under the Proposed Rule will need to be considered in light of other applicable U.S. and foreign laws, including the tax law requirements imposed on deferred compensation arrangements under Sections 409A and 457A of the Internal Revenue Code of 1986, as amended.

5. Maintaining Policies and Procedures to Ensure Compliance

The Proposed Rule requires covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure transparency of the compensation plan and compliance with the Proposed Rule. It would require that policies and procedures be tailored to balance risk and reward for the covered financial institution and address the requirements of the Proposed Rule. In addition, the policies and procedures would be required to provide for independent monitoring of incentive-based compensation awards and payments, risks taken and actual risk outcomes to determine whether the compensation payments have been reduced to reflect adverse risk outcomes or high levels of risk taken. To ensure an unbiased risk analysis, such monitoring must be done by a group or person independent of the covered individual, where practicable in light of the institution's size and complexity (e.g., a group or person at the covered financial institution with a separate reporting line to senior management).

6. Disclosure Requirement

The Proposed Rule would require a covered financial institution to provide annual reports to the appropriate federal agency regarding its incentive-based compensation arrangements for covered persons. In particular, a covered financial institution would be required to disclose the structure of its incentive-based compensation arrangements in sufficient detail to enable the applicable federal agency to determine whether those arrangements provide covered persons with excessive compensation or could lead to material financial loss. A covered financial institution would not be required to report the actual compensation of particular individuals and the submitted annual reports generally would be confidential and considered non-public to the extent permitted by law.

7. Request for Comments Regarding the Proposed Rule

While it can be expected that the final rule will be very similar to the Proposed Rule, the federal agencies have made a number of specific requests for comment regarding various aspects of the Proposed Rule that are expected to be addressed in the final rule. Notably, the Proposed Rule was approved by the SEC by a 3-2 vote, and therefore, because the final rule will need to be approved by the SEC, as well as each of the other applicable federal agencies, the public comment process may have a significant effect on the ultimate final rule.

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