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SEC Proposes Incentive-Based Compensation Rule: How to Determine Whether Your Firm Will Be Impacted

The SEC recently released a proposed rule (the "Rule") with respect to the implementation of incentive-based compensation arrangements for certain "covered financial institutions" (which includes investment advisers). The Rule followed the release of a substantially similar rule issued by the Department of Treasury, Office of Comptroller of the Currency, jointly with a number of other federal government agencies responsible for governing financial institutions. The Rule, if adopted, would implement a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act and effectively replace a rule proposed in April 2011, which also addressed the general requirements applicable to the incentive-based compensation arrangements of all covered institutions.

In general, we expect that the substantive provisions of the Rule will not apply to many private fund advisers, because in order to be covered by the Rule, an adviser must have total consolidated assets (i.e., balance sheet assets) of at least $1 billion. This Alert focuses on how the $1 billion is calculated and how the consolidation rules would apply. At the end of this discussion, we have also included a high level summary of the requirements applicable to advisers crossing the $1 billion threshold.

The Rule applies to registered and unregistered investment advisers ***with total consolidated assets*** of at least $1 billion. For investment advisers, total consolidated assets are calculated based on the total assets shown on the adviser's balance sheet as of the most recent fiscal year end. In the Rule, the SEC clarified that it did not intend for this calculation to include "non-proprietary assets," such as client assets under management, regardless of whether such assets appear on the adviser's balance sheet. This method of calculation is consistent with the reporting requirement in Item 1.O of Part 1A of Form ADV (in which an adviser must indicate if it has assets of $1 billion or more). While the Rule is not clear on this point, we believe it is reasonable to exclude the assets of employee co-investment vehicles and similar "family and friends" vehicles, as those are "managed" assets that are not part of the adviser's balance sheet. We would recommend investment advisers review their responses to Item 1.O of Part 1A of Form ADV to confirm they have responded based on total consolidated assets (and have not included client assets under management in this calculation). Investment advisers who believe they may have miscalculated this amount may want to consider filing an "other-than-annual amendment" to correct their response based on the SEC guidance in the Rule.

With respect to the "consolidation" requirement, assets are determined at the adviser level, and are not consolidated with affiliates unless the affiliates are "operationally integrated." For purposes of affiliation, the Rule adopts the "controlling, controlled by, or under common control" standard found in Form ADV. For purposes of determining whether two affiliates are "operationally integrated," the Rule indirectly refers to the position taken in the Richard Ellis, Inc. No-Action Letter (the "Ellis Test").[1] As a result, advisers may, depending on their structure and operations, be required to consolidate the assets of certain affiliates for purposes of determining whether they meet the $1 billion

[1] The Ellis Test allows two affiliated entities to be treated as "separate" for purposes of the Investment Advisers Act of 1940, as amended, if: (a) each is adequately capitalized; (b) there is a buffer between the personnel (such as a board of directors, a majority of whose members are independent of the parent); (c) each has separate employees, officers and directors who are engaged in providing advice in the day-to-day business of an entity or are otherwise engaged in the investment advisory business of such entity; (d) each makes investment decisions as to what investment advice is communicated to, or used on behalf of, their respective clients and uses sources of investment information not limited to that used by the other entity; and (e) each keeps investment advice confidential until communicated to its client.

threshold. For example, we would expect that most fund general partners would have to be aggregated with the applicable management company under the Ellis Test. Consolidation with fund general partners may impact whether an investment adviser is subject to the Rule depending on the treatment of carry received by a fund general partner. More specifically, if a general partner of a fund has substantial carry accruals on its balance sheet as of the end of a fiscal year, such amounts may be deemed to be assets on the balance sheet for purposes of calculating the $1 billion threshold.

We note that the test is measured at fiscal year-end. As a result, an investment adviser would only be subject to the Rule if it had assets on its balance sheet equal to, or exceeding $1 billion at the end of the fiscal year.

A comment period is in effect through July 22, 2016, during which time all comments will be jointly reviewed by the various agencies. Following the comment period, a final rule will be adopted. As a result, there could still be material changes made to the Rule before it becomes final.

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The following is a high-level summary discussing some of the other relevant takeaways of the Rule:

- <u>What does the Rule require?</u> – An adviser that has at least $1 billion in total consolidated assets is prohibited from establishing or maintaining incentive-based payment compensation arrangements that encourage inappropriate risks (1) by providing excessive compensation, fees, or benefits to an executive officer, employee, director, or principal shareholder or (2) that could lead to material financial loss. The factors that should be considered for each of these prohibited categories are as follows:

  <u>Excessive Compensation:</u>

  - Combined value of all compensation, fees, or benefits provided to a covered person;
  - Compensation history of the covered person and other individuals with comparable expertise at the covered institution;
  - Financial condition of the covered institution;
  - Compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the covered institution's operations and assets;
  - For post-employment benefits, the projected total cost and benefit to the covered institution; and
  - 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 covered institution.

  <u>Material Financial Loss:</u>

  - Appropriately balances risk and reward, which at a minimum means that the arrangement (a) includes financial and non-financial measures of performance, (b) is designed to allow non-financial measures of performance to override financial measures of performance, when appropriate, and (c) is subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance;
  - Is compatible with effective risk management and controls; and
  - Is supported by effective governance.

  The board of directors (or a committee thereof)[2] for each covered adviser would be required to: (i) conduct oversight of the covered institution's incentive-based compensation program; (ii) approve incentive-based compensation arrangements for senior executive officers, including amounts of awards and, at the time of

[2] The Rule defines "director" to include "any member of a covered institution's governing body," which would include members of a general partner, managing member or similar governing entity of an adviser.

vesting, payouts under such arrangements; and (iii) approve material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

Advisers with at least $50B in consolidated assets are subject to additional obligations including disclosure, recordkeeping, deferral, forfeiture and downward adjustment, claw-back requirements, and increased risk management and controls requirements, as well as requirements to establish an independent compensation committee, and implement policies and procedures that are consistent with the requirements and prohibitions of the Rule.

Covered advisers are required to create and maintain records of incentive-based compensation programs for seven years demonstrating compliance with the Rule, and produce the records upon SEC request.

- <u>Is carry treated as "incentive-based compensation"?</u> – The treatment of carry is not specifically addressed by the Rule, which defines "incentive-based compensation" as any variable compensation, fees, or benefits that serve as an incentive or reward for performance. While it would be consistent with the position the SEC has taken in the past to treat carry as incentive-based compensation (e.g., guidance with respect to the "pay-to-play" rules), commenters are expected to request that carry be excluded as incentive-based compensation under the Rule.
- <u>When is the date of compliance?</u> – Advisers must comply no later than the beginning of the first calendar quarter that begins at least 540 days after the final rule is published in the Federal Register. Incentive-based compensation plans with a performance period beginning before the compliance date are not affected. Asset size is determined as of the beginning of the first calendar quarter that begins after the final rule is published. There is a 540-day transition period for institutions moving to a higher asset level. Upon a decrease in total consolidated assets, an adviser must comply with the requirements to which it was subject before the decrease for four consecutive regulatory periods.