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SEC aims for transparency in incentive-based pay packages

by Joshua Horn 03/10/2011

In accordance with rulemaking required under the Dodd-Frank Act, the SEC recently voted to propose rules for incentive based pay at broker-dealers and investment advisers. The fundamental purpose of these proposed rules is to promote enhanced disclosure of incentive-based compensation practices at firms with over $1 billion in assets. The proposed rulemaking would also impose additional obligations on broker-dealers and investment advisers with $50 billion in assets. The SEC proposal is also focused on barring pay practices that promote inappropriate risk taking. In short, the SEC is seeking to foster transparency and, at the same time, protect investors from compensation practices that would reward high risk at the potential expense of the client.

First, the rulemaking would require the disclosure of incentive-based compensation to the SEC by broker-dealers and investment advisers with over $1 billion in assets. Second, the rulemaking would prohibit compensation packages that would reward unduly risky investment practices. Third, the rulemaking would impose upon covered firms the obligation to adopt and maintain policies and procedures governing incentive-based compensation programs.

Under this proposed rulemaking scheme, covered firms would be required to annually report and describe to the SEC information regarding their incentive-based compensation programs. The reported information would have to include, among other things, a description of the compensation plan, an explanation regarding why the plan will not cause material economic harm and a description why the covered firm believes that its covered individuals (which include employees, directors and principal shareholders) are not overpaid. At its core, the proposed rulemaking would prohibit those pay practices that foster excessive risk taking or that may lead to "material financial loss."

There would be heightened requirements under this proposed rulemaking for firms that have more than $50 billion in assets. Under the proposal, these firms would have to have a three year deferral of at least fifty percent of any incentive-based compensation for its executive directors. Also, such pay to executive directors would have to be awarded in a pro rata basis. Pay arrangements for these larger firms must be adjusted reflect the firm's losses after pay is initially awarded. Finally, these larger firms would have to identify those employees not in an executive office, but who could expose the firm to material risk. Any such compensation to these individuals would have to be approved by the company board or a designated committee.

The proposed rule is now open to comment, and it will surely receive comments from both sides of the aisle. On one side, such a proposed rule will be seen as unfairly intrusive on how firms compensate their employees. Conversely, this proposed regulatory structure will be seen as offering new transparencies and the protection of the investing public against an individual opting for high risk/high compensation at the potential expense of a client. In the end, the requirements of Dodd-Frank will certainly impose additional transparency and a level of additional risk avoidance for the investing public. Broker-dealers and investment advisers will need to be adequately prepared to address this transparency in our post Dodd-Frank world.