The Dodd-Frank Act requires NCUA to issue this rule jointly with five other agencies – the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission. The NCUA Board has approved issuing the preamble and NCUA's portion of the proposed rule text. This preamble and proposed rule will not be published in the Federal Register until after all of the agencies have acted, and the final version may differ from the version posted here.

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 42

Docket No. OCC-2011-0001

RIN 1557-AD39

FEDERAL RESERVE SYSTEM

12 CFR Part 236

Docket No.

RIN

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 372

RIN 3064-AD86

FEDERAL HOUSING FINANCE AGENCY

12 CFR Part 1232

RIN 2590-AA42

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 741 and 751

RIN 3133-AE48

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 303

Release No.; File no.

RIN

Incentive-based Compensation Arrangements

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Federal Housing Finance Agency (FHFA); National Credit Union Administration (NCUA); and U.S. Securities and Exchange Commission (SEC).

ACTION: Notice of Proposed Rulemaking and Request for Comment.

SUMMARY: The OCC, Board, FDIC, FHFA, NCUA, and SEC (the Agencies) are seeking comment on a joint proposed rule (the proposed rule) to revise the proposed rule the Agencies published in the Federal Register on April 14, 2011, and to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 956 generally requires that the Agencies jointly issue regulations or guidelines: (1) prohibiting incentive-based payment arrangements that the Agencies determine encourage inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss; and (2) requiring those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate Federal regulator.

DATES: Comments must be received by July 22, 2016.

ADDRESSES: Although the Agencies will jointly review the comments submitted, it would facilitate review of the comments if interested parties send comments to the Agency that is the appropriate Federal regulator, as defined in section 956(e) of the Dodd-Frank Act, for the type of covered institution addressed in the comments. Commenters are encouraged to use the title "Incentive-based Compensation Arrangements" to facilitate the organization and distribution of comments among the Agencies. Interested parties are invited to submit written comments to:

Office of the Comptroller of the Currency: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the

Federal eRulemaking Portal or e-mail, if possible. Please use the title "Incentive-based Compensation Arrangements" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- Federal eRulemaking Portal—Regulations.gov: Go to www.regulations.gov. Enter "Docket ID OCC-2016-____" in the Search Box and click "Search." Click on "Comment Now" to submit public comments.
- Click on the "Help" tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting public comments.
- E-mail: regs.comments@occ.treas.gov.
- Mail: Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 400 7th Street, SW., Suite 3E-218, Mail Stop 9W-11, Washington, DC 20219.
- Fax: (571) 465-4326.
- Hand Delivery/Courier: 400 7th Street, SW., Suite 3E-218, Mail Stop 9W-11, Washington, DC 20219.

Instructions: You must include "OCC" as the agency name and "Docket ID OCC-2011-0001" in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rule by any of the following methods:

- Viewing Comments Electronically: Go to www.regulations.gov. Enter "Docket ID OCC-2016-____" in the Search box and click "Search." Click on "Open Docket Folder" on the right side of the screen and then "Comments." Comments can be filtered by clicking on "View All" and then using the filtering tools on the left side of the screen.

- Click on the "Help" tab on the Regulations.gov home page to get information on using Regulations.gov. Supporting materials may be viewed by clicking on "Open Docket Folder" and then clicking on "Supporting Documents." The docket may be viewed after the close of the comment period in the same manner as during the comment period.

- Viewing Comments Personally: You may personally inspect and photocopy comments at the OCC, 400 7th Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 649-6700 or, for persons who are deaf or hard of hearing, TTY, (202) 649-5597. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.

Board of Governors of the Federal Reserve System: You may submit comments, identified by Docket No. and RIN No., by any of the following methods:

- Agency Web Site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

- E-mail: regs.comments@federalreserve.gov. Include the docket number and RIN number in the subject line of the message.

- Fax: (202) 452-3819 or (202) 452-3102.

- Mail: Address to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's Web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room 3515, 1801 K Street, NW. (between 18th and 19th Streets NW), Washington, DC 20006 between 9:00 a.m. and 5:00 p.m. on weekdays.

Federal Deposit Insurance Corporation: You may submit comments, identified by RIN 3064-AD86, by any of the following methods:

- Agency Web Site: http://www.FDIC.gov/regulations/laws/federal/propose.html. Follow instructions for submitting comments on the Agency Web Site.
- E-mail: Comments@FDIC.gov. Include the RIN 3064-AD86 on the subject line of the message.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivery: Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.
- Public Inspection: All comments received, including any personal information provided, will be posted generally without change to *http://www.fdic.gov/regulations/laws/federal*.

Federal Housing Finance Agency: You may submit your written comments on the proposed rulemaking, identified by RIN number, by any of the following methods:

- E-mail: Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail to RegComments@fhfa.gov. Please include "RIN 2590-AA42" in the subject line of the message.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments. If you submit your comment to the Federal eRulemaking Portal, please also send it by e-mail to FHFA at RegComments@fhfa.gov to ensure timely receipt by the Agency. Please include ''RIN'' in the subject line of the message.
- U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service: The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN, Federal Housing Finance Agency, 400 7th Street, SW., Washington, DC 20219.

- Hand Delivery/Courier: The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN, Federal Housing Finance Agency, 400 7th Street, SW., Washington, DC 20219.

All comments received by the deadline will be posted without change for public inspection on the FHFA Web site at http://www.fhfa.gov, and will include any personal information provided, such as name, address (mailing and email), and telephone numbers. Copies of all comments timely received will be available for public inspection and copying at the address above on government-business days between the hours of 10:00 a.m. and 3:00 p.m. To make an appointment to inspect comments please call the Office of General Counsel at (202) 414-6924.

National Credit Union Administration: You may submit comments by any of the following methods (please send comments by one method only):

- Federal eRulemaking Portal: http:// www.regulations.gov. Follow the instructions for submitting comments.
- Agency Web site: http://www.ncua.gov. Follow the instructions for submitting comments.
- E-mail: Address to regcomments@ncua.gov. Include ''[Your name] Comments on ''Notice of Proposed Rulemaking for Incentive-based Compensation Arrangements'' in the e-mail subject line.
- Fax: (703) 518–6319. Use the subject line described above for e-mail.
- Mail: Address to Gerard S. Poliquin, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428.
- Hand Delivery/Courier: Same as mail address.
- Public Inspection: All public comments are available on the agency's Web site at http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx as submitted, except when not possible for technical reasons. Public comments will not be edited to remove any identifying or contact information. Paper copies of comments may be inspected in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9:00 a.m. and 3:00 p.m. To make an appointment, call (703) 518–6546 or send an e-mail to OGCMail@ncua.gov.

Securities and Exchange Commission: You may submit comments by the following method:

Electronic Comments

- Use the SEC's Internet comment form (http://www.sec.gov/rules/exorders.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

All submissions should refer to File Number [ ]. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The SEC will post all comments on the SEC's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for Web site viewing and printing in the SEC's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; the SEC does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda or other substantive items may be added by the SEC or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the SEC's Web site. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by email.

FOR FURTHER INFORMATION CONTACT:

OCC: Patrick T. Tierney, Assistant Director, Alison MacDonald, Senior Attorney, and Melissa Lisenbee, Attorney, Legislative and Regulatory Activities, (202) 649-5490, and Judi McCormick, Analyst, Operational Risk Policy, (202) 649-6415, Office of the Comptroller of the Currency, 400 7th Street, SW., Washington, DC 20219.

BOARD: Teresa Scott, Manager, (202) 973-6114, Meg Donovan, Senior Supervisory Financial Analyst, (202) 872-7542, or Joe Maldonado, Supervisory Financial Analyst, (202) 973-7341, Division of Banking Supervision and Regulation; or Laurie Schaffer, Associate General Counsel, (202) 452-2272, Michael Waldron, Special Counsel, (202) 452-2798, Gillian Burgess, Counsel, (202) 736-5564, Flora Ahn, Counsel, (202) 452-2317, or Steve Bowne, Senior Attorney, (202) 452-3900, Legal Division, Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.

FDIC: Rae-Ann Miller, Associate Director, Risk Management Policy, Division of Risk Management Supervision (202) 898-3898, Catherine Topping, Counsel, Legal Division, (202) 898-3975, and Nefretete Smith, Counsel, Legal Division, (202) 898-6851.

FHFA: Mary Pat Fox, Manager, Executive Compensation Branch, (202) 649-3215; or Lindsay Simmons, Assistant General Counsel, (202) 649-3066, Federal Housing Finance Agency, 400 7th Street, SW., Washington, DC 20219.

NCUA: Vickie Apperson, Program Officer, and Jeffrey Marshall, Program Officer, Office of Examination & Insurance, (703) 518-6360; or Elizabeth Wirick, Senior Staff Attorney, Office of General Counsel, (703) 518-6540, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314.

SEC: Raymond A. Lombardo, Branch Chief, Kevin D. Schopp, Special Counsel, Division of Trading & Markets, (202) 551-5777 or tradingandmarkets@sec.gov; Sirimal R. Mukerjee, Senior Counsel, Melissa R. Harke, Branch Chief, Division of Investment Management, (202) 551-6787 or IARules@SEC.gov, U. S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. INTRODUCTION

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act")[1] requires the Agencies to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at certain financial institutions (referred to as "covered financial institutions").[2] Specifically, section 956 of the Dodd-Frank Act ("section 956") requires that the Agencies prohibit any types of incentive-based compensation[3] arrangements, or any feature of any such arrangements, that the Agencies

[1] Pub. L. 111-203, 124 Stat. 1376 (2010).
[2] 12 U.S.C. 5641.
[3] Section 956(b) uses the term "incentive-based payment arrangement." It appears that Congress used the terms "incentive-based payment arrangement" and "incentive-based compensation arrangement"

determine encourage inappropriate risks by a covered financial institution: (1) by providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or (2) that could lead to material financial loss to the covered financial institution. Under the Act, a covered financial institution also must disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements sufficient to determine whether the structure provides excessive compensation, fees, or benefits or could lead to material financial loss to the institution. The Dodd-Frank Act does not require a covered financial institution to report the actual compensation of particular individuals.

