Breakout 3:

How the Changing Regulatory and Judicial Environment Is Affecting Compensation Decisions in the Boardroom

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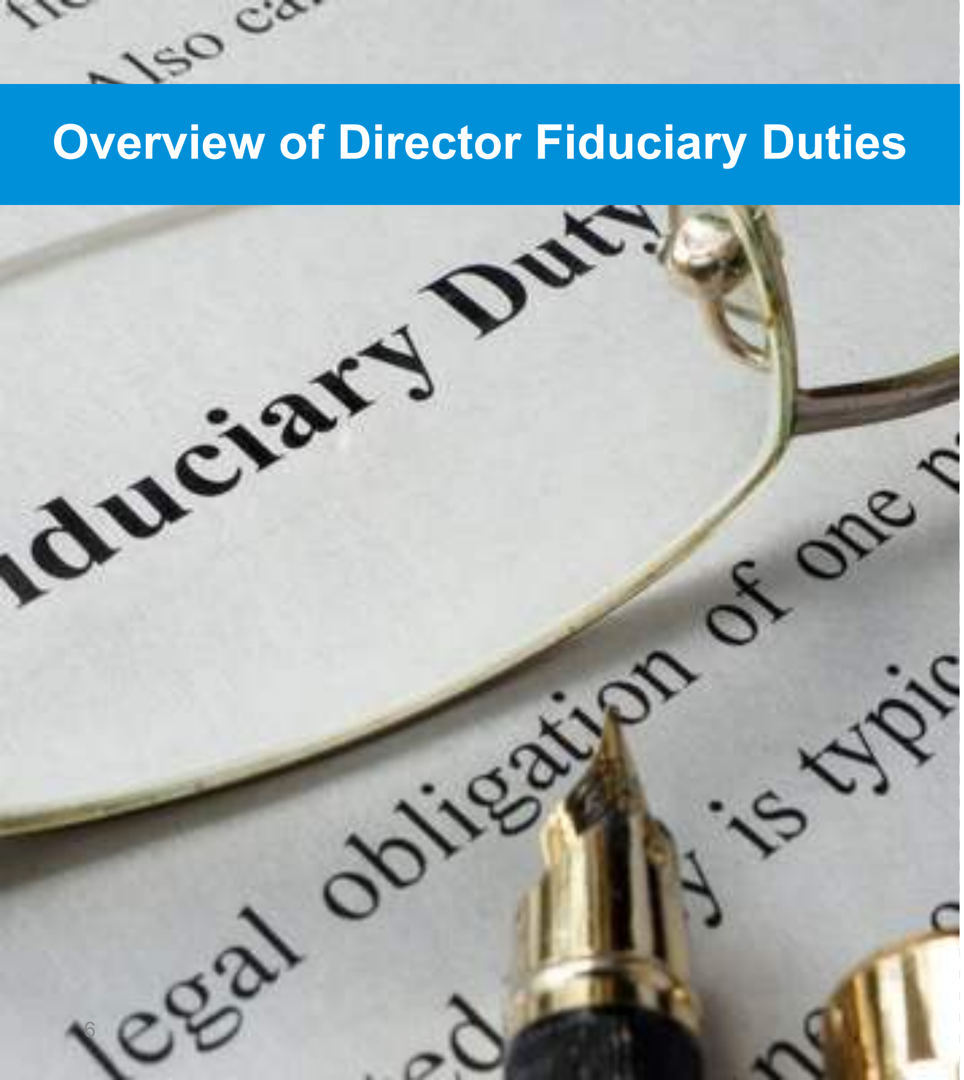
Agenda

1. Introduction
2. Overview of Fiduciary Duties
3. Proposed Interagency Compensation Rules (Again)
4. Current DEI Issues
5. Lightning Round
6. Top Themes and Takeaways

Overview of Director Fiduciary Duties



While exact contours may vary from state to state, directors must protect the interests of the corporation and act in shareholders’ best interests

Core fiduciary duties

- Duty of care
- Duty of loyalty

Other duties – including duty of good faith, duty of disclosure and duty of oversight – stem from these core fiduciary duties

Failure to carry out these duties can expose directors to shareholder derivative suits

Breaking Down Directors' Duties

Duty of Care: Having the right information and following a good process to make thoughtful decisions

- Directors should be informed of all material information reasonably available when making decisions for the company
- Directors may rely on management and experts where reasonable

Duty of Loyalty: Acting in good faith for the benefit of the company and its shareholders and not for the directors' own personal interests

- Protect the interests of and avoid injuring the company and its shareholders
- Includes the duty to take adequate steps to ensure the company's business and affairs are properly administered by management
- Directors cannot ignore red flags

Applying these Duties in the Real World

Understand how effective compensation supports the company's strategy and performance

- Human capital management and corporate culture
- Retention and succession planning initiatives
- Drive financial success through appropriate incentives

