BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: April 19, 2016

To: Board of Governors

From: Staff[1]

Subject: Re-proposed joint rules implementing the incentive compensation requirements of the Dodd-Frank Act

ACTIONS REQUESTED: Approval to invite public comment on the attached draft notice of proposed rulemaking (the "NPR" or "proposed rule") that would implement the incentive compensation provisions of section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] The NPR would be issued jointly with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Securities and Exchange Commission, and the Federal Housing Finance Agency (collectively, the "Agencies"). It is anticipated that each agency will have completed its internal review and approval procedures by early May, 2016.

Staff requests authority to make technical and minor changes to the attached materials prior to publication in the Federal Register in order to respond to comments from the Federal Register or to incorporate non-substantive changes requested by the other agencies as part of the approval process.

EXECUTIVE SUMMARY: Section 956 requires the Agencies to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at certain financial institutions. A proposal was previously issued in 2011 ("2011 Proposed Rule") by the Agencies along with the Office of Thrift Supervision.[3] Since then, incentive-based compensation practices have evolved in the financial services industry and the Agencies have gained additional

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[1] Mr. Alvarez, Ms. Schaffer, Mr. Waldron, Mss. Burgess and Ahn, and Mr. Bowne (Legal Division) and Mr. Gibson, Mr. Solomon, Mss. Williams, Scott, Donovan, and White, and Mr. Maldonado (Division of Banking Supervision and Regulation).

[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] 76 FR 21170 (April 14, 2011).

supervisory experience. In light of these developments and the comments received on the 2011 Proposed Rule, staff recommends that the Board join the other Agencies in seeking comment on a revised proposal that includes new, more specific and more stringent requirements, especially for the largest institutions (and subsidiaries thereof).

- Scope of application. The proposed rule would apply to covered institutions that have $1 billion or more in total consolidated assets.[4] The rule applies different requirements to three levels of institutions based on asset size: entities with total consolidated assets equal to or greater than $250 billion (Level 1); those with assets between $50 and $250 billion (Level 2); and those with assets between $1 and $50 billion (Level 3). For covered institutions that are subsidiaries of other covered institutions, levels would generally be determined by reference to the average total consolidated assets of the top-tier parent covered institution.
- Tailoring by asset size. Limits on incentive-based compensation arrangements would be tailored based on the levels noted above, with more stringent requirements applying to the largest organizations.
    - Smaller covered institutions with assets between $1 and $50 billion (Level 3) would be required to maintain records documenting their incentive-based compensation arrangements and to ensure that those arrangements (1) appropriately balance risk and financial rewards, (2) are compatible with effective risk management and controls, and (3) are supported by effective governance.
    - Covered institutions with $50 billion or more in consolidated assets (Level 1 and Level 2) would be subject to mandatory deferral, forfeiture and clawback requirements. The mandatory deferral requirements for Level 1 covered institutions would be higher than for Level 2 covered institutions. Level 1 and Level 2 covered institutions would also be subject to more detailed and rigorous requirements for incentive-based compensation

[4] Section 956 specifically applies to specified financial institutions with at least $1 billion in assets. Financial institution covered by section 956 include: depository institution holding companies; depository institutions; registered broker-dealers; investment advisers; Fannie Mae; Freddie Mac; and any other financial institution determined by the Agencies. The proposed rule would also apply to the U.S. operations of foreign banking organizations with at least $1 billion in assets and the Federal Home Loan Banks. The Board's proposed rule would cover depository institution holding companies and their subsidiaries that are not covered by another agency's rule, U.S. operations of a foreign banking organization that are not covered by another agency's rule, state member banks, and Edge and Agreement Corporations.

arrangements, risk management frameworks, governance, and policies and procedures and more detailed recordkeeping and disclosure requirements.

- Covered persons. Certain prohibitions and requirements would apply to all executive officers, employees, directors and principal shareholders who receive incentive-based compensation ("covered persons"). Most of the more stringent requirements would apply only to senior executive officers and significant risk-takers. A significant risk-taker would generally be an individual in a covered institution with at least $50 billion in assets who is not a senior executive officer but was among the top 5 percent (for organizations with more than $250 billion in consolidated assets) or top 2 percent (for organizations with between $50 and $250 billion in consolidated assets) of most highly compensated covered persons in the entire consolidated organization or (2) had authority to commit or expose 0.5 percent or more of the capital of a covered institution.

DISCUSSION: As noted above, the proposed rule would apply to any covered institution with at least $1 billion in assets, with requirements tiered to the asset size of the covered institution.

Requirements and Prohibitions Applicable to All Covered Institutions (Level 1, Level 2, and Level 3).