The Act defines "covered financial institution" to include any of the following types of institutions that have $1 billion or more in assets: (A) a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act ("FDIA") (12 U.S.C. 1813); (B) a broker-dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o); (C) a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; (D) an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)); (E) the Federal National Mortgage Association (Fannie Mae); (F) the Federal Home Loan Mortgage Corporation (Freddie Mac); and (G) any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for these purposes.

The Act also requires that any compensation standards adopted under section 956 be comparable to the safety and soundness standards applicable to insured depository institutions under section 39 of the FDIA[4] and that the Agencies take the compensation standards described in section 39 of the FDIA into consideration in establishing compensation standards under

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interchangeably. The Agencies have chosen to use the term "incentive-based compensation arrangement throughout the proposed rule and this Supplementary Information section for the sake of clarity.

[4] 12 U.S.C. 1831p-1. The OCC, Board, and FDIC (collectively, the "Federal Banking Agencies") each have adopted guidelines implementing the compensation-related and other safety and soundness standards in section 39 of the FDIA. See 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.[5] As explained in greater detail below, the standards established by the proposed rule are comparable to the standards established under section 39 of the FDIA.

In April 2011, the Agencies published a joint notice of proposed rulemaking that proposed to implement section 956 (2011 Proposed Rule).[6] Since the 2011 Proposed Rule was published, incentive-based compensation practices have evolved in the financial services industry. The Board, the OCC, and the FDIC have gained experience in applying guidance on incentive-based compensation,[7] FHFA has gained supervisory experience in applying compensation-related rules[8] adopted under the authority of the Safety and Soundness Act,[9] and foreign jurisdictions have adopted incentive-based compensation remuneration codes, regulations, and guidance.[10] In light of these developments and the comments received on the 2011 Proposed Rule, the Agencies are publishing a new proposed rule to implement section 956.

The first part of this Supplementary Information section provides background information on the proposed rule, including a summary of the 2011 Proposed Rule and areas in which the proposed rule differs from the 2011 Proposed Rule. The second part contains a

[5] 12 U.S.C. 1831p-1(c).
[6] 76 FR 21170 (April 14, 2011).
[7] OCC, Board, FDIC, and Office of Thrift Supervision, "Guidance on Sound Incentive Compensation Policies" ("2010 Federal Banking Agency Guidance"), 75 FR 36395 (June 25, 2010).
[8] These include the Executive Compensation Rule (12 CFR Part 1230), the Golden Parachute Payments Rule (12 CFR Part 1231), and the Federal Home Loan Bank Directors' Compensation and Expenses Rule (12 CFR Part 1261 Subpart C).
[9] The Safety and Soundness Act means the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended (12 U.S.C. 4501 et seq.). 12 CFR §1201.1.
[10] See, e.g., the European Union, Directive 2013/36/EU (effective January 1, 2014); United Kingdom Prudential Regulation Authority ("PRA") and Financial Conduct Authority ("FCA"), "PRA PS12/15 / FCA PS15/16: Strengthening the Alignment of Risk and Reward: New Remuneration Rules" (June 25, 2015) ("UK Remuneration Rules"), available at http://www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps1215.pdf; Australian Prudential Regulation Authority ("APRA"), Prudential Practice Guide SPG 511 – Remuneration (November 2013), available at http://www.apra.gov.au/Super/Documents/Prudential-Practice-Guide-SPG-511-Remuneration.pdf; Canada, The Office of the Superintendent of Financial Institutions ("OSFI") Corporate Governance Guidelines (January 2013) ("OSFI Corporate Governance Guidelines"), available at http://www.osfi-bsif.gc.ca/eng/fi-if/rg-ro/gdn-ort/gl-ld/pages/cg_guideline.aspx and Supervisory Framework (December 2010) ("OSFI Supervisory Framework"), available at http://www.osfi-bsif.gc.ca/Eng/Docs/sframew.pdf; Switzerland, Financial Market Supervisory Authority ("FINMA"), 2010/01 FINMA Circular on Remuneration Schemes (October 2009) ("FINMA Remuneration Circular"), available at https://www.finma.ch/en/documentation/circulars/#Order=2.

section-by-section description of the proposed rule.[11] To help explain how the requirements of the proposed rule would work in practice, the Appendix to this Supplementary Information section sets out an example of an incentive-based compensation arrangement for a hypothetical senior executive officer at a hypothetical large banking organization and an example of how a forfeiture and downward adjustment review might be conducted for a senior manager at a hypothetical large banking organization.

For ease of reference, the proposed rules of the Agencies are referenced in this Supplementary Information section using a common designation of section ___.1 to section ___.14 (excluding the title and part designations for each agency). Each agency would codify its rule, if adopted, within its respective title of the Code of Federal Regulations.[12]

A. Background

Incentive-based compensation arrangements are critical tools in the management of financial institutions. These arrangements serve several important objectives, including attracting and retaining skilled staff and promoting better performance of the institution and individual employees. Well-structured incentive-based compensation arrangements can promote the health of a financial institution by aligning the interests of executives and employees with those of the institution's shareholders and other stakeholders. At the same time, poorly structured incentive-based compensation arrangements can provide executives and employees with incentives to take inappropriate risks that are not consistent with the long-term health of the institution and, in turn, the long-term health of the U.S. economy. Larger financial institutions in particular are interconnected with one another and with many other companies and markets, which can mean that any negative impact from inappropriate risk-taking can have broader consequences. The risk of these negative externalities may not be fully taken into account in incentive-based compensation arrangements, even arrangements that otherwise align the interests of shareholders and other stakeholders with those of executives and employees.

[11] This section-by-section description also includes certain examples of how the proposed rule would work in practice. These examples are intended solely for purposes of illustration and do not cover every aspect of the proposed rule. They are provided as an aid to understanding the proposed rule and do not carry the force and effect of law or regulation.

[12] Specifically, the Agencies propose to codify the rules as follows: 12 CFR part 42 (OCC); 12 CFR part 236 (the Board); 12 CFR part 372 (FDIC); 17 CFR part 303 (SEC); 12 CFR Parts 741 and 751 (NCUA); and 12 CFR part 1232 (FHFA).

There is evidence that flawed incentive-based compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007. Some compensation arrangements rewarded employees – including non-executive personnel like traders with large position limits, underwriters, and loan officers – for increasing an institution's revenue or short-term profit without sufficient recognition of the risks the employees' activities posed to the institutions, and therefore potentially to the broader financial system.[13] Traders with large position limits, underwriters, and loan officers are three examples of non-executive personnel who had the ability to expose an institution to material amounts of risk. Significant losses caused by actions of individual traders or trading groups occurred at some of the largest financial institutions during and after the financial crisis.[14]

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[13] See, e.g., Financial Crisis Inquiry Commission, "Financial Crisis Inquiry Report" (January 2011), at 209, 279, 291, 343, available at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf; Senior Supervisors Group, "Observations on Risk Management Practices during the Recent Market Turbulence" (March 6, 2008), available at https://www.newyorkfed.org/medialibrary/media/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.

[14] A large financial institution suffered losses in 2012 from trading by an investment office in its synthetic credit portfolio. These losses amounted to approximately $5.8 billion, which was approximately 3.6 percent of the holding company's tier 1 capital. https://www.sec.gov/Archives/edgar/data/19617/000001961713000221/0000019617-13-000221-index.htm Form 10-K 2013, Pages 69 and 118. In 2007, a proprietary trading group at another large institution caused losses of an estimated $7.8 billion (approximately 25 percent of the firm's total stockholder's equity). http://www.morganstanley.com/about-us-ir/shareholder/10k113008/10k1108.pdf Form 10-K 2008, Pages 45 and 108. Between 2005 and 2008, one futures trader at a large financial institution engaged in activities that caused losses of an estimated EUR4.9 billion in 2007, which was approximately 23 percent of the firm's 2007 tier 1 capital. http://www.societegenerale.com/sites/default/files/03%20March%202008%202008%20Registration%20Document.pdf, Pages, 52, 159-160; http://www.societegenerale.com/sites/default/files/12%20May%202008%20The%20report%20by%20the%20General%20Inspection%20of%20Societe%20Generale.pdf, Pages 1-71.
In 2011, one trader at another large financial institution caused losses of an estimated $2.25 billion, which represented approximately 5.4 percent of the firm's tier 1 capital. https://www.fca.org.uk/news/press-releases/fca-bans-kweku-mawuli-adoboli-from-the-financial-services-industry, Page1; https://www.ubs.com/global/en/about_ubs/investor_relations/other_filings/sec.html. 2012 SEC Form 20-F, Page 34. In 2007, one trader caused losses of an estimated $264 million at a large financial institution, which represented approximately 1.7 percent of its tier 1 capital. http://www.federalreserve.gov/newsevents/press/enforcement/20081118a.htm, Page1; https://www.bmo.com/ci/ar2008/downloads/bmo_ar2008.pdf, Page 61.

Of particular note were incentive-based compensation arrangements for employees in a position to expose the institution to substantial risk that failed to align the employees' interests with those of the institution. For example, some institutions gave loan officers incentives to write a large amount of loans or gave traders incentives to generate high levels of trading revenues, without sufficient regard for the risks associated with those activities. The revenues that served as the basis for calculating bonuses were generated immediately, while the risk outcomes might not have been realized for months or years after the transactions were completed. When these, or similarly misaligned incentive-based compensation arrangements, are common in an institution, the foundation of sound risk management can be undermined by the actions of employees seeking to maximize their own compensation.

