



## 5<sup>th</sup> Annual Bank Director Workshop

# Impact of Dodd-Frank and Increased Regulation on Compensation Practices

April 7, 2011

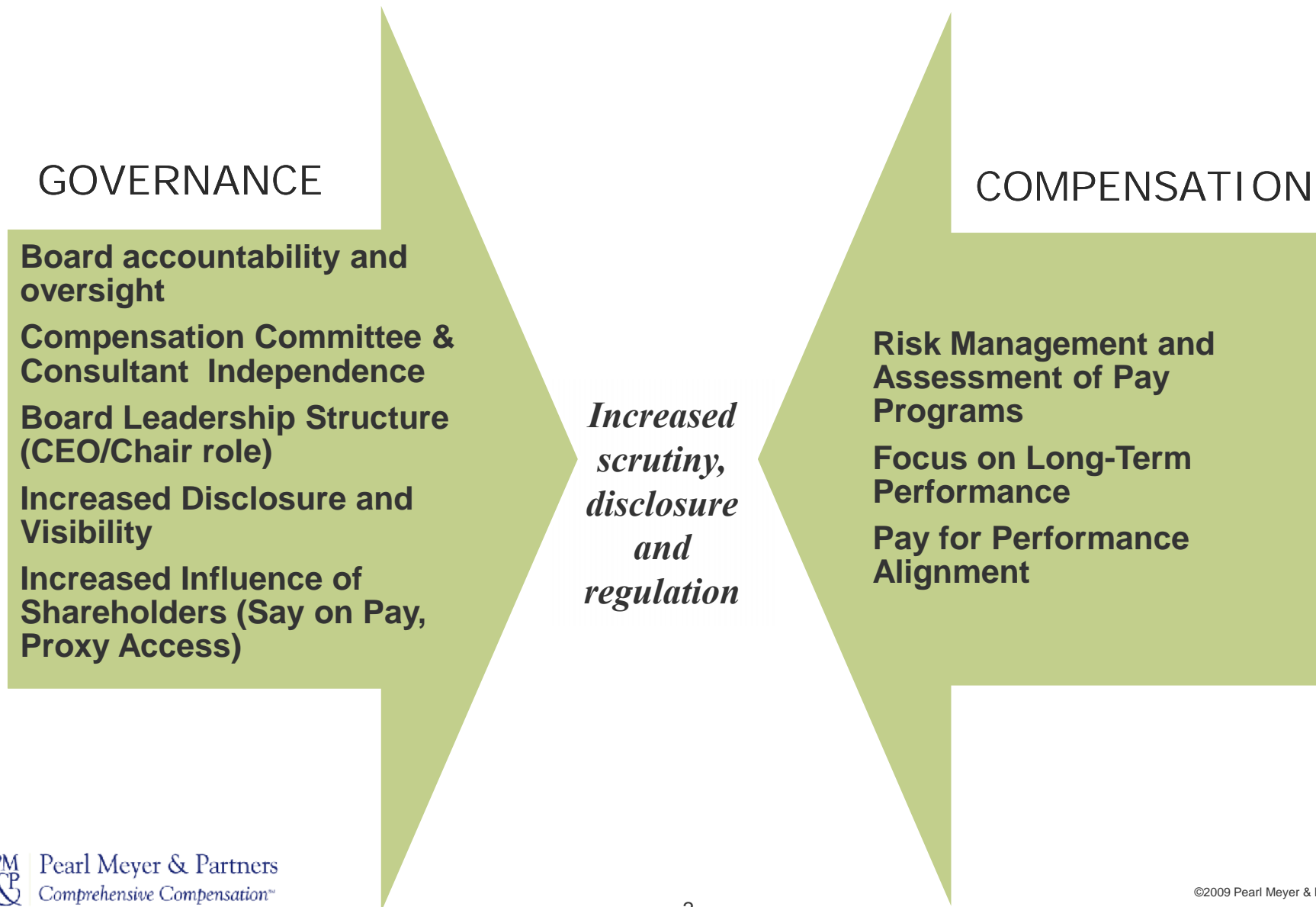
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## **■ A Poll....Raise Your Hand if...**

- ? You have made or are considering changes to your executive compensation policies and practices as a result of Dodd Frank and/or recent regulatory guidelines?**
- ? You have completed or begun defining a process for conducting a risk assessment of compensation programs?**
- ? You have recently reviewed your Board oversight/Committee charters in light of increased legislation/regulation?**
- ? You have increased communication to your bank regulators and stakeholders?**
- ? You have recently developed or enhanced your claw back policy?**