The proposed rule would prohibit all covered institutions from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk by providing covered persons with excessive compensation, fees, or benefits or that could lead to material financial loss to the covered institution. These are the standards imposed by section 956.

The proposed rule provides that compensation, fees, and benefits will be considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into consideration all relevant factors, including: the combined value of all compensation, fees, or benefits; the compensation history of the covered person and other individuals with comparable expertise at the covered institution; the financial condition of the covered institution; compensation practices at comparable institutions; 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. These standards are very

similar to the safety and soundness standards applicable to insured depository institutions under section 39 of the Federal Deposit Insurance Act.[5]

The proposed rule also provides that an incentive-based compensation arrangement will be considered to encourage inappropriate risks that could lead to material financial loss to the covered institution, unless the arrangement appropriately balances risk and reward, is compatible with effective risk management and controls, and is supported by effective governance. The proposed rule would require incentive-based compensation arrangements to: include financial and non-financial measures of performance; be designed to allow non-financial measures of performance to override financial measures of performance, when appropriate; and be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.

Under the proposed rule, the board of directors of any covered institution (or a committee thereof) would be required to conduct oversight of the incentive-based compensation program; approve incentive-based compensation arrangements for senior executive officers, including awards and payouts; and approve material exceptions or adjustments to such incentive-based compensation policies or arrangements.

All covered institutions would be required to create annually and maintain for at least seven years records that document the structure of incentive-based compensation arrangements and that demonstrate compliance with the proposed rule. The records would be required to be disclosed to the covered institution's appropriate Federal regulator upon request.

As noted above, these prohibitions and requirements would apply to covered persons, who are executive officers, employees, directors and principal shareholders who receive incentive-based compensation. A "senior executive officer" would be a covered person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions at a covered institution for any period of time in the relevant performance period: president, chief executive officer, executive chairman, chief operating

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[5] 12 U.S.C. 1831p-1; Interagency Guidelines Establishing Standards for Safety and Soundness (the "Federal Banking Agency Safety and Soundness Guidelines"), 12 CFR part 30, Appendix A (OCC); 12 CFR part 208, Appendix D-1 (Board); 12 CFR part 364, Appendix A (FDIC). Section 956 requires that any compensation standards adopted under that section be comparable to the safety and soundness standards applicable to insured depository institutions under section 39 of the FDIA and that the Agencies take the compensation standards described in section 39 of the FDIA into consideration in establishing compensation standards under this rule.

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.

For covered institutions with at least $50 billion in assets, a significant risk-taker would generally be an individual who is not a senior executive officer but was among the top 5 percent (for organizations with more than $250 billion in consolidated assets) or top 2 percent (for organizations with between $50 and $250 billion in consolidated assets) of most highly compensated covered persons in the entire consolidated organization or (2) had authority to commit or expose 0.5 percent or more of the capital of a covered institution. To prevent evasion of the proposed rule, individuals who have the authority to commit or expose 0.5% or more a covered institution's capital would be significant risk-takers even if they were employed by an affiliate of the covered institution, regardless of whether that affiliate was itself a covered institution (e.g., an affiliate with less than $1 billion in consolidated assets). Agencies could designate additional individuals as significant risk-takers because of their ability to expose a covered institution to risks that could lead to material financial loss in relation to the covered institution's size, capital, or overall risk tolerance. Covered institutions could also designate additional individuals as significant risk-takers.

Additional Requirements for Level 1 and Level 2 Covered Institutions.

For covered institutions with $50 billion or more in assets (Level 1 and Level 2), the proposed rule would require that incentive-based compensation arrangements for senior executive officers and significant risk-takers include deferral, risk of downward adjustment and forfeiture, and clawback, and include other features designed to safeguard against inappropriate risk-taking and ensure that such arrangements appropriately balance risk and reward.

Deferral. Under the proposed rule, the mandatory deferral requirements would be tiered as follows:

- A Level 1 covered institution ($250 billion or more in assets) would be required to defer for at least four years from the end of the performance period at least 60 percent of a senior executive officer's qualifying incentive-based compensation and 50 percent of a significant risk-taker's qualifying incentive-based compensation. If the incentive-based compensation is awarded under a plan with a performance period of three years or more

(a "long-term incentive plan"), then the deferral period is reduced to two years from four years following the end of the performance period.[6]

- A Level 2 covered institution (between $50 and $250 billion in assets) would be required to defer for at least three years after the end of the performance period at least 50 percent of a senior executive officer's qualifying incentive-based compensation and 40 percent of a significant risk-taker's qualifying incentive-based compensation. Thus, Level 2 covered institutions would be required to defer a reduced amount of incentive-based compensation, and for a shorter period. Similarly, the deferral period for a long-term incentive plan at a Level 2 covered institutions is reduced to one year from three years.