The effect of flawed incentive-based compensation practices is demonstrated by the arrangements implemented by Washington Mutual (WaMu). According to the Senate Permanent Subcommittee on Investigations Staff's report on the failure of Washington Mutual "[l]oan officers and processors were paid primarily on volume, not primarily on the quality of their loans, and were paid more for issuing higher risk loans. Loan officers and mortgage brokers were also paid more when they got borrowers to pay higher interest rates, even if the borrower qualified for a lower rate – a practice that enriched WaMu in the short term, but made defaults more likely down the road."[15]

Flawed incentive-based compensation arrangements were evident in not just U.S. financial institutions, but also major financial institutions worldwide.[16] In a 2009 survey of banking organizations engaged in wholesale banking activities, the Institute of International Finance found that 98 percent of respondents recognized the contribution of incentive-based compensation practices to the financial crisis.[17]

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[15] Staff of S. Permanent Subcomm. on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse at 143 (Comm. Print 2011).
[16] See Financial Stability Forum, "FSF Principles for Sound Compensation Practices" (April 2009) (the "FSB Principles"), available at http://www.financialstabilityboard.org/publications/r_0904b.pdf; Senior Supervisors Group, "Risk-management Lessons from the Global Banking Crisis of 2008" (October 2009), available at http://www.newyorkfed.org/newsevents/news/banking/2009/ma091021.html. The Financial Stability Forum was renamed the Financial Stability Board ("FSB") in April 2009.
[17] See Institute of International Finance, Inc., "Compensation in Financial Services: Industry Progress and the Agenda for Change" (March 2009), available at

Shareholders and other stakeholders in a covered institution[18] have an interest in aligning the interests of executives, managers, and other employees with the institution's long-term health. However, aligning the interests of shareholders (or members, in the case of credit unions, mutual savings associations, mutual savings banks, some mutual holding companies, and Federal Home Loan Banks) and other stakeholders with employees may not always be sufficient to protect the safety and soundness of an institution, deter excessive compensation, or deter behavior or inappropriate risk-taking that could lead to material financial loss at the institution. Executive officers and employees of a covered institution may be willing to tolerate a degree of risk that is inconsistent with the interests of stakeholders, as well as broader public policy goals.

Generally, the incentive-based compensation arrangements of a covered institution should reflect the interests of the shareholders and other stakeholders, to the extent that the incentive-based compensation makes those covered persons demand more or less reward for their risk-taking at the covered institution, and to the extent that incentive-based compensation changes those covered persons' risk-taking. However, risks undertaken by a covered institution – particularly a larger institution – can spill over into the broader economy, affecting other institutions and stakeholders. Therefore, there may be reasons why the preferences of all of the stakeholders are not fully reflected in incentive-based compensation arrangements. Hence, there is a public interest in curtailing the inappropriate risk-taking incentives provided by incentive-based compensation arrangements. Without restrictions on incentive-based compensation arrangements, covered institutions may engage in more risk-taking than is optimal from a societal perspective, suggesting that regulatory measures may be required to cut back on the risk-taking incentivized by such arrangements. Particularly at larger institutions, shareholders and other stakeholders may have difficulty effectively monitoring and controlling the impact of incentive-based compensation arrangements throughout the institution that may affect the institution's risk profile, the full range of stakeholders, and the larger economy.

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http://www.oliverwyman.com/ow/pdf_files/OW_En_FS_Publ_2009_CompensationInFS.pdf. See also UBS, "Shareholder Report on UBS's Write-Downs," (April 18, 2008), at 41-42 (identifying incentive effects of UBS compensation practices as contributing factors in losses suffered by UBS due to exposure to the subprime mortgage market), available at http://www.ubs.com/1/ShowMedia/investors/agm?contentId=140333&name=080418ShareholderReport.pdf.

[18] As discussed below, the proposed rule uses the term "covered institution" rather than the statutory term "covered financial institution."

As a result, supervision and regulation of incentive-based compensation can play an important role in helping safeguard covered institutions against incentive-based compensation practices that threaten safety and soundness, are excessive, or could lead to material financial loss. In particular, such supervision and regulation can help address the negative externalities affecting the broader economy or other institutions that may arise from inappropriate risk-taking by large financial institutions.

B. Supervisory Experience

To address such practices, the Federal Banking Agencies proposed, and then later adopted, the 2010 Federal Banking Agency Guidance governing incentive-based compensation programs, which applies to all banking organizations regardless of asset size. This Guidance uses a principles-based approach to ensure that incentive-based compensation arrangements appropriately tie rewards to longer-term performance and do not undermine the safety and soundness of banking organizations or create undue risks to the financial system. In addition, to foster implementation of improved incentive-based compensation practices, the Board, in cooperation with the OCC and FDIC, initiated in late 2009 a multidisciplinary, horizontal review ("Horizontal Review") of incentive-based compensation practices at 25 large, complex banking organizations, which is still ongoing.[19] One goal of the Horizontal Review is to help improve the Federal Banking Agencies' understanding of the range and evolution of incentive-based compensation practices across institutions and categories of employees within institutions. The second goal is to provide guidance to each institution in implementing the 2010 Federal Banking Agency Guidance. The supervisory experience of the Federal Banking Agencies in this area is also relevant to the incentive-based compensation practices at broker-dealers and investment advisers.

[19] The financial institutions in the Horizontal Review are Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; Capital One Financial Corporation; Citigroup Inc.; Discover Financial Services; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; Northern Trust Corporation; The PNC Financial Services Group, Inc.; State Street Corporation; SunTrust Banks, Inc.; U.S. Bancorp; and Wells Fargo & Company; and the U.S. operations of Barclays plc, BNP Paribas, Credit Suisse Group AG, Deutsche Bank AG, HSBC Holdings plc, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Societe Generale, and UBS AG.

As part of the Horizontal Review, the Board conducted reviews of line of business operations in the areas of trading, mortgage, credit card, and commercial lending operations as well as senior executive incentive-based compensation awards and payouts. The institutions subject to the Horizontal Review have made progress in developing practices that would incorporate the principles of the 2010 Federal Banking Agency Guidance into their risk management systems, including through better recognition of risk in incentive-based compensation decision-making and improved practices to better balance risk and reward. Many of those changes became evident in the actual compensation arrangements of the institutions as the review progressed. In 2011, the Board made public its initial findings from the Horizontal Review, recognizing the steps the institutions had made towards improving their incentive-based compensation practices, but also noting that each institution needed to do more.[20] In early 2012, the Board initiated a second, cross-firm review of 12 additional large banking organizations ("2012 LBO Review"). The Board also monitors incentive-based compensation as part of ongoing supervision. Supervisory oversight focuses most intensively on large banking organizations because they are significant users of incentive-based compensation and because flawed approaches at these organizations are more likely to have adverse effects on the broader financial system. As part of that supervision, the Board also conducts targeted incentive-based compensation exams and considers incentive-based compensation in the course of wider line of business and risk-related reviews.

For the past several years, the Board also has been actively engaged in international compensation, governance, and conduct working groups that have produced a variety of publications aimed at further improving incentive-based compensation practices.[21]

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[20] Board, "Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations" (October 2011) ("2011 FRB White Paper), available at http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf.

[21] See, e.g., FSB Principles; FSB, "FSB Principles for Sound Compensation Practices: Implementation Standards, Basel, Switzerland" (September 2009), available at http://www.fsb.org/wp-content/uploads/r_090925c.pdf?page_moved=1 (together with the FSB Principles, the "FSB Principles and Implementation Standards"); Basel Committee on Banking Supervision, "Report on Range of Methodologies for Risk and Performance Alignment of Remuneration" (May 2011); Basel Committee on Banking Supervision, "Principles for the Effective Supervision of Financial Conglomerates" (September 2012); FSB, "Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards - First, Second, Third, and Fourth Progress Reports" (June 2012, August 2013,

The FDIC reviews incentive-based compensation practices as part of its safety and soundness examinations of state nonmember banks, most of which are smaller community institutions that would not be covered by the proposed rule. FDIC incentive-based compensation reviews are conducted in the context of the 2010 Federal Banking Agency Guidance and Section 39 of the FDIA. Of the 518 bank failures resolved by the FDIC between 2007 and 2015, 65 involved banks with total assets of $1 billion or more that would have been covered by the proposed rule. Of the 65 institutions that failed with total assets of $1 billion or more, 18 institutions or approximately 28 percent, were identified as having some level of issues or concerns related to compensation arrangements, many of which involved incentive-based compensation. Overall, most of the compensation issues related to either excessive compensation or tying financial incentives to metrics such as corporate performance or loan production without adequate consideration of related risks. Also, several cases involved poor governance practices, most commonly, dominant management influencing improper incentives.[22]

The OCC reviews and assesses compensation practices at individual banks as part of its normal supervisory activities. For example, the OCC identifies matters requiring attention (MRAs) relating to compensation practices, including matters relating to governance and risk management and controls for compensation. The OCC's Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches[23] (the "OCC's Heightened Standards") require covered banks to establish and adhere to compensation programs that prohibit incentive-based payment arrangements that encourage inappropriate risks by providing excessive compensation or that

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November 2014, November 2015), available at http://www.fsb.org/publications/?policy_area%5B%5D=24.

[22] The Inspector General of the appropriate federal banking agency must conduct a Material Loss Review ("MLR") when losses to the Deposit Insurance Fund from failure of an insured depository institution exceed certain thresholds. See FDIC MLRs, available at https://www.fdicig.gov/mlr.shtml; Board MLRs available at http://oig.federalreserve.gov/reports/audit-reports.htm; and OCC MLRs, available at https://www.treasury.gov/about/organizational-structure/ig/Pages/audit_reports_index.aspx. See also the Subcommittee Report.