## Regulation is Driving Significant Change in Two Areas





# Dodd Frank Update – What You Should be Focusing on Now

## ■ Dodd-Frank Wall Street Reform Act - Overview

- Signed into law July 21, 2010
- Represents a “sea change” for executive compensation and corporate governance
  - Impacts executive compensation policies and practices
  - Increases role of Board/Compensation Committee
  - Increases independence standards of Committees and their consultants
- Expands disclosure/transparency – “windows to the boardroom”
- Increases influence of shareholders on compensation practices
  - Say on pay
  - Proxy access
- Focuses on financial institutions (public and non public) – incentive practices that cause excessive compensation or potential for material financial loss

Primarily applies to public companies but “trickle down” is inevitable

## ■ Dodd-Frank Implementation Schedule

- New SEC calendar issued in conjunction with final Say on Pay & Say on Frequency rules (January 25, 2011)
- Guidance for some provisions delayed and may not be available until year end; many with likely implementation in 2012 or beyond.

### Effective 2011

- *Say on Pay*
- *Say on Frequency*
- Say on Golden Parachutes
- **CEO/COB Role Disclosure**
- Broker No-Vote Rule

### Delayed

- *Financial Institution Excessive Compensation Rules (FDIC proposed rules released – expected late 2011)*
- **Committee/Advisor Independence**
- Pay for Performance Disclosure
- Internal Equity Ratio Disclosure
- Claw back Policies
- Proxy Access (SEC issued rules in Aug 2010 but on hold pending litigation)
- Hedging Disclosure

# ■ Dodd Frank - Key Areas to Focus on Now

## GOVERNANCE

Key Area	Impact	What to Do Now
<b>Governance Structure and Practices</b>	<b>All public companies but best practice for all organizations</b>	<ul style="list-style-type: none"> <li>■ Clarify rationale if combined Chair/CEO role</li> <li>■ Consider Lead Director if employee Chair</li> <li>■ Review and update charters to ensure they reflect emerging requirements and responsibilities (e.g. risk assessment)</li> <li>■ Be prepared to develop/enhance claw back policy in line with requirements</li> </ul>
<b>Independence Standards (Compensation Committee/ Consultant)</b>	<b>All Companies</b>	<ul style="list-style-type: none"> <li>■ Assess Compensation Committee independence (assume Audit Committee standard pending SEC rules)</li> <li>■ Ensure Compensation Committee has authority (and funding) to retain advisors that report directly to the Committee</li> <li>■ Assess your consultant/advisor independence</li> </ul>
<b>Shareholder Influence</b>	<b>Public Companies</b>	<ul style="list-style-type: none"> <li>■ Understand and address potential shareholder issues - consider increased outreach in light of Say on Pay</li> <li>■ Assuming proxy filed already, review shareholder say on frequency vote and determine approach going forward</li> <li>■ Identify potential shareholders eligible for proxy access to assess potential impact</li> </ul>

## ■ Dodd Frank - Key Areas to Focus on Now

### COMPENSATION

Key Area	Impact	What to Do Now
<b><i>Say on Pay/ Say on Frequency/ Say on Golden Parachutes</i></b>	<b><i>All Public Companies</i></b>	<ul style="list-style-type: none"> <li>■ Understand perspective of shareholder advisory firms (e.g. ISS, Glass Lewis)</li> <li>■ Understand impact of no broker vote</li> <li>■ Enhance proxy disclosure in line with new expected/best practices –tell the “story”; pay for performance alignment is key</li> </ul>
<b><i>Incentive Compensation Arrangements and Risk</i></b>	<b><i>All Companies</i></b>	<ul style="list-style-type: none"> <li>■ Build on risk assessment begun in 2010 and further refine processes used for evaluating risk</li> <li>■ Develop appropriate documentation, procedures, incentive plan features to mitigate risk</li> <li>■ Compensation Committee should understand all incentive plans to ensure compliance with risk requirements</li> </ul>
<b><i>Disclosure/ Reporting</i></b>	<b><i>Public Companies</i></b>	<ul style="list-style-type: none"> <li>■ Clarify/communicate compensation philosophy</li> <li>■ Ensure CD&amp;A tells a clear story, particularly regarding pay-performance</li> <li>■ Assess and monitor pay-for-performance alignment</li> <li>■ Have perspective on internal pay relationships</li> </ul>

