Client Update
New Incentive Compensation Rules: Implications for Private Equity Firms

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The Securities and Exchange Commission has been working together with other U.S. federal financial regulators since 2011 to issue regulations under Section 956 of the Dodd-Frank Act that would restrict incentive compensation practices in an effort to curb "inappropriate" risk-taking at banks, broker-dealers, investment advisers and other covered financial institutions ("CFIs"). Over the course of the past week, the Federal Deposit Insurance Corporation and several other agencies have released revised proposed rules to implement Section 956.[1] The proposals released to date preview what are expected to be substantially similar proposed rules coming from the SEC in the near term. The SEC's version of the proposed rules should provide additional detail that would apply specifically to investment advisers—including advisers to private equity funds ("PE Managers") and other private funds—and to broker-dealers. The proposed rules differ significantly from the original rule proposals issued in 2011.

WILL THE PROPOSED RULES APPLY TO ALL PE FIRMS?

No. The minimum requirements of the proposed rules apply only to PE Managers with total consolidated assets of $1 billion or more, not counting any non-proprietary assets. (In other words, third party assets under management by the PE Manager are not included in consolidated assets for this purpose, even if GAAP requires those assets to be consolidated onto the PE Manager's balance sheet.) PE Managers with total consolidated assets of less than $1 billion are not subject to the proposed rules at all.

[1] See Debevoise Client Update, Compensation Practices at Financial Institutions Targeted: Proposed Incentive Compensation Rules Aim to Curb Excessive Risk-Taking, at http://www.debevoise.com/~/media/files/insights/publications/2016/04/20160426c_compensation_practices_at_financial_institutions_targeted.pdf.

The more stringent provisions of the proposed rules would apply to PE Managers with $50 billion or more in total consolidated assets. However, we are not aware of any PE Managers meeting that threshold.[2]

WHAT ARE HIGHLIGHTS OF THE PROPOSED RULES?

Highlights of the proposed rules applicable to any PE Manager with total consolidated assets between $1 billion and $50 billion are as follows:

- non-proprietary assets are not included in the determination of asset thresholds, even if reflected on the consolidated balance sheet, exempting all (or almost all) PE Managers from the more exacting requirements of the rules and many (perhaps most) PE Managers from the proposed rules altogether;
- in determining incentive compensation to be awarded for all employees and directors, covered PE Managers must (1) take into account both financial and nonfinancial risk-based measures and (2) subject these awards to risk adjustments, which may prove difficult to implement for standard carried interest arrangements;
- although reporting obligations are curtailed from the 2011 proposal, the proposed rules contain expanded recordkeeping requirements; and
- new corporate governance procedures are mandated, which (among other things) may require covered PE Managers to establish a board-level compensation oversight function.

The proposal contemplates a fairly lengthy transition period and a significant "grandfathering" provision. Final rules will become effective on the first day of the first calendar quarter that begins at least 540 days after the final rule is published, and the proposed rules would not apply to any incentive compensation plan with a performance period that began before the effective date of the final rules. Similar transition periods apply when a PE Manager first becomes subject to the rules.

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[2] For a detailed discussion of the requirements applicable to CFIs with $50 billion or more in total consolidated assets, please see the Debevoise Client Update referenced in note 1 above. For these larger institutions, the proposed rules: require the deferral of 40-60% of incentive compensation for 3-4 years *after* the end of a performance period (or for 1-2 years where the performance period is 3 years or more); prescribe new requirements on the form of deferred compensation; subject a broader pool of executives and significant risk-takers of the institution to these more stringent provisions; prohibit accelerated vesting of deferred awards; impose a new seven-year post-vesting clawback; circumscribe the use of certain performance measures; and prohibit hedging, among other new requirements.

HOW ARE COVERED PE FIRMS DETERMINED UNDER THE PROPOSED RULES?

CFIs under the Dodd-Frank Act include, among other institutions, investment advisers, as defined under the Investment Advisers Act of 1940 (the "Advisers Act"), whether or not the investment adviser is required to register under the Advisers Act. Thus, the proposed rules apply both to registered investment advisers and to "exempt reporting advisers" and other international firms (including those based outside of the United States) operating under various Advisers Act exemptions.

