LUSE GORMAN February, 2011

FINANCIAL INSTITUTIONS ALERT

FDIC Proposes Incentive-Based Compensation Rules For Financial Institutions Over $1 Billion

The Federal Deposit Insurance Corporation (FDIC) has approved a joint proposed rulemaking ("Proposed Rule") to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which prohibits incentive-based compensation arrangements, or any feature of such arrangements, that encourage inappropriate risk-taking by providing excessive compensation or that may lead to a material financial loss.

While the FDIC approved the Proposed Rule, it must be independently approved by each of the five federal members of the Federal Financial Institutions Examination Council (FFIEC), the Securities Exchange Commission (SEC) and the Federal Housing Finance Agency (FHFA), before it will be published in the Federal Register for public comment.

Incentive-Based Compensation. Only incentive-based compensation paid to "covered persons" would be subject to the Proposed Rule. Covered Persons include any executive officer, employee, director or principal shareholder of an institution with total consolidated assets of $1 billion or more, including federally insured credit unions. The Proposed Rule does not apply to financial institutions with total consolidated assets of less than $1 billion, which is consistent with Dodd-Frank.

The Proposed Rule defines incentive-based compensation as any variable compensation that serves as incentive for performance. The rule specifically excludes base salary, dividends paid and appreciation realized on stock or other equity instruments owned outright by a covered person. However, stock or other equity awarded to a covered person under a contract, plan or other arrangement would not be considered owned outright while subject to vesting or a deferral arrangement.

As directed by Section 956 of Dodd-Frank, the Proposed Rule is intended to require financial institutions with over $1 billion in assets to disclose their incentive-based compensation arrangements in a manner that enables the financial institution's Federal regulator (or regulators) to determine whether the arrangements provide excessive compensation and could lead to a material loss to the financial institution. Additionally, while the Proposed Rule does not apply to financial institutions with total consolidated assets of less than $1 billion, the overall prohibition on compensation arrangements that encourage inappropriate risk taking by providing excessive compensation should be considered by all financial institutions.

Annual Report. All depository institutions with total consolidated assets of $1 billion or more will be required to file an annual report that details the structure of its incentive-based compensation plans with its appropriate Federal bank regulator in a format specified by such regulator. The form of the report has not yet been specified by each regulator but must include:

- A clear narrative description of the components of the incentive-based compensation arrangements applicable to covered persons (executive officers, employees, directors or principal shareholders); and

- A succinct description of the policies and procedures governing the incentive-based arrangements; and
- The specific reasons the institution believes the structure of its incentive-based compensation plan does not provide covered persons (executive officers, employees, directors or principal shareholders) incentives to engage in behavior that is likely to cause the financial institution a material financial loss and does not provide excessive compensation; and
- Any material changes to the incentive-based compensation arrangements, policies and procedures since the last report was submitted; and
- For depository institutions with assets of $50 billion or more, a succinct description of any specific incentive compensation policies and procedures for the institution's executive officers and other individuals who individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance.

The detail of information provided in this annual compensation report should be commensurate with the size and complexity of the institution, as well as the scope and nature of its incentive-based compensation arrangements.

Additional Requirements For Financial Institutions With Assets Over $50 Billion. For depository institutions with total consolidated assets greater than $50 billion, the Proposed Rule requires that at least 50% of incentive-based payments be deferred for a minimum of three years for designated executives. The rule contains a clawback provision, which requires that the deferred amounts be adjusted for actual losses or other measures or performance that are realized or become better known during the deferral period. Boards of directors of these larger institutions must identify employees (not only executive officers) who individually have the ability to expose the institution to losses (for example, traders) that are substantial in relation to the institution's size, capital, or overall risk tolerance, and must determine that the incentive compensation for these employees appropriately balances risk and rewards according to enumerated standards.

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For further details on the information contained in this newsletter, please contact any of the persons listed below.

Eric Luse	■	(202) 274-2002	eluse@luselaw.com
John J. Gorman	■	(202) 274-2001	jgorman@luselaw.com
Beverly J. White	■	(202) 274-2005	bwhite@luselaw.com
Alan Schick	■	(202) 274-2008	aschick@luselaw.com
Larry Spaccasi	■	(202) 274-2037	lspaccasi@luselaw.com
Kip Weissman	■	(202) 274-2029	kweissman@luselaw.com
Norma Sharara	■	(202) 274-2035	nsharara@luselaw.com
Max Seltzer	■	(202) 274-2038	mseltzer@luselaw.com
Jeff Cardone	■	(202) 274-2033	jcardone@luselaw.com
Joe Daly	■	(202) 274-2034	jdaly@luselaw.com
Gary Lax	■	(202) 274-2031	glax@luselaw.com