# 2011 SOP and SOF Vote Results – Updated stats will be shared during meeting

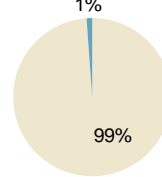
## 2011 Proxy Votes: Shareholder "Say on Frequency" and "Say on Pay" Vote Results

Proxy Dates: 12/2/2010 to 3/17/2011

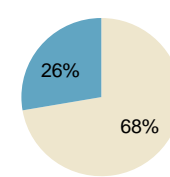
### TOTAL SAMPLE:

	#	%
SOP/SOF Votes:	671	
SOP/SOF Vote Results*:	173	26%
SOP Votes		
Consistent with Recommendation	171	99%
Against Recommendation	2	1%
SOF Votes (n=170)*		
Consistent with Recommendation	115	68%
Against Recommendation	44	26%

SOP Vote Results



SOF Vote Results



■ Consistent with Recommendation   
 ■ Consistent with Recommendation  
■ Against Recommendation       
 ■ Against Recommendation

\*Note: the discrepancy in the number of SOP vs. SOF votes is due to TARP exemptions from SOF and results from companies that did not make recommendations

- Five companies (no banks yet) have failed to receive majority vote for Say on Pay

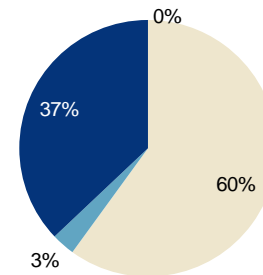
- ISS recommendation against SOP due to Pay for Performance evaluation, i.e. CEO pay increased while TSR below median relative to GICS code group and poor pay practices.

## 2011 Proxy Votes: Shareholder "Say on Frequency" Vote Results

Proxy Dates: 12/2/2010 to 3/17/2011

### TOTAL SAMPLE:

	#	%
Say on Frequency Votes:	671	
Say on Frequency Vote Results:	170	25%
Votes for		
Annual:	102	60%
Biennial:	5	3%
Triennial:	63	37%
Abstain:	0	0%



■ Annual:   
 ■ Biennial:   
 ■ Triennial:   
 ■ Abstain:

- Interestingly, majority support would have been likely in both cases if broker discretionary votes were able to be counted



# Bank Regulations Regarding Risk Assessment of Incentive Compensation Programs

## ■ Compensation Risk – Everyone’s in the Game

- 2008 - TARP institutions mandated to assess risk and certify compensation programs do not motivate risk taking.
- Dec 2009 - SEC guidelines finalized to require all public companies to provide:
  - Separate discussion in proxy regarding compensation policies or practices “reasonably likely to pose a material adverse risk to the company”
- June 2010 - Bank regulators release principles-based guidelines for assessing incentive compensation risk
- 2011 - FDIC issues proposed rules enforcing Dodd-Frank Act Section 956 (awaiting results from comment period)

## Overview of Bank Regulator Guidance

- New proposed regulations expand on the Agency guidance to implement and enforce Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act
- The intent is to control risk related to the use of incentive compensation arrangements (ICAs) for employees at covered financial institutions

### Agency Guidance – June (FRB, FDIC, OTS, OCC)

- Effective June 25, 2010
- Impacts all financial institutions
- Principles-based guidance
- Three principles:
  - Design features should mitigate risk taking
  - Effective controls
  - Strong corporate governance
- Size and complexity of institution and ICAs considered
- Covered individuals:
  - Senior executive officers
  - Individual employees whose activities may expose the institution to material risk
  - Groups of employees who in the aggregate may expose the institution to risk
  -

### FDIC Proposal – February (FRB, FDIC, OTS, OCC, NCUA,

- In comment period
- Impacts institutions > \$1b
- Prohibition of ICAs to Covered Persons that encourage inappropriate risk by:
  - Providing excessive compensation; or
  - Creating a potential for material financial loss
- Requires annual reports to appropriate regulator (s) of the structure of ICAs
- Requires policies and procedures for ICAs that are commensurate with the size and complexity of the institution
- Special rules for institutions with assets greater than \$50 billion
  - Mandatory deferral of a substantial portion of ICAs to executive officers
  - Enhanced internal review and approval of ICAs for other individuals who have the ability to expose the institution to significant loss