The proposed rules introduce a new categorization framework with three asset levels to tailor prohibitions to the size of each institution. The three tiers are as follows: *Level 1*, CFIs with total consolidated assets greater than or equal to $250 billion; *Level 2*, CFIs with total consolidated assets greater than or equal to $50 billion and less than $250 billion; and *Level 3*, CFIs with total consolidated assets of greater than or equal to $1 billion and less than $50 billion. The SEC's regulatory regime for broker-dealers and investment advisers generally would apply the rules on an entity-by-entity basis (although advisers that are treated by the SEC as a single investment adviser because they are operationally integrated may be aggregated).

In welcome news for our PE Manager clients, as noted above, the newly proposed rules clarify that, for investment advisers only, non-proprietary assets (such as client assets under management) are *not* included in determining the adviser's total consolidated assets. This means that private fund assets and other assets under management that are consolidated into a PE Manager's balance sheet will not be counted in determining average total consolidated assets. As a result, many PE Managers will not be subject to the proposed rules at all. PE Managers that are covered by the rules most likely will be considered Level 3 CFIs and, therefore, required to comply with only the minimum requirements (thus escaping the proposed rules' most draconian provisions).

The proposed rules do allow the regulators to treat a Level 3 CFI with at least $10 billion in total consolidated assets as a higher level institution (*e.g.*, as a Level 2 or Level 1 CFI) with respect to some or all of the rules *if* the CFI's complexity of operations or compensation practices are consistent with those of a Level 1 or 2 entity. The agencies expect to use this authority on an infrequent basis and only with advance notice. It does not appear that PE Managers would be likely targets of this potential exercise of discretion because they typically do not engage in the high-risk behaviors and compensation practices associated with the larger regulated institutions.

HOW WILL CARRIED INTEREST ARRANGEMENTS BE IMPACTED?

"Incentive-based compensation" under the proposed rules means any variable compensation, fees or benefits that serve as an incentive or reward for performance. This can include compensation earned under an incentive plan, annual bonuses or discretionary awards.

This means that:

- Payments made exclusively for reasons other than to induce performance (such as salary and retention awards) are intended to be excluded from the rules.
- Dividends and appreciation on owned (*i.e.*, vested) equity interests are also excluded.
- Annual bonuses paid out of management fees or from other PE Manager income would in most cases be covered by the rules.
- Carried interest arrangements and incentive arrangements based on fund performance may fall within the definition of "incentive-based compensation" under the proposed rules, but it is unclear how the proposed rules would apply to those arrangements.

For all incentive-based compensation, the rules envision: (1) a performance period (*e.g.*, a calendar year), followed by (2) an "award" to an individual of a specific amount of incentive compensation determined based on performance during the period (*e.g.*, a bonus paid to an employee after the end of a calendar year that was calculated based on the employee's performance during such calendar year), and (3) for the larger institutions covered by the rules, a deferral period after which the award vests and pays out. In addition, under the minimum requirements of the proposed rules, (1) each CFI must apply both financial and nonfinancial performance measures *during* the performance period (*i.e.*, *before* the incentive compensation is awarded) and (2) the compensation to be awarded must be subject to risk adjustments to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and nonfinancial performance, as discussed in more detail below.

This paradigm works with respect to annual bonuses paid to employees of PE Managers. It is not at all clear, however, how this paradigm applies to carried interest arrangements. Grants of carried interest generally are not preceded by a performance period (except to the extent award levels are based on past performance, such as fundraising success or a history of successful investing). Rather, the award of a share of the carried interest (*i.e.*, the grant of a profits interest) typically is made up front at the commencement of a fund or

commencement of employment, and sometimes at the time an investment is made.

Of course, it is true that carried interest distributions, if any, made to an employee of a PE Manager upon the sale of a portfolio investment are directly linked to the successful (or not) performance of the investment; but this is inherent in the nature of the interest. The carried interest percentage typically is *not* adjusted up or down following grant based on any assessment of performance factors. Reductions are made only to the extent time vesting is not satisfied or other adjustment mechanics put in place at the time of grant are utilized. In other words, there generally is no assessment of an individual's performance after the employee is given a right to share in the carry, or an adjustment to that percentage based on the employee's performance. Unless the amount of carry granted is made subject to downward adjustment (which is unusual), there is no opportunity to conduct risk adjustments as required by the rules.

In order to comply with the proposed rules, PE Managers may need to take into account risk measures for prior funds, build in risk metrics prior to the award of carried interests, or subject the carried interest to longer-term vesting periods and/or post-grant adjustments.