Deferred incentive-based compensation could vest no faster than on a pro rata annual basis, and the deferred amount would be required to consist of substantial amounts of both deferred cash and equity-like instruments throughout the deferral period. The proposed rule would also prohibit covered institutions with $50 billion or more in assets from accelerating the payment of a covered person's deferred incentive-based compensation, except in the case of death or disability of the covered person.

Additionally, if a senior executive officer or significant risk-taker receives incentive-based compensation in the form of options, the amount of such options used to meet the minimum required deferred incentive-based compensation could not exceed 15 percent of the amount of total incentive-based compensation. This limitation would have the effect of reducing the attraction of using options as a form of incentive-based compensation, but does not limit the amount of options a covered institution may grant to its employees.

Forfeiture and Downward Adjustment. The proposed rule would require a covered institution with $50 billion or more in assets to make subject to forfeiture and downward adjustment all unvested deferred and un-awarded incentive-based compensation of any senior executive officer or significant risk-taker. Under the proposed rule, "forfeiture" means a reduction of the amount of deferred incentive-based compensation awarded to a person that has

[6] The proposed rule would require the same deferral percentage, but a shorter deferral period, for incentive-based compensation awarded under a long-term incentive plan as for other incentive-based compensation. Many institutions currently count all incentive-based compensation awarded under long-term incentive plans as deferred, without additional deferral requirements after the end of the performance period.

not vested. "Downward adjustment" means a reduction of the amount of a covered person's incentive-based compensation not yet awarded for any performance period that has already begun.

A covered institution with $50 billion or more in assets would be required to consider forfeiture or downward adjustment of incentive-based compensation if certain adverse outcomes occur. The adverse outcomes that trigger forfeiture and downward adjustment would be: poor financial performance attributable to a significant deviation from the covered institution's risk parameters; inappropriate risk-taking, regardless of the impact on financial performance; material risk management or control failures; non-compliance with statutory, regulatory, or supervisory standards that results in either an enforcement or legal action brought by a federal or state regulator or agency, or a restatement of a financial statement to correct a material error; and other aspects of conduct or poor performance as defined by the covered institution.

Clawback. The term "clawback" refers to a mechanism by which a covered institution can recover vested incentive-based compensation from a senior executive officer or significant risk-taker if certain events occur. The proposed rule would require covered institutions with $50 billion or more in assets to include clawback provisions that, at a minimum, allow the covered institution to potentially recover incentive-based compensation from a current or former senior executive officer or significant risk-taker for seven years following the date on which such compensation vests, if the covered institution determines that the senior executive officer or significant risk-taker engaged in specified types of significant misconduct. The types of misconduct that would trigger clawback would be: that resulted in significant financial or reputational harm to the covered institution, fraud, or intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation.

Maximum incentive-based compensation opportunity. For covered institutions with $50 billion or more in assets, incentive-based compensation awards could not exceed target amounts by more than 125% for any senior executive officer or more than 150% for any significant risk-taker.

Other Requirements.

The proposed rule would include additional requirements for covered institutions with $50 billion or more in assets, including:

- Limitations on the use of hedging, relative performance measures, and volume-driven incentive-based compensation.
- A requirement for independent risk management frameworks for incentive-based compensation programs.
- A requirement for a compensation committee composed solely of directors who are not senior executive officers, which obtains input on the effectiveness of the institution's incentive-based compensation program at balancing risk and reward from the risk and audit committees, management and the internal audit or risk management function.
- A requirement for detailed policies and procedures that, among other things, are consistent with the requirements and prohibitions of the proposed rule.

Transition period: To allow institutions time to adjust their incentive-based compensation programs to the proposed rule, the compliance date would be the beginning of the first calendar quarter that begins at least 540 days (effectively eighteen months) after a final rule is published in the Federal Register. The proposed rule would not apply to any incentive-based compensation plan with a performance period that begins before the compliance date.

CONCLUSION: Based on the foregoing, staff recommends that the Board approve the attached draft notice of proposed rulemaking with a public comment period that will close on July 22, 2016. Staff also requests the ability to make technical and minor changes to the proposed rule and Federal Register notice, in consultation with Governor Tarullo, in order to ensure consistency among the Agencies. SEC staff has indicated that Commissioners may have further changes. Staff will consult with Governor Tarullo on any changes received from any Agency.

Attachments