[23] 12 CFR Part 30, Appendix D.

could lead to material financial loss. The OCC includes an assessment of the banks' compensation practices when determining compliance with the OCC's Heightened Standards.

In addition to safety and soundness oversight, FHFA has express statutory authorities and mandates related to compensation paid by its regulated entities. FHFA reviews compensation arrangements before they are implemented at Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Office of Finance of the Federal Home Loan Bank System. By statute, FHFA must prohibit its regulated entities from providing compensation to any executive officer of a regulated entity that is not reasonable and comparable with compensation for employment in other similar businesses (including publicly held financial institutions or major financial services companies) involving similar duties and responsibilities.[24] FHFA also has additional authority over the Enterprises during conservatorship, and has established compensation programs for Enterprise executives.[25]

In early 2014, FHFA issued two final rules related to compensation pursuant to its authority over compensation under the Safety and Soundness Act.[26] The Executive Compensation Rule sets forth requirements and processes with respect to compensation provided to executive officers by the Enterprises, the Federal Home Loan Banks, and the Federal Home Loan Bank System's Office of Finance.[27] Under the rule, those entities may not enter into an incentive plan with an executive officer or pay any incentive compensation to an executive officer without providing advance notice to FHFA.[28] FHFA's Golden Parachute Payments Rule governs golden parachute payments in the case of a regulated entity's insolvency, conservatorship, or troubled condition.[29]

In part because of the work described above, incentive-based compensation practices and the design of incentive-based compensation arrangements at banking organizations supervised by

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[24] 12 U.S.C. 4518(a).

[25] As conservator, FHFA succeeded to all rights, titles, powers and privileges of the Enterprises, and of any shareholder, officer or director of each company with respect to the company and its assets. The Enterprises have been under conservatorship since September 2008.

[26] 12 CFR parts 1230 and 1231, under the authority of the Safety and Soundness Act (12 U.S.C. 4518), as amended by the Housing and Economic Recovery Act of 2008. Congress enacted HERA, including new or amended provisions addressing compensation at FHFA's regulated entities, at least in part in response to the financial crisis that began in 2007.

[27] 12 CFR Part 1230.

[28] 12 CFR 1230.3(d).

[29] 12 CFR Part 1231.

the Federal Banking Agencies have improved significantly in the years since the recent financial crisis. However, the Federal Banking Agencies have continued to evaluate incentive-based compensation practices as a part of their ongoing supervision responsibilities, with a particular focus on the design of incentive-based compensation arrangements for senior executive officers; deferral practices (including compensation at risk through forfeiture and clawback mechanisms); governance and the use of discretion; ex ante risk adjustment; and control function participation in incentive-based compensation design and risk evaluation. The Federal Banking Agencies' supervision has been focused on ensuring robust risk management and governance practices rather than on prescribing levels of pay.

Generally, the supervisory work of the Federal Banking Agencies and FHFA has promoted more risk-sensitive incentive-based compensation practices and effective risk governance. Incentive-based compensation decision-making increasingly leverages underlying risk management frameworks to help ensure better risk identification, monitoring, and escalation of risk issues. Prior to the recent financial crisis, many institutions had no effective risk adjustments to incentive-based compensation at all. Today, the Board has observed that incentive-based compensation arrangements at the largest banking institutions reflect risk adjustments, the largest banking institutions take into consideration adverse outcomes, more pay is deferred, and more of the deferred amount is subject to reduction based on failure to meet assigned performance targets or as a result of adverse outcomes that trigger forfeiture and clawback reviews.[30]

Similarly, prior to the recent financial crisis, institutions rarely involved risk management and control personnel in incentive-based compensation decision-making. Today, control functions frequently play an increased role in the design and operation of incentive-based compensation, and institutions have begun to build out frameworks to help validate the effectiveness of risk adjustment mechanisms. Risk-related performance objectives and "risk reviews" are increasingly common. Prior to the recent financial crisis, boards of directors had begun to consider the relationship between incentive-based compensation and risk, but were focused on incentive-based compensation for senior executives. Today, refined policies and

[30] See generally 2011 FRB White Paper. The 2011 FRB White Paper provides specific examples of how compensation practices at the institutions involved in the Board's Horizontal Review of Incentive Compensation have changed since the recent financial crisis.

procedures promote some consistency and effectiveness across incentive-based compensation arrangements. The role of boards of directors has expanded and the quality of risk information provided to those boards has improved. Finance and audit committees work together with compensation committees with the goal of having incentive-based compensation result in prudent risk-taking.

Notwithstanding the recent progress, incentive-based compensation practices are still in need of improvement, including better targeting of performance measures and risk metrics to specific activities, more consistent application of risk adjustments, and better documentation of the decision-making process. Congress has required the Agencies to jointly prescribe regulations or guidelines that cover not only depository institutions and depository institution holding companies, but also other financial institutions. While the Federal Banking Agencies' supervisory approach based on the 2010 Federal Banking Agency Guidance and the work of FHFA have resulted in improved incentive-based compensation practices, there are even greater benefits possible under rule-based supervision. Using their collective supervisory experiences, the Agencies are proposing a uniform set of enforceable standards applicable to a larger group of institutions supervised by all of the Agencies. The proposed rule would promote better incentive-based compensation practices, while still allowing for some flexibility in the design and operation of incentive-based compensation arrangements among the varied institutions the Agencies supervise, including through the tiered application of the proposed rule's requirements.

C. Overview of the 2011 Proposed Rule and Public Comment

The Agencies proposed a rule in 2011, rather than guidelines, to establish requirements applicable to the incentive-based compensation arrangements of all covered institutions. The 2011 Proposed Rule would have supplemented existing rules, guidance, and ongoing supervisory efforts of the Agencies.

The 2011 Proposed Rule would have prohibited incentive-based compensation arrangements that could encourage inappropriate risks. It would have required compensation practices at regulated financial institutions to be consistent with three key principles—that incentive-based compensation arrangements should appropriately balance risk and financial rewards, be compatible with effective risk management and controls, and be supported by strong corporate governance. The Agencies proposed that financial institutions with $1 billion or more in assets be required to have policies and procedures to ensure compliance with the requirements of the rule, and submit an annual report to their Federal regulator describing the structure of their incentive-based compensation arrangements.

The 2011 Proposed Rule included two additional requirements for “larger financial institutions.”[31] The first would have required these larger financial institutions to defer 50 percent of the incentive-based compensation for executive officers for a period of at least three years. The second would have required the board of directors (or a committee thereof) to identify and approve the incentive-based compensation for those covered persons who individually have the ability to expose the institution to possible losses that are substantial in relation to the institution’s size, capital, or overall risk tolerance, such as traders with large position limits and other individuals who have the authority to place at risk a substantial part of the capital of the covered institution.

The Agencies received more than 10,000 comments on the 2011 Proposed Rule, including from private individuals, community groups, several members of Congress, pension funds, labor federations, academic faculty, covered institutions, financial industry associations, and industry consultants.

The vast majority of the comments were substantively identical form letters of two types. The first type of form letter urged the Agencies to minimize the incentives for short-term risk-taking by executives by requiring at least a five-year deferral period for executive bonuses at big banks, banning executives’ hedging of their pay packages, and requiring specific details from banks on precisely how they ensure that executives will share in the long-term risks created by their decisions. These commenters also asserted that the final rule should apply to the full range of important financial institutions and cover all the key executives at those institutions. The second type of form letter stated that the commenter or the commenter’s family had been affected by the financial crisis that began in 2007, a major cause of which the commenter believed to be faulty pay practices at financial institutions. These commenters suggested various

[31] In the 2011 Proposed Rule, the term “larger covered financial institution” for the Federal Banking Agencies and the SEC meant those covered institutions with total consolidated assets of $50 billion or more. For the NCUA, all credit unions with total consolidated assets of $10 billion or more would have been larger covered institutions. For FHFA, Fannie Mae, Freddie Mac, and all Federal Home Loan Banks with total consolidated assets of $1 billion or more would have been larger covered institutions.

methods of improving these practices, including basing incentive-based compensation on measures of a financial institution's safety and stability, such as the institution's bond price or the spread on credit default swaps.

Comments from community groups, members of Congress, labor federations, and pension funds generally urged the Agencies to strengthen the proposed rule and many cited evidence suggesting that flawed incentive-based compensation practices in the financial industry were a major contributing factor to the recent financial crisis. Their suggestions included: revising the 2011 Proposed Rule's definition of "incentive-based compensation"; defining "excessive compensation"; increasing the length of time for or amount of compensation subject to the mandatory deferral provision; requiring financial institutions to include quantitative data in their annual incentive-based compensation reports; providing for the annual public reporting by the Agencies of information quantifying the overall sensitivity of incentive-based compensation to long-term risks at major financial institutions; prohibiting stock ownership by board members; and prohibiting hedging strategies used by highly-paid executives on their own incentive-based compensation.

The academic faculty commenters submitted analyses of certain compensation issues and recommendations. These recommendations included: adopting a corporate governance measure tied to stock ownership by board members; regulating how deferred compensation is reduced at future payment dates; requiring covered institutions' executives to have "skin in the game" for the entire deferral period; and requiring disclosure of personal hedging transactions rather than prohibiting them.