Many PE Managers will not want to restructure their carried interest arrangements in these ways, especially since the changes do not seem necessary to address the types of "inappropriate" risk-taking that the proposed rules were intended to address. After all, carried interest arrangements currently in use already expressly link performance to risk because carried interest distributions are only made when gains are realized in respect of a portfolio investment. We anticipate that the industry will submit comments on the proposed rules (just as they did in 2011), including requests for clarification on whether and how the proposed rules should apply to carried interest arrangements.

WHAT OTHER REQUIREMENTS WOULD APPLY TO THE INCENTIVE COMPENSATION ARRANGMENTS OF PE MANAGERS?

For all PE Managers covered by the proposed rules, incentive compensation arrangements must not encourage "inappropriate" risks (1) by providing covered persons with "excessive" compensation or (2) that could lead to material financial loss.

The general framework for determining when incentive compensation is "excessive" remains largely unchanged from the 2011 proposal. Compensation is considered excessive when amounts paid are unreasonable or disproportionate to

the value of the services performed by the covered person, taking into account all relevant factors, including six mandated factors: (1) the combined value of all compensation, fees or benefits provided; (2) the compensation history of the covered person and other individuals with comparable expertise at the CFI; (3) the financial condition of the CFI; (4) compensation practices at comparable institutions (based on factors like asset size, location and complexity of operations/assets); (5) for post-employment benefits, the projected total cost and benefit to the CFI; and (6) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the CFI. The new rules clarify that this list is not meant to be exclusive but leave open the question of how relevant factors should be weighed in determining whether the amount of compensation is excessive.

In addition, incentive compensation must (1) appropriately balance risk and reward; (2) be compatible with effective risk management and controls; and (3) be supported by effective governance. With respect to all covered persons at a PE Manager subject to the rules (*i.e.*, *all* employees and directors), each of the following newly proposed criteria must be met, in each case, prior to the award of incentive compensation:

- *All incentive compensation arrangements must include both financial and nonfinancial measures of performance*. Financial measures are generally tied to achievement of strategic objectives, but financial measures alone cannot be the basis for determining incentive compensation. Nonfinancial measures of risk-taking activity must be taken into account.
- *The arrangement must be designed to allow nonfinancial measures to override financial measures when appropriate in determining incentive compensation*. Any violation of risk performance measures means that the employee should not be eligible to receive the full target amount of incentive compensation under the proposed rules.
- *Any amounts to be awarded would be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and nonfinancial performance*. A loss in value of equity is not considered an adjustment; the cash or percentage of equity awarded would have to be adjusted downward.

As discussed above, these requirements could prove difficult to apply in the standard carried interest context. In addition, for other types of incentive compensation in a PE Manager, like annual bonuses to employees, these new rules would require the enumeration of specific nonfinancial, risk-based criteria, as well as financial performance criteria, for each covered person of a firm.

Additional requirements, including deferral and clawback requirements, apply to larger (Level 1 and Level 2) CFIs.

WHAT ARE THE NEW DISCLOSURE AND REPORTING REQUIREMENTS?

The proposed rules thankfully omit the annual reporting requirements of the 2011 proposal, but do impose certain disclosure and significant documentation and recordkeeping requirements on covered PE Managers. These include the annual creation and maintenance for seven years of records that document the structure of incentive compensation arrangements and demonstrate compliance with the final rules, which must be disclosed to the applicable regulator upon request. There is no requirement to report the actual amount of compensation to individuals. More exacting recordkeeping requirements apply to larger (Level 1 and Level 2) CFIs.

WHAT ARE THE NEW CORPORATE GOVERNANCE REQUIREMENTS?

The proposed rules include a requirement for all CFIs, including covered PE Managers, that the board of directors or a committee of the board: (1) conduct oversight of the CFI's incentive programs; (2) approve incentive arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and (3) approve any material exceptions or adjustments to incentive compensation policies or arrangements for senior executive officers. These rules may require CFIs to establish a board-level oversight function.

WHAT'S NEXT?

The proposed rules were approved by the National Credit Union Administration at its meeting on April 21, 2016 and by each of the Office of the Comptroller of the Currency, the FDIC and the Federal Housing Finance Agency on April 26, 2016. The proposed rules must also be approved by the Board of Governors of the Federal Reserve System and the SEC. Each of the remaining regulators is expected to vote on the rules in the coming weeks. The comment period ends July 22, 2016. Following public comment, final rules will be adopted by the various agencies.

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Please do not hesitate to contact us with any questions.