Incentive Compensation

Primary Statute: HEA section 487(a)(20)
Primary Regulations: 34 CFR Part 668.14(22)(i)

Background

Under the Higher Education Act of 1965, institutions of higher education participating in the federal student aid programs must agree they will not provide incentive payments to recruiters who work for or with the school in exchange for enrolling students or obtaining financial aid.

The requirements, known broadly as "incentive compensation" rules,[1] were developed over time in response to reports of aggressive and abusive marketing and recruitment practices, particularly among for-profit postsecondary education providers. An investigation led by Senator Sam Nunn produced a landmark 1990 report that detailed examples of such practices, including competitions with cash or other rewards for contacting and, ultimately, enrolling the highest number of students or submitting the largest number of loan applications. The report recommended that institutions be prohibited from making payments of any commission, bonus, or salary incentive to recruiters.

In 1992, when Congress reauthorized the Higher Education Act, it adopted the recommendation of the Nunn Commission report on incentive compensation, along with other policies designed to crack down on the predatory practices of institutions of higher education. The new requirement was included in the section of the law governing institutions' certification of federal student aid eligibility, so it applied to all institutions participating in the federal student aid programs authorized by Title IV of the HEA, and a violation could result in the loss of Title IV eligibility. Specifically, the law stated:

> The institution **will not provide any commission, bonus, or other incentive payment** based directly or indirectly on **success in securing enrollments or financial aid** to any persons or entities engaged in any student recruiting or admission activities or in making decisions regarding the award of student financial assistance, except that this paragraph shall not apply to the recruitment of foreign students residing in foreign countries who are not eligible to receive Federal student assistance. [Emphasis added]

A conference report issued alongside the new provisions of the law clarified that it did not prohibit merit-based salary reviews generally, but rather incentive payments based solely on success in student recruitment, enrollment, or financial aid awards.

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[1] The incentive compensation ban, like most federal policies, is rooted in a series of congressional, executive, and judicial actions. Most often, the first step in the process of articulating a new, specific federal policy is action by Congress. The cognizant executive agency—in the case of the incentive compensation ban, the U.S. Department of Education—can move to enforce the restriction as specified in law or regulate to define and further clarify the requirement. Under either approach, the federal courts can become involved either to stay the statutory requirement, restrict enforcement, or intervene in the process of promulgating regulations. Generically, all these actions create "rules" that program participants must comply with.

Implementation of the New Requirements

Following passage of the 1992 reauthorization, the U.S. Department of Education (ED) responded to questions from institutions of higher education about the incentive compensation rules, as well as specifics of possible compensation plans. Their responses led to varying interpretations of the underlying provisions of the incentive compensation ban, and, although it was of particular interest to ED's Inspector General, enforcement was minimal.

In 2000, the high-profile case of Computer Learning Centers (CLC) altered the landscape. The publicly traded for-profit college, accredited by the Accrediting Council for Independent Colleges and Schools (ACICS), had been under investigation by numerous state regulators and faced lawsuits from students since at least 1998, facing allegations of poor quality, misrepresentations about graduates' success in finding jobs, and fraud. ED issued a final program review determination in 2000 that found the school had violated incentive compensation rules by basing recruiters' salaries on the average number of students they enrolled monthly, and ordered it to repay more than $185 million in federal student aid. Just a few weeks later, CLC canceled its classes, permanently closed the institution without warning, and filed for bankruptcy.

2002 Regulations and the Hansen Memo

In 2021, under a new administration facing pressure from Congress and a higher education industry seeking clarity about how IC rules would be applied in the future, ED announced that it would conduct a new rulemaking on the incentive compensation rules. The final rule, published in November 2002, created 12 safe harbors, outlining compensation structures to recruiters that ED specified did *not* violate the law. They were:

- Fixed compensation (e.g., annual salaries or hourly wages), as long as they are not adjusted more than twice during a 12-month period and those adjustments are not based solely on the number of students recruited, admitted, enrolled, or awarded financial aid;
- Compensation based on recruitment of students into non-Title IV-eligible programs;
- Compensation to those who arrange contracts between employers and institutions in which the employer pays at least half of the tuition and fees (as long as the compensation is not based on the number of employees who enroll at the school and the recruiters don't have contact with the employees directly);
- Compensation in a profit-sharing or bonus plan, as long as the payments are the same and made to all of the institution's full-time professional and administrative staff;
- Compensation based on students successfully completing at least one academic year of their educational programs;
- Compensation for employees who do pre-enrollment work such as answering phone calls or distributing materials to prospective students;
- Compensation to managers or supervisors who do not oversee employees directly involved in recruiting or admissions activities;

- Up to one annual token gift provided to students or alumni (not to exceed $100 in value and not in cash form);
- Profit distributions based proportionately on someone's ownership interest in the college;
- Compensation for all web-based recruitment and admission activities that refer prospective students to the institution or allow them to apply to the college online;
- Payments to any third-party organizations, including through tuition-sharing, that deliver services to the institution, as long as the services don't include recruiting, admissions, and federal student aid awards; and
- Payments to any third-party organizations, including through tuition-sharing, that deliver services to the institution, including recruiting, admissions, and federal student aid awards, as long as the employees of those organizations are not compensated through incentive payments.

As those rules were being finalized, ED also made changes to its internal practices that greatly reduced the penalty to institutions found in violation of incentive compensation rules. The "Hansen Memo," so called because it was sent from Deputy Secretary Bill Hansen to the chief operating officer of the Office of Federal Student Aid, stated that "improper recruiting does not render a recruited student ineligible to receive student aid funds for attendance at the institution on whose behalf the recruiting is conducted. Accordingly, the Department should treat a violation of the law as a compliance matter for which remedial or punitive sanctions should be considered."