Understand the company's risks in connection with compensation matters

- Regulatory scrutiny
- Reputational risk and loss of trust
- Increased competition for top talent if peer companies have more effective compensation strategy

Develop a strategic direction and find the balance point where effective compensation meets appropriate guardrails

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Core Fiduciary Duties of ERISA Plan Fiduciaries

Duty to act prudently

- Plan fiduciaries are required to discharge their duties with the care, skill, prudence, and diligence that a prudent person acting in a like capacity would use in similar circumstances

Duty to diversify the assets of the plan

- Plan fiduciaries are required to refrain from investing disproportionately large amounts in a single security or in a single type of security

Duty of loyalty

- Requires fiduciaries to act in the interest of plan participants and beneficiaries

Duty to comply with provisions of the plan

- Requires fiduciaries to discharge their duties in accordance with the documents and instruments governing the plan to the extent consistent with ERISA

Duty to pay only reasonable plan expenses

- ERISA allows plan assets to be used for two purposes: paying benefits and paying reasonable expenses of administering the plan

Duty not to engage in certain prohibited transactions

- ERISA prohibits transactions between employer sponsored retirement plans and “parties in interest”
  - A party in interest includes any plan fiduciary, counsel, or employee of the plan; any person providing services to the plan; and an employer or employee organization whose employees are covered by the plan

Proposed Interagency Compensation Rules (Again)

A Closer Look

- **Background**
- **Covered Institutions**
- **Covered Individuals**
- **Incentive-Based Compensation Prohibitions**
- **Documentary Compliance and Governance**

Background

In 2010, Congress enacted the Dodd-Frank Act in the wake of the 2008 financial crisis

Dodd-Frank sought to create guardrails around executive compensation by:

- Requiring recoupment of incentive compensation received by executives from faulty financials
- Mandating more robust disclosures to shareholders regarding executive compensation
- Reining in incentive-based compensation practices that were seen as promoting overly risky behavior at financial institutions (under Section 956)

Section 956 of the Dodd-Frank Act

- Sought to reign in incentive-based compensation practices that were seen as promoting overly risky behavior at financial institutions
- Jointly tasks the following regulatory bodies with prescribing regulations/guidelines covering incentive-based compensation at covered financial institutions:
  - (1) the FDIC, (2) the OCC, (3) the FHFA, (4) the National Credit Union Association, (5) the SEC, and (6) the Board of Governors of the Federal Reserve System

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Background Continued

Timeline of proposed rulemaking under Section 956 of Dodd-Frank

- 2011: regulations to enforce Section 956 were initially proposed jointly by all relevant regulators
- 2016: updated regulations to enforce Section 956 proposed by all relevant regulators
- May 6, 2024 (current proposed rule): regulators issued a notice of proposed rulemaking and request for public comment to implement Section 956

Current proposed rule

- Includes the same rule text put forth in 2016, while also exploring potential alternatives to certain provisions
- Relevant regulators request renewed review and public commentary on the entirety of the proposal

As of July 2024, the current proposal has been approved by:

- (1) the FDIC, (2) the FHFA, (3) the OCC, and (4) the National Credit Union Association National Credit Union Administration Board
- The SEC and the Board of Governors of the Federal Reserve System have yet to vote to approve the proposed rule

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Covered Institutions

The following types of institutions that have at least $1 billion in assets are considered covered financial institutions under the statute:

- Depository institutions and their holding companies
- Broker-dealers, credit unions
- Investment advisers
- Fannie Mae and Freddie Mac
- Other financial institutions as determined in the regulators' discretion

Covered financial institutions are further broken down into three tiers in the proposed regulation, with more stringent requirements applying to higher asset-valued, Level 1 and 2 entities

Level 1	Greater than or equal to $250 billion
Level 2	Greater than or equal to $50 billion and less than $250 billion
Level 3	Greater than or equal to $1 billion and less than $50 billion

Covered Individuals

"Covered Person" under Section 956 generally applies to:

- Executive officers, employees, directors and principal shareholders (10% holders or more) — who earn incentive-based compensation from a covered institution
- Additional rules apply to covered persons at a Level 1 or 2 institution who are senior executive officers or significant risk-takers

Senior executive officers generally include those who have the title of, or function as:

- President, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head of a major business line or control function

Significant risk-takers generally include non-senior executives whose compensation is at least one-third incentive-based *and who either:*

- (1) are among the top 2%-5% — depending on whether the institution is Level 1 or 2 — of the highest compensated non-senior executive covered persons at the relevant institution, or
- (2) have the authority to commit or expose at least 0.5% of the institution's capital

Incentive-Based Compensation Prohibitions

The proposed rule regulates "incentive-based compensation"

- Broadly defined in the Notice as "any variable compensation, fees or benefits that serve as an incentive or reward for performance." (*See* Notice of Proposed Rulemaking and Request for Public Comment (May 5, 2024))