A number of covered institutions and financial industry associations favored the issuance of guidelines instead of rules to implement section 956. Others expressed varying degrees of support for the 2011 Proposed Rule but also requested numerous clarifications and modifications. Many of these commenters raised questions concerning the 2011 Proposed Rule's scope, suggesting that certain types of institutions be excluded from the coverage of the final rule. Some of these commenters questioned the need for the excessive compensation prohibition or requested that the final rule provide specific standards for determining when compensation is excessive. Many of these commenters also opposed the 2011 Proposed Rule's mandatory deferral provision, and some asserted that the provision was unsupported by empirical evidence and potentially harmful to a covered institution's ability to attract and retain key employees. In addition, many of these commenters asserted that the material risk-taker provision in the 2011 Proposed Rule was unclear or imposed on the boards of directors of covered institutions duties more appropriately undertaken by the institutions' management. Finally, these commenters expressed concerns about the burden and timing of the 2011 Proposed Rule.

D. International Developments

The Agencies considered international developments in developing the 2011 Proposed Rule, mindful that some covered institutions operate in both domestic and international competitive environments.[32] Since the release of the 2011 Proposed Rule, a number of foreign jurisdictions have introduced new compensation regulations that require certain financial institutions to meet certain standards in relation to compensation policies and practices. In June 2013, the European Union adopted the Capital Requirements Directive ("CRD") IV, which sets out requirements for compensation structures, policies, and practices that apply to all banks and investment firms subject to the CRD. [33] The rules require that up to 100 percent of the variable remuneration shall be subject to malus[34] or clawback arrangements, among other requirements.[35] The PRA's and the FCA's Remuneration Code requires covered companies to defer 40 to 60 percent of a covered person's variable remuneration – and recently updated their implementing regulations to extend deferral periods to seven years for senior executives and to five years for

[32] See 76 FR at 21178. See, e.g., FSB Principles and Implementation Standards.
[33] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 (effective January 1, 2014). The remuneration rules in CRD IV were carried over from CRD III with a few additional requirements. CRD III directed the Committee of European Bank Supervisors ("CEBS"), now the European Banking Authority ("EBA"), to develop guidance on how it expected the compensation principles under CRD III to be implemented. See CEBS Guidelines on Remuneration Policies and Practices (December 10, 2010) ("CEBS Guidelines"), available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32010L0076&from=EN.
[34] Malus is defined by the European Union as "an arrangement that permits the institution to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performance." See, PRA expectations regarding the application of malus to variable remuneration - SS2/13 UPDATE, available at: http://www.bankofengland.co.uk/pra/Documents/publications/ss/2015/ss213update.pdf.
[35] CRD IV provides that at least 50 percent of total variable remuneration should consist of equity-linked interests and at least 40 percent of any variable remuneration must be deferred over a period of three to five years. In the case of variable remuneration of a particularly high amount, the minimum amount required to be deferred is increased to 60 percent.

certain other covered persons.[36] The PRA also implemented, in July 2014, a policy requiring firms to set specific criteria for the application of malus and clawback. The PRA's clawback policy requires that variable remuneration be subject to clawback for a period of at least seven years from the date on which it is awarded.[37]

Also in 2013, the EBA finalized the process and criteria for the identification of categories of staff who have a material impact on the institution's risk profile ("Identified Staff").[38] These Identified Staff are subject to provisions related, in particular, to the payment of variable compensation. The standards cover remuneration packages for Identified Staff categories and aim to ensure that appropriate incentives for prudent, long-term oriented risk-taking are provided. The criteria used to determine who is identified are both qualitative (i.e., related to the role and decision-making authority of staff members) and quantitative (i.e., related to the level of total gross remuneration in absolute or in relative terms).

More recently, in December 2015, the EBA released its final Guidelines on Sound Remuneration Policies.[39] The final Guidelines on Sound Remuneration Policies set out the governance process for implementing sound compensation policies across the European Union under CRD IV, as well as the specific criteria for categorizing all compensation components as either fixed or variable pay. The final Guidelines on Sound Remuneration Policies also provide guidance on the application of deferral arrangements and pay-out instruments to ensure that variable pay is aligned with an institution's long-term risks and that any ex-post risk adjustments can be applied as appropriate. These Guidelines will apply as of January 1, 2017, and will

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[36] See UK Remuneration Rules.

[37] See PRA, "PRA PS7/14: Clawback" (July 2014), available at http://www.bankofengland.co.uk/pra/Pages/publications/ps/2014/ps714.aspx.

[38] EBA Regulatory Technical Standards on criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile under Article 94(2) of Directive 2013/36/EU. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 (December 16, 2013), available at https://www.eba.europa.eu/documents/10180/526386/EBA-RTS-2013-11+%28On+identified+staff%29.pdf/c313a671-269b-45be-a748-29e1c772ee0e.

[39] EBA, "Guidelines for Sound Remuneration Policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and Disclosures under Article 450 of Regulation (EU) No 575/2013" (December 21, 2015) ("EBA Remuneration Guidelines"), available at https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b.

replace the Guidelines on Remuneration Policies and Practices that were published by the CEBS in December 2010.

Other regulators, including those in Canada, Australia, and Switzerland, have taken either a guidance-based approach to the supervision and regulation of incentive-based compensation or an approach that combines guidance and regulation that is generally consistent with the FSB Principles and Implementation Standards. In Australia,[40] all deposit-taking institutions and insurers are expected to comply in full with all the requirements in the APRA's Governance standard (which includes remuneration provisions). APRA also supervises according to its Remuneration Prudential Practice Guide (guidance). In Canada,[41] all federally regulated financial institutions (domestic and foreign) are expected to comply with the FSB Principles and Implementation Standards, and the six Domestic Systemically Important Banks and three largest life insurance companies are expected to comply with the FSB's Principles and Implementation Standards. OSFI has also issued a Corporate Governance Guideline that contain compensation provisions.[42] Switzerland's Swiss Financial Markets Supervisory Authority has also published a principles-based rule on remuneration consistent with the FSB Principles and Implementation Standards that applies to major banks and insurance companies.[43]

As compensation practices continue to evolve, the Agencies recognize that international coordination in this area is important to ensure that internationally active financial organizations are subject to consistent requirements. For this reason, the Agencies will continue to work with their domestic and international counterparts to foster sound compensation practices across the financial services industry. Importantly, the proposed rule is consistent with the FSB Principles and Implementation Standards.

E. Overview of the Proposed Rule

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[40] See APRA, "Prudential Standard CPS 510 Governance" (January 2015), available at http://www.apra.gov.au/CrossIndustry/Documents/Final-Prudential-Standard-CPS-510-Governance-%28January-2014%29.pdf; APRA, Prudential Practice Guide PPG 511 – Remuneration (November 30, 2009), available at http://www.apra.gov.au/adi/PrudentialFramework/Pages/adi-prudential-framework.aspx.

[41] See OSFI Corporate Governance Guidelines and OSFI Supervisory Framework.

[42] See OSFI Corporate Governance Guidelines.

[43] See FINMA Remuneration Circular.

The Agencies are re-proposing a rule, rather than proposing guidelines, to establish general requirements applicable to the incentive-based compensation arrangements of all covered institutions. Like the 2011 Proposed Rule, the proposed rule would prohibit incentive-based compensation arrangements at covered institutions that could encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss. However, the proposed rule reflects the Agencies' collective supervisory experiences since they proposed the 2011 Proposed Rule. These supervisory experiences, which are described above, have allowed the Agencies to propose a rule that incorporates practices that financial institutions and foreign regulators have adopted to address the deficiencies in incentive-based compensation practices that helped contribute to the financial crisis that began in 2007. For that reason, the proposed rule differs in some respects from the 2011 Proposed Rule. This section provides a general overview of the proposed rule and highlights areas in which the proposed rule differs from the 2011 Proposed Rule. A more detailed, section-by-section description of the proposed rule and the reasons for the proposed rule's requirements is provided later in this Supplementary Information section.

Scope and Initial Applicability. Similar to the 2011 Proposed Rule, the proposed rule would apply to any covered institution with average total consolidated assets greater than or equal to $1 billion that offers incentive-based compensation to covered persons.

The compliance date of the proposed rule would be no later than the beginning of the first calendar quarter that begins at least 540 days 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.

Definitions. The proposed rule includes a number of new definitions that were not included in the 2011 Proposed Rule. These definitions are described later in the section-by-section analysis in this Supplementary Information section. Notably, the Agencies have added a definition of significant risk-taker, which is intended to include individuals who are not senior executive officers but who are in the position to put a Level 1 or Level 2 covered institution at risk of material financial loss. This definition is explained in more detail below.

Applicability. The proposed rule distinguishes covered institutions by asset size, applying less prescriptive incentive-based compensation program requirements to the smallest covered institutions within the statutory scope and progressively more rigorous requirements to the larger covered institutions. Although the 2011 Proposed Rule contained specific requirements for covered financial institutions with at least $50 billion in total consolidated assets, the proposed rule creates an additional category of institutions with at least $250 billion in average total consolidated assets. These larger institutions are subject to the most rigorous requirements under the proposed rule.

The proposed rule identifies three categories of covered institutions based on average total consolidated assets:[44]

- Level 1 (greater than or equal to $250 billion);
- Level 2 (greater than or equal to $50 billion and less than $250 billion); and
- Level 3 (greater than or equal to $1 billion and less than $50 billion).[45]

Upon an increase in average total consolidated assets, a covered institution would be required to comply with any newly applicable requirements under the proposed rule no later than the first day of the first calendar quarter that begins at least 540 days after the date on which the covered institution becomes a Level 1, Level 2, or Level 3 covered institution. The proposed rule would grandfather any incentive-based compensation plan with a performance period that begins before such date. Upon a decrease in total consolidated assets, a covered institution would remain subject to the provisions of the proposed rule that applied to it before the decrease until total consolidated assets fell below $250 billion, $50 billion, or $1 billion, as applicable, for four consecutive regulatory reports (e.g., Call Reports).