Whereas the requirement had long been a condition of institutions' certification for Title IV federal financial aid eligibility, and a violation of incentive compensation rules would thus typically result in the limitation, suspension, or termination of federal financial aid eligibility, this reduced potential violations to a much smaller fine. Specifically, rather than fining institutions for the entirety of the federal aid received while the institution used prohibited incentive compensation practices, ED would account for the amount of the illegal payments to recruiters, and would heavily weigh the "pervasiveness of the improper practices" and "extent to which the institution appeared to be knowingly violating the law."

Between 1998 and 2010, ED identified incentive compensation violations at 32 institutions through program reviews. An additional 22 institutions reached settlement agreements related to incentive compensation (generally reached with no admission of the violation by the college). A 2010 report from the Government Accountability Office (GAO) found that ED's enforcement of the incentive compensation ban was inadequate. The Office of the Inspector General concurred in a 2015 report, saying that because of the Hansen Memo, "FSA employees were hesitant to take enforcement actions against schools that might have violated the incentive compensation ban."

2010 Regulations and the Bundled Services Guidance

When the Obama Administration took office, ED began the process of removing the safe harbors and issuing new regulations. ED wrote at the time that its "experience demonstrates that unscrupulous actors routinely rely upon these safe harbors to circumvent the intent of [the law]." The new regulations, finalized in 2010, largely restored the original interpretation of the statute, specifying that only general merit-based salary increases (not based on success in recruiting and enrolling students) and profit-sharing payments to individuals other than those involved in recruitment were exempt from the requirements.

The next year, however, ED issued new guidance that effectively restored one of the safe harbors from the 2002 regulations, albeit without public comment or regulatory language. The so-called "bundled services" guidance clarified that certain types of revenue-sharing agreements between an institution and a third party could also qualify under incentive compensation rules if:

- Recruiting and enrollment work is only one of a bundled set of services that the third party provides; and
- The third party is unaffiliated with the institution.

The guidance was issued at the request of a handful of companies that were developing a new business model: online program management companies (OPMs). ED argued in its guidance that "the independence of the third party (both as a corporate matter and as a decision maker) from the institution that provides the actual teaching and educational services is a significant safeguard against the abuses the Department has seen... ."

Today, OPMs are a multi-billion-dollar industry. In exchange for the OPM bearing the start-up costs of an online program, institutions often pay OPMs between 40% and 65% of tuition revenue from the recruited students, with some OPMs charging as much as 80% of revenue. Moreover, some contracts obtained by The Century Foundation and arrangements that have been made public showed that OPMs and institutions do not always maintain the required independence of the OPM as a decision-maker. In some instances, OPMs have control over curriculum decisions, admissions standards, and more. Given the growing number of institutions partnering with OPMs, some have called for the rescission or revision of the bundled services guidance, more caution on the part of institutions of higher education, and/or heightened transparency into OPM contracts. Despite these concerns, institutions such as Schreiner University and the University of California, Berkeley, have successfully introduced new academic programs in partnership with OPMs.

In April 2022, GAO released a report on the prevalence of OPM agreements and examined ED's ability to assess whether OPM arrangements complied with the incentive compensation rules. GAO found that ED's instructions to auditing agencies and colleges were inadequate and, as a result, it had not obtained sufficient information to evaluate compliance. GAO recommended that ED provide additional direction for auditors when they ask about OPM contracts and provide additional guidance to colleges so they are prepared to answer OPM-related questions and share OPM contracts with auditors and ED staff.

ED agreed with GAO's recommendations and began taking steps to address the concerns. In February 2023, ED released new guidance that would expand the scope of collection of information on third-party servicers. Under current rules, third-party servicers are entities that colleges contract with to administer federal financial aid programs. The new guidance included OPMs under the definition of third-party servicers, requiring colleges and universities to submit a wide range of information about their relationships with OPMs and other entities.

Many higher education institutions immediately pushed back, arguing that the new guidance would include almost any person or organization that a college contracts with and create unnecessary administrative burden on colleges, universities, and their outside vendors. In response to these concerns, ED initially delayed implementation of the new guidance from May to September 2023 to allow colleges and other affected organizations more time to understand the requests and gather information. It then delayed the due date again, announcing plans in May 2023 to revise its February 2023 guidance and notifying institutions that they would have six months to comply from the date the updated guidance is released.

In March 2023, ED conducted public hearings on the bundled services exception to the incentive compensation rule. Specifically, ED sought information about the structure of agreements between institutions and OPMs, the role and scope that recruitment plays in these agreements, and how contract incentives impact tuition, institutional expenses, and student outcomes. It also requested information about the costs and benefits of the current OPM contracts and what would happen if revenue-sharing models that incentivize recruitment were shifted to a different payment structure.

Proponents of greater oversight and accountability have generally supported ED's interest in revisiting the 2011 bundled services exception, encouraging ED to narrow or eliminate the provision entirely. Proponents argue that as currently written, the guidance has corrupted program quality, led to deceptive practices, and demonstrated that recruiting plays a substantially larger role in the bundle of services provided than once believed. Critics argue that the tuition-sharing payment structures allowed by the bundled services exception have spurred the creation of new, innovative online education models, and that eliminating the exception would curtail educational opportunities.

This memo will be updated after ED announces next steps, if any, to adjust incentive compensation guidance.

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