# Impact on Executive Compensation Programs – Emerging Best Practices

# Risk Management and Assessment of Pay Programs

## LOWER RISK

## HIGHER RISK

### MIX

At least half of compensation in base salary

Most of compensation paid based long-term, sustained performance

Majority of compensation in incentive pay

Most of compensation paid based on annual, short-term results

### MEASURES

Balance of performance measures:

- Financial, operational, quality
- Short and long-term
- Bank and Individual
- Absolute and relative
- Formula and discretion

1 (or few) performance measures

1 (or few) performance perspectives (e.g. all top line metrics without accounting for quality)

Same performance measures used for short and long-term incentives

### DESIGN FEATURES

Cap/maximum payout

Appropriate performance-payout curve

Multi-year performance period (or hold back/deferral if focus on short-term)

Discretion allowed

Claw back

Ownership/holding requirements

No cap/unlimited upside

Threshold/target set too high

Quarterly or single year performance without some focus on longer-term

Formulaic calculation

No claw back

No ownership/holding requirements

# Risk Management and Assessment of Pay Programs

## LOWER RISK

## HIGHER RISK

### GOAL SETTING

Centralized review process for approving goals  
Realistic goals considering historical and projected performance  
Performance goals adjusted for risk



Decentralized process for approving goals  
Unrealistic goals and/or goals that are not aligned with historical and/or projected performance  
Performance goals are not adjusted for risk

### CONTROLS AND GOVERNANCE PROTOCOLS

Robust process to review and approve plan designs AND payouts  
Compensation Committee/Executive management reviews and approves the range of potential payouts (i.e. scenario test)  
Guidelines and approvals are in place for adjusting results as appropriate



No centralized process in place to review and approve plan designs OR payouts  
Compensation Committee and/or Executive management do not understand the full range of potential payouts

## ■ Focus on Long-Term Horizon

### ■ Compensation practices should be adjusted to:

- Consider risk horizon and timeframe of results/rewards
  - » If results not known for several years – timing for reward should not be based on one year
- Place more focus on longer term, sustainable performance
  - » Adjust the “mix” of total compensation to focus more on long-term performance; enhance long-term incentive timeframes/vesting
- Ensure reward periods match the timeframe required to determine whether a decision/action was successful
  - » If not, change design features to allow for better alignment

### ■ Short-term incentive techniques

- Holdbacks/deferrals – portion of annual award contingent on sustained future performance
- Payment in stock – pay part (or above target) payouts in stock
- Shifting mix to long-term (can be cash for mutuals/private banks)

### ■ Long-term incentive techniques

- Extended vesting of awards (i.e. longer multi-year periods)
- Performance vesting of restricted stock
- Stock ownership and retention guidelines
- Hold until or past retirement requirements

## ■ Pay-Performance Alignment

### ■ A complex balancing act


- Economic environment
- Influences out of control of management (e.g. stock price, rates)
- Optics and perceptions - media/public/shareholders
- Disclosure limitations
- Regulatory mandates
- Piecemeal view

### ■ Assess pay-performance relationship

- Review one and three year trends
- Relative to internal goals and peers/industry

### ■ Stress test to understand potential range of outcomes for performance and pay

- Do you know the maximum payout/total compensation that can result under compensation programs?
- Is the payout leverage appropriate (i.e. does incremental performance result in appropriate incremental pay and vice versa)?
- What is the share ratio of pay-performance?



Increased disclosure will drive increased scrutiny

## ■ In Summary...

- ✓ **Review and Define Your Governance and Risk Controls**
  - Review governance practices in light of pending legislation (independence, process, disclosure)
  - Clarify roles of management, Compensation Committee, Board
  - Establish process for assessing risk and ongoing compliance
  - Clarify/define your compensation philosophy
- ✓ **Review Compensation Program and Incentive Plans**
  - Review current programs to determine whether they support desired philosophy going forward
  - Review incentive plans in particular to ensure they do not motivate and reward inappropriate risk taking
  - Ensure compensation program supports long-term view of performance
  - Ensure total compensation program embraces balance and is aligned with both company business strategy and shareholder interests
- ✓ **Continue to Stay Informed**
  - Regulations are constantly changing
  - Past practice is NOT best practice
  - New set of lenses



# QUESTIONS?