A covered institution under the Board's, the OCC's, or the FDIC's proposed rule that is a subsidiary of another covered institution under the Board's, the OCC's, or the FDIC's proposed

[44] 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. A detailed explanation of consolidation under the proposed rule is included under the heading "Definitions pertaining to covered institutions" below in this Supplementary Information section.
[45] As explained later in this Supplementary Information section, the proposed rule includes a reservation of authority that would allow the appropriate Federal regulator of a Level 3 covered institution with average total consolidated assets greater than or equal to $10 billion and less than $50 billion to require the Level 3 covered institution to comply with some or all of the provisions of sections __.5 and __.7 through __.11 of the proposed rule if the agency determines that the complexity of operations or compensation practices of the Level 3 covered institution are consistent with those of a Level 1 or Level 2 covered institution.

rule, respectively, may meet any requirement of the Board's, OCC's, or the FDIC's proposed rule if the parent covered institution complies with that requirement in such a way that causes the relevant portion of the incentive-based compensation program of the subsidiary covered institution to comply with that requirement.

Requirements and Prohibitions Applicable to All Covered Institutions. Similar to the 2011 Proposed Rule, 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.

Also consistent with the 2011 Proposed Rule, 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 provided to a covered person;
- 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, 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.

The proposed rule is also similar to the 2011 Proposed Rule in that it 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.

However, unlike the 2011 Proposed Rule, the proposed rule specifically provides that an incentive-based compensation arrangement would not be considered to appropriately balance risk and reward unless it:

- Includes financial and non-financial measures of performance;
- Is designed to allow non-financial measures of performance to override financial measures of performance, when appropriate; and
- Is subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.

The proposed rule also contains requirements for the board of directors of a covered institution that are similar to requirements included in the 2011 Proposed Rule. Under the proposed rule, the board of directors of each covered institution (or a committee thereof) would be required to:

- Conduct oversight of the covered institution's incentive-based compensation program;
- Approve incentive-based compensation arrangements for senior executive officers, including amounts of awards and, at the time of vesting, payouts under such arrangements; and
- Approve material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

The 2011 Proposed Rule contained an annual reporting requirement, which has been replaced by a recordkeeping requirement in the proposed rule. 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.

Disclosure and Recordkeeping Requirements for Level 1 and Level 2 Covered Institutions. The proposed rule includes more detailed disclosure and recordkeeping requirements for larger covered institutions than the 2011 Proposed Rule. The proposed rule would require all Level 1 and Level 2 covered institutions to create annually and maintain for at least seven years records that document: (1) the covered institution's senior executive officers and significant risk-takers, listed by legal entity, job function, organizational hierarchy, and line of business; (2) the incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on the percentage of incentive-based compensation deferred and form of award; (3) any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and (4) any material changes to the covered institution's incentive-based compensation arrangements and policies. Level 1 and Level 2 covered institutions would be required to create and maintain records in a manner that would allow for an independent audit of incentive-based compensation arrangements, policies, and procedures, and to provide the records described above in such form and frequency as the appropriate Federal regulator requests.

Deferral, Forfeiture and Downward Adjustment, and Clawback Requirements for Level 1 and Level 2 Covered Institutions. The proposed rule would require incentive-based compensation arrangements that appropriately balance risk and reward. For Level 1 and Level 2 covered institutions, the proposed rule would require that incentive-based compensation arrangements for certain covered persons include deferral of payments, risk of downward adjustment and forfeiture, and clawback to appropriately balance risk and reward. The 2011 Proposed Rule required deferral for three years of 50 percent of annual incentive-based compensation for executive officers of covered financial institutions with $50 billion or more in total consolidated assets. The proposed rule would apply deferral requirements to significant risk-takers as well as senior executive officers, and, as described below, would require 40, 50, or

60 percent deferral depending on the size of the covered institution and whether the covered person receiving the incentive-based compensation is a senior executive officer or a significant risk-taker. Unlike the 2011 Proposed Rule, the proposed rule would explicitly require a shorter deferral period for incentive-based compensation awarded under a long-term incentive plan. The proposed rule also provides more detailed requirements and prohibitions than the 2011 Proposed Rule with respect to the measurement, composition, and acceleration of deferred incentive-based compensation; the manner in which deferred incentive-based compensation can vest; increases to the amount of deferred incentive-based compensation; and the amount of deferred incentive-based compensation that can be in the form of options.

Deferral. Under the proposed rule, the mandatory deferral requirements for Level 1 and Level 2 covered institutions for incentive-based compensation awarded each performance period would be as follows:

- A Level 1 covered institution would be required to defer at least 60 percent of a senior executive officer's "qualifying incentive-based compensation" (as defined in the proposed rule) and 50 percent of a significant risk-taker's qualifying incentive-based compensation for at least four years. A Level 1 covered institution also would be required to defer for at least two years after the end of the related performance period at least 60 percent of a senior executive officer's incentive-based compensation awarded under a "long-term incentive plan" (as defined in the proposed rule) and 50 percent of a significant risk-taker's incentive-based compensation awarded under a long-term incentive plan. Deferred compensation may vest no faster than on a pro rata annual basis, and, for covered institutions that issue equity or are subsidiaries of covered institutions that issue equity, the deferred amount would be required to consist of substantial amounts of both deferred cash and equity-like instruments throughout the deferral period. Additionally, if a senior executive officer or significant risk-taker receives incentive-based compensation in the form of options for a performance period, the amount of such options used to meet the minimum required deferred compensation may not exceed 15 percent of the amount of total incentive-based compensation awarded for that performance period.

- A Level 2 covered institution would be required to defer 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 for at least three years. A Level 2 covered institution also would be required to defer for at least one year after the end of the related performance period at least 50 percent of a senior executive officer's incentive-based compensation awarded under a long-term incentive plan and 40 percent of a significant risk-taker's incentive-based compensation awarded under a long-term incentive plan. Deferred compensation may vest no faster than on a pro rata annual basis, and, for covered institutions that issue equity or are subsidiaries of covered institutions that issue equity, the deferred amount would be required to consist of substantial amounts of both deferred cash and equity-like instruments throughout the deferral period. Additionally, if a senior executive officer or significant risk-taker receives incentive-based compensation in the form of options for a performance period, the amount of such options used to meet the minimum required deferred compensation may not exceed 15 percent of the amount of total incentive-based compensation awarded for that performance period.

The proposed rule would also prohibit Level 1 and Level 2 covered institutions 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.

Forfeiture and Downward Adjustment. Compared to the 2011 Proposed Rule, the proposed rule provides more detailed requirements for Level 1 and Level 2 covered institutions to reduce (1) incentive-based compensation that has not yet been awarded to a senior executive officer or significant risk-taker, and (2) deferred incentive-based compensation of a 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 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. The proposed rule would require a Level 1 or Level 2 covered institution to make subject to forfeiture all unvested deferred incentive-based compensation of any senior executive officer or significant risk-taker, including unvested deferred amounts awarded under long-term incentive plans. This forfeiture requirement would apply to all unvested, deferred incentive-based compensation for those individuals, regardless of whether the deferral was required by the proposed rule. Similarly, a Level 1 or Level 2 covered institution would also be required to make subject to downward adjustment all incentive-based compensation amounts not yet awarded to any senior executive officer or significant risk-taker for the current performance period, including amounts payable under long-term incentive plans. A Level 1 or Level 2 covered institution would be required to consider forfeiture or downward adjustment of incentive-based compensation if any of the following adverse outcomes occur:

- Poor financial performance attributable to a significant deviation from the covered institution's risk parameters set forth in the covered institution's policies and procedures;
- Inappropriate risk-taking, regardless of the impact on financial performance;
- Material risk management or control failures;
- Non-compliance with statutory, regulatory, or supervisory standards resulting in enforcement or legal action brought by a federal or state regulator or agency, or a requirement that the covered institution report 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. In addition to deferral, downward adjustment, and forfeiture, the proposed rule would require a Level 1 or Level 2 covered institution to include clawback provisions in the incentive-based compensation arrangements for senior executive officers and significant risk-takers. 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 clawback provisions that, at a minimum, allow the covered institution to 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 misconduct 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. The 2011 Proposed Rule did not include a clawback requirement.

Additional Prohibitions. The proposed rule contains a number of additional prohibitions for Level 1 and Level 2 covered institutions that were not included in the 2011 Proposed Rule. These prohibitions would apply to:

- Hedging;
- Maximum incentive-based compensation opportunity (also referred to as leverage);
- Relative performance measures; and
- Volume-driven incentive-based compensation.

Risk Management and Controls. The proposed rule's risk management and controls requirements for large covered institutions are generally more extensive than the requirements contained in the 2011 Proposed Rule. The proposed rule would require all Level 1 and Level 2 covered institutions to have a risk management framework for their incentive-based compensation programs that is independent of any lines of business; includes an independent compliance program that provides for internal controls, testing, monitoring, and training with written policies and procedures; and is commensurate with the size and complexity of the covered institution's operations. In addition, the proposed rule would require Level 1 and Level 2 covered institutions to:

- Provide individuals in control functions with appropriate authority to influence the risk-taking of the business areas they monitor and ensure covered persons engaged in control functions are compensated independently of the performance of the business areas they monitor; and
- Provide for independent monitoring of: (1) incentive-based compensation plans to identify whether the plans appropriately balance risk and reward; (2) events related to forfeiture and downward adjustment and decisions of forfeiture and downward adjustment reviews to determine consistency with the proposed rule; and (3) compliance of the incentive-based compensation program with the covered institution's policies and procedures.