Regulation proposes that incentive-based compensation should not be *excessive* or designed in a way that could *lead to material financial loss*

- "Excessive" when amounts paid are "unreasonable or disproportionate" to the value of the services performed by the individual

The following nonexhaustive factors typically illustrate "unreasonable or disproportionate" amounts of incentive-based compensation:

1. The total value of all compensation and benefits provided to the individual;
2. The compensation history of the individual and relevant benchmarking of individuals with the same expertise at comparable entities;
3. The institution's financial condition;
4. Compensation practices at peer entities;
5. The projected cost of post-employment benefits, if applicable; and
6. Fraud, breach of fiduciary duty or insider abuse by the individual

Incentive-Based Compensation Prohibitions

Avoiding material financial loss:

- Under the proposed regulation, an incentive-based compensation arrangement encourages inappropriate risks that could lead to material financial loss *unless* the arrangement (1) balances risk and reward, (2) is compatible with sound risk management, and (3) is backed by strong corporate governance
- To appropriately balance risk and regard, the proposed regulation provides that an incentive-based compensation arrangement must:
  - Include both financial and nonfinancial performance measures, with a mechanism for nonfinancial measures to override financial measures in appropriate circumstances, and
  - Allow for award adjustments in the case of losses, inappropriate risk-taking and compliance failures

Documentary Compliance and Governance

The proposed regulation imposes robust documentary compliance and governance requirements for covered institutions

To meet the required compliance standards, institutions must:

1. Maintain detailed records regarding incentive-based compensation for seven years, and
2. Be ready to provide the records to the appropriate federal regulator if requested to do so

Enhanced disclosure, compliance and recordkeeping obligations apply only to Level 1 and 2 institutions

- **Note**—additional limitations and requirements apply to financial institutions with assets of $50 billion or more.

Current DEI Issues

DEI in the Moment

Background

- Trends: ESG in general and DEI in particular
- Impact on incentive compensation design and administration

Differing viewpoints and societal campaigns

Bringing the discussion back to business

Students for Fair Admissions, Inc. v. President & Fellows of Harvard College

- In *Students for Fair Admissions, Inc. v. President & Fellows of Harvard College*, the plaintiff, Students for Fair Admissions ("SFFA"), a nonprofit membership organization, filed separate lawsuits against Harvard University and the University of North Carolina in 2014, alleging that their admissions processes discriminate against Asian-American applicants by using a "personal rating" system that is biased against them and thus violate Title VI of the Civil Rights Act of 1964 and the Equal Protection Clause of the Fourteenth Amendment
- In 2023, the U.S. Supreme Court ruled in favor of SFFA in a 5-3 decision, stating that the race-conscious admissions processes violate Title VI of the Civil Rights Act as well as the Equal Protection Clause

Application (or Aftermath?) in the Workplace

Equal Employment Opportunity Commission

- Immediately following the Supreme Court’s decision, EEOC Chair Charlotte Burrows issued an EEOC press release, taking the position that the decision does “not address employer efforts to foster diverse and inclusive workforces,” and that “[i]t remains lawful for employers to implement diversity, equity, inclusion and accessibility programs that seek to ensure workers of all backgrounds are afforded equal opportunity in the workplace.”
- In contrast, EEOC Commissioner Andrea Lucas authored a Reuters article that same day, stating that “poorly structured voluntary diversity programs pose both legal and practical risks for companies. Those risks existed before the Supreme Court decision… Now they may be even higher.”

State Attorneys General likewise split on corporate DEI initiatives

Where does this leave companies?

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Next Steps for DEI Initiatives

The decision and the accompanying anti-DEI backlash should not cause companies to abandon DEI programs altogether. Directors should, however, reexamine DEI programs through a post-SFFA lens and consider taking steps to mitigate risk

- Review existing programs and training for vulnerabilities (i.e., the type of DEI practices that are most likely to face scrutiny)
- Review written materials and public disclosures
- Articulate the justifications for and the importance of existing DEI programs
- Ensure consistent corporate message among the board and management on the benefits and objectives of the company's programs
- Continue to monitor state and local laws to ensure compliance

Lightning Round

- FTC ban on non-competes – a break for now, but what does it mean?
- Confidentially speaking, don’t forget about whistleblowers
- DOL Fiduciary Rule – where will it land?
- Director compensation – trends to consider as directors’ plates continue to fill

Top Themes and Takeaways

Review compensation programs from value creation mindset and articulate why these programs are important for the business and how they align with the business strategy

Consider which compensation issues may materially impact the business and address as part of strategic and operational decision-making process

Undertake a critical review of management and board processes around compensation risks and make adjustments as needed

Ensure corporate records reflect strong governance and initiatives to identify, monitor and mitigate compensation risks

Designate personnel to keep directors informed of legal and regulatory developments addressing compensation

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Thank You.

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