Governance. Unlike the 2011 Proposed Rule, the proposed rule would require each Level 1 or Level 2 covered institution to establish a compensation committee composed solely of directors who are not senior executive officers to assist the board of directors in carrying out its responsibilities under the proposed rule. The compensation committee would be required to obtain input from the covered institution's risk and audit committees, or groups performing similar functions, and risk management function on the effectiveness of risk measures and adjustments used to balance incentive-based compensation arrangements. Additionally, management would be required to submit to the compensation committee on an annual or more frequent basis a written assessment of the effectiveness of the covered institution's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the risk profile of the covered institution. The compensation committee would also be required to obtain an independent written assessment from the internal audit or risk management function of the effectiveness of the covered institution's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the risk profile of the covered institution.

Policies and Procedures. The proposed rule would require all Level 1 and Level 2 covered institutions to have policies and procedures that, among other requirements:

- Are consistent with the requirements and prohibitions of the proposed rule;
- Specify the substantive and procedural criteria for forfeiture and clawback;
- Document final forfeiture, downward adjustment, and clawback decisions;
- Specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person;
- Identify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions, including when discretion is authorized;
- Describe how discretion is exercised to achieve balance;
- Require that the covered institution maintain documentation of its processes for the establishment, implementation, modification, and monitoring of incentive-based compensation arrangements;
- Describe how incentive-based compensation arrangements will be monitored;
- Specify the substantive and procedural requirements of the independent compliance program; and
- Ensure appropriate roles for risk management, risk oversight, and other control personnel in the covered institution's processes for designing incentive-based

compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback, and vesting and assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.

These policies and procedures requirements for Level 1 and Level 2 covered institutions are generally more detailed than the requirements in the 2011 Proposed Rule.

Indirect Actions. The proposed rule would prohibit covered institutions from doing indirectly, or through or by any other person, anything that would be unlawful for the covered institution to do directly under the proposed rule. This prohibition is similar to the evasion provision contained in the 2011 Proposed Rule.

Enforcement. For five of the Agencies, the proposed rule would be enforced under section 505 of the Gramm-Leach-Bliley Act, as specified in section 956. For FHFA, the proposed rule would be enforced under subtitle C of the Safety and Soundness Act.

Conservatorship or Receivership for Certain Covered Institutions. FHFA's and NCUA's proposed rules contain provisions that would apply to covered institutions that are managed by a government agency or a government-appointed agent, or that are in conservatorship or receivership or are limited-life regulated entities under the Safety and Soundness Act or the Federal Credit Union Act.[46]

A detailed description of the proposed rule and requests for comments are set forth below.

[46] The FDIC's proposed rule would not apply to institutions for which the FDIC is appointed receiver under the FDIA or Title II of the Dodd-Frank Act, as appropriate, as those statutes govern such cases.

II. SECTION-BY-SECTION DESCRIPTION OF THE PROPOSED RULE

§ ___.1 Authority, Scope and Initial Applicability.

Section ___.1 provides that the proposed rule is issued pursuant to section 956. The Agencies also have listed applicable additional rulemaking authority in their respective authority citations.

The OCC is issuing the proposed rule under its general rulemaking authority, 12 U.S.C. 93a and the Home Owners' Loan Act, 12 U.S.C. 1461 et seq., its safety and soundness authority under 12 U.S.C. 1818, and its authority to regulate compensation under 12 U.S.C. 1831p-1.

The Board is issuing the proposed rule under its safety and soundness authority under section 5136 of the Revised Statutes (12 U.S.C. 24), the Federal Reserve Act (12 U.S.C. 321-338a), the FDIA (12 U.S.C. 1818), the Bank Holding Company Act (12 U.S.C. 1844(b)), the Home Owners' Loan Act (12 U.S.C. 1462a and 1467a), and the International Banking Act (12 U.S.C. 3108).

The FDIC is issuing the proposed rule under its general rulemaking authority, 12 U.S.C. 1819 Tenth, as well as its general safety and soundness authority under 12 U.S.C. 1818 and authority to regulate compensation under 12 U.S.C. 1831p-1.

FHFA is issuing the proposed rule pursuant to its authority under the Safety and Soundness Act (particularly 12 U.S.C. 4511(b), 4513, 4514, 4518, 4526, and ch. 46 subch. III.).

NCUA is issuing the proposed rule under its general rulemaking and safety and soundness authorities in the Federal Credit Union Act, 12 U.S.C. 1751 et.seq.

The SEC is issuing the proposed rule pursuant to its rulemaking authority under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 (15 U.S.C. 78q, 78w, 80b–4, and 80b–11).

The approach taken in the proposed rule is within the authority granted by section 956. The proposed rule would prohibit types and features of incentive-based compensation arrangements that encourage inappropriate risks. As explained more fully below, incentive-based compensation arrangements that result in payments that are unreasonable or disproportionate to the value of services performed could encourage inappropriate risks by providing excessive compensation, fees, and benefits. Further, incentive-based compensation arrangements that do not appropriately balance risk and reward, that are not compatible with effective risk management and controls, or that are not supported by effective governance are the types of incentive-based compensation arrangements that could encourage inappropriate risks that could lead to material financial loss to covered institutions. Because these types of incentive-based compensation arrangements encourage inappropriate risks, they would be prohibited under the proposed rule.

The Federal Banking Agencies have found that any incentive-based compensation arrangement at a covered institution will encourage inappropriate risks if it does not sufficiently expose the risk-takers to the consequences of their risk decisions over time, and that in order to do this, it is necessary that meaningful portions of incentive-based compensation be deferred and placed at risk of reduction or recovery. The proposed rule reflects the minimums that are required to be effective for that purpose, as well as minimum standards of robust governance, and the disclosures that the statute requires. The Agencies' position in this respect is informed by the country's experience in the recent financial crisis, as well as by their experience supervising their respective institutions and their observation of the experience and judgments of regulators in other countries.

Consistent with section 956, section ___.1 provides that the proposed rule would apply to a covered institution with average total consolidated assets greater than or equal to $1 billion that offers incentive-based compensation arrangements to covered persons.

The Agencies propose the compliance date of the proposed rule to be the beginning of the first calendar quarter that begins at least 540 days after the final rule is published in the Federal Register. Any incentive-based compensation plan with a performance period that begins before such date would not be required to comply with the requirements of the proposed rule. Whether a covered institution is a Level 1, Level 2, or Level 3 covered institution[47] on the compliance date would be determined based on average total consolidated assets as of the beginning of the first calendar quarter that begins after a final rule is published in the Federal Register. For

[47] As discussed below, the proposed rule includes baseline requirements for all covered institutions and additional requirements for Level 1 and Level 2 covered institutions, which are larger covered institutions.

example, if the final rule is published in the Federal Register on November 1, 2016, then the compliance date would be July 1, 2018. In that case, any incentive-based compensation plan with a performance period that began before July 1, 2018 would not be required to comply with the rule. Whether a covered institution is a Level 1, Level 2, or Level 3 covered institution on July 1, 2018 would be determined based on average total consolidated assets as of the beginning of the first quarter of 2017.

The Agencies recognize that most incentive-based compensation plans are implemented at the beginning of the fiscal or calendar year. Depending on the date of publication of a final rule, the proposed compliance date would provide at least 18 months, and in most cases more than two years, for covered institutions to develop and approve new incentive-based compensation plans and 18 months for covered institutions to develop and implement the supporting policies, procedures, risk management framework, and governance that would be required under the proposed rule.

1.1. The Agencies invite comment on whether this timing would be sufficient to allow covered institutions to implement any changes necessary for compliance with the proposed rule, particularly the development and implementation of policies and procedures. Is the length of time too long or too short and why? What specific changes would be required to bring existing policies and procedures into compliance with the rule? What constraints exist on the ability of covered institutions to meet the proposed deadline?

1.2. The Agencies invite comment on whether the compliance date should instead be the beginning of the first performance period that starts at least 365 days after the final rule is published in the Federal Register in order to have the proposed rule's policies, procedures, risk management, and governance requirements begin when the requirements applicable to incentive-compensation plans and arrangements begin. Why or why not?

Section ___.1 also specifies that the proposed rule is not intended to limit the authority of any Agency under other provisions of applicable law and regulations. For example, the proposed rule would not affect the Federal Banking Agencies' authority under section 39 of the FDIA and the Federal Banking Agency Safety and Soundness Guidelines. The Board's Enhanced Prudential Standards under 12 CFR Part 252 (Regulation YY) would not be affected. The OCC's Heightened Standards also would continue to be in effect. The NCUA's authority under

12 U.S.C. 1761a, 12 CFR 701.2, part 701 App. A, Art. VII. section 8, 701.21(c)(8)(i), 701.23(g)(1), 701.33, 702.203, 702.204, 703.17, 704.19, 704.20, part 708a, 712.8, 721.7, and part 750, and the NCUA Examiners Guide, Chapter 7,[48] would not be affected. Neither would the proposed rule affect the applicability of FHFA's executive compensation rule, under section 1318 of the Safety and Soundness Act (12 U.S.C. 4518), 12 CFR part 1230.

The Agencies acknowledge that some individuals who would be considered covered persons, senior executive officers, or significant risk-takers under the proposed rule are subject to other Federal compensation-related requirements. Further, some covered institutions may be subject to SEC rules regarding the disclosure of executive compensation, [49] and mortgage loan originators are subject to the Consumer Financial Protection Bureau's restrictions on compensation. This rule is not intended to affect the application of these other Federal compensation-related requirements.

§ ___.2 Definitions.

Section ___.2 defines the various terms used in the proposed rule. Where the proposed rule uses a term defined in section 956, the proposed rule generally adopts the definition included in section 956.[50]

Definitions pertaining to covered institutions.

Section 956(e)(2) of the Dodd-Frank Act defines the term "covered financial institution" to mean a depository institution; a depository institution holding company; a registered broker-dealer; a credit union; an investment adviser; the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") (together, the "Enterprises"); and any other financial institution that the Agencies determine, jointly, by rule, should be treated as a covered financial institution for purposes of section 956. Section 956(f) provides that the requirements of section 956 do not apply to covered financial institutions with assets of less than $1 billion.

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[48] The NCUA Examiners Guide, Chapter 7, available at https://www.ncua.gov/Legal/GuidesEtc/ExaminerGuide/Chapter07.pdf.

[49] See Item 402 of Regulation S-K. 17 CFR 229.402.

[50] The definitions in the proposed rule would be for purposes of administering section 956 and would not affect the interpretation or construction of the same or similar terms for purposes of any other statute or regulation administered by the Agencies.

The Agencies propose to jointly, by rule, designate additional financial institutions as covered institutions. The Agencies propose to include the Federal Home Loan Banks as covered institutions because they pose risks similar to those of some institutions covered under the proposed rule and should be subject to the same regulatory regime. The Agencies also propose to include as covered institutions the state-licensed uninsured branches and agencies of a foreign bank, organizations operating under section 25 or 25A of the Federal Reserve Act (i.e., Edge and Agreement Corporations), as well as the other U.S. operations of foreign banking organizations that are treated as bank holding companies pursuant to section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106). Applying the same requirements to these institutions would be consistent with other regulatory requirements that are applicable to foreign banking organizations operating in the United States and would not distort competition for human resources between U.S. banking organizations and foreign banking organizations operating in the United States. These offices and operations currently are referenced in the Federal Banking Agency Guidance and are subject to section 8 of the FDIA (12 U.S.C. 1818), which prohibits institutions from engaging in unsafe or unsound practices to the same extent as insured depository institutions and bank holding companies.[51]

In addition, the Agencies propose to jointly, by rule, designate state-chartered non-depository trust companies that are members of the Federal Reserve System as covered institutions. The definition of "covered financial institution" under section 956 of the Dodd-Frank Act includes a depository institution as such term is defined in section 3 of the FDIA (12 U.S.C. 1813); that term includes all national banks and any state banks, including trust companies, that are engaged in the business of receiving deposits other than trust funds. As a consequence of these definitions, all national banks, including national banks that are non-depository trust companies, are "depository institutions" within the meaning of section 956, but non-FDIC insured state non-depository trust companies that are members of the Federal Reserve System are not. In order to achieve equal treatment across similar entities with different charters, the Agencies propose to include state-chartered non-depository member trust companies as covered institutions. These institutions would be "regulated institutions" under the definition of "state member bank" in the Board's rule.

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[51] <u>See</u> 12 U.S.C. 1813(c)(3) and 1818(b)(4).

Each Agency's proposed rule contains a definition of the term "covered institution" that describes the covered financial institutions the Agency regulates.

The Agencies have tailored the requirements of the proposed rule to the size and complexity of covered institutions, and are proposing to designate covered institutions as Level 1, Level 2, or Level 3 covered institutions to effectuate this tailoring. The Agencies have observed through their supervisory experience that large financial institutions typically have complex business activities in multiple lines of business, distinct subsidiaries, and regulatory jurisdictions, and frequently operate and manage their businesses in ways that cross those lines of business, subsidiaries, and jurisdictions. Level 3 covered institutions would generally be subject to only the basic set of prohibitions and disclosure requirements. The proposed rule would apply additional prohibitions and requirements to incentive-based compensation arrangements at Level 1 and Level 2 covered institutions, as discussed below. Whether a covered institution that is a subsidiary of a depository institution holding company is a Level 1, Level 2, or Level 3 covered institution would be based on the average total consolidated assets of the top-tier depository institution holding company. Whether that subsidiary has at least $1 billion will be based on the subsidiary's average total consolidated assets.

The Agency definitions of covered institution, Level 1, Level 2, and Level 3 covered institution, and related terms are summarized below.

<u>Covered Institution and Regulated Institution.</u> Each Agency has set forth text for its Agency-specific definition of the term "covered institution" that specifies the entities to which that Agency's rule applies.[52] Under the proposed rule, a "covered institution" would include all of the following:

- In the case of the OCC:

[52] The Agency-specific definitions are intended to be applied only for purposes of administering a final rule under section 956.

- A national bank, Federal savings association, or Federal branch or agency of a foreign bank[53] with average total consolidated assets greater than or equal to $1 billion; and
- A subsidiary of a national bank, Federal savings association, or Federal branch or agency of a foreign bank, if the subsidiary (A) is not a broker, dealer, person providing insurance, investment company, or investment adviser; and (B) has average total consolidated assets greater than or equal to $1 billion.

- In the case of the Board, the proposed definition of the term "covered institution" is a "regulated institution" with average total consolidated assets greater than or equal to $1 billion, and the Board's definition of the term "regulated institution" includes:
  - A state member bank, as defined in 12 CFR 208.2(g);
  - A bank holding company, as defined in 12 CFR 225.2(c), that is not a foreign banking organization, as defined in 12 CFR 211.21(o), and a subsidiary of such a bank holding company that is not a depository institution, broker-dealer or investment adviser;
  - A savings and loan holding company, as defined in 12 CFR 238.2(m), and a subsidiary of a savings and loan holding company that is not a depository institution, broker-dealer or investment adviser;
  - An organization operating under section 25 or 25A of the Federal Reserve Act (Edge and Agreement Corporation);
  - A state-licensed uninsured branch or agency of a foreign bank, as defined in section 3 of the FDIA (12 U.S.C. 1813); and
  - The U.S. operations of a foreign banking organization, as defined in 12 CFR 211.21(o), and a U.S. subsidiary of such foreign banking organization that is not a depository institution, broker-dealer, or investment adviser.
- In the case of the FDIC, "covered institution" means a:
  - State nonmember bank, state savings association, and a state insured branch of a foreign bank, as such terms are defined in section 3 of the FDIA, 12 U.S.C. 1813, with average total consolidated assets greater than or equal to $1 billion; and

[53] The term "Federal branch or agency of a foreign bank" refers to both insured and uninsured Federal branches and agencies of foreign banks.

- A subsidiary of a state nonmember bank, state savings association, or a state insured branch of a foreign bank, as such terms are defined in section 3 of the FDIA, 12 U.S.C. 1813, that: (i) Is not a broker, dealer, person providing insurance, investment company, or investment adviser; and (ii) Has average total consolidated assets greater than or equal to $1 billion.

- In the case of the NCUA, a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act, meaning an insured credit union as defined under 12 U.S.C. 1752(7) or credit union eligible to make application to become an insured credit union under 12 U.S.C. 1781. Instead of the term "covered financial institution," the NCUA uses the term "credit union" throughout its proposed rule, as credit unions are the only type of covered institution NCUA regulates. The scope section of the rule defines the credit unions that will be subject to this rule–that is, credit unions with $1 billion or more in total consolidated assets.
- In the case of the SEC, a broker or dealer registered under section 15 of the Securities Exchange Act of 1934, 15 U.S.C. 78o; and an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-2(a)(11).[54] The proposed rule would not apply to persons excluded from the definition of investment adviser contained in section 202(a)(11) of the Investment Advisers Act nor would it apply to such other persons not within the intent of section 202(a)(11) of the Investment Advisers Act, as the SEC may designate by rules and regulations or order. Section 956 does not contain exceptions or exemptions for investment advisers based on registration.[55]

[54] By its terms, the definition of "covered financial institution" in section 956 includes any institution that meets the definition of "investment adviser" under the Investment Advisers Act of 1940 ("Investment Advisers Act"), regardless of whether the institution is registered as an investment adviser under that Act. Banks and bank holding companies are generally excluded from the definition of "investment adviser" under section 202(a)(11) of the Investment Advisers Act, although they would still be "covered institutions" under the relevant Agency's proposed rule.

[55] Commenters to the 2011 Proposed Rule requested clarification with respect to those entities that are excluded from the definition of "investment adviser" under the Investment Advisers Act and those that are exempt from registration as an investment adviser under the Investment Advisers Act. Section 956 expressly includes any institution that meets the definition of investment adviser regardless of whether the institution is registered under the Investment Advisers Act. See supra note 54. Thus, the proposed rule would apply to institutions that meet the definition of investment adviser under section 202(a)(11) of the Investment Advisers Act and would not exempt any such institutions that may be prohibited or exempted from registering with the SEC under the Investment Advisers Act.

- In the case of FHFA, the proposed definition of the term "covered institution" is a "regulated institution" with average total consolidated assets greater than or equal to $1 billion, and FHFA's definition of the term "regulated institution" means an Enterprise, as defined in 12 U.S.C. 4502(10), and a Federal Home Loan Bank.

<u>Level 1, Level 2, and Level 3 covered institutions</u>. The Agencies have tailored the requirements of the proposed rule to the size and complexity of covered institutions. All covered institutions would be subject to a basic set of prohibitions and disclosure requirements, as described in section __.4 of the proposed rule.

The Agencies are proposing to group covered institutions into three levels. The first level, Level 1 covered institutions, would generally be covered institutions with average total consolidated assets of greater than $250 billion and subsidiaries of such institutions that are covered institutions. The next level, Level 2 covered institutions, would generally be covered institutions with average total consolidated assets between $50 billion and $250 billion and subsidiaries of such institutions that are covered institutions. The smallest covered institutions, those with average total consolidated assets between $1 and $50 billion, would be Level 3 covered institutions and generally would be subject to only the basic set of prohibitions and requirements.[56]

The proposed rule would apply additional prohibitions and requirements to incentive-based compensation arrangements at Level 1 and Level 2 covered institutions, as described in section __.5 and sections __.7 through __.11 of the proposed rule and further discussed below. The specific requirements of the proposed rule that would apply to Level 1 and Level 2 covered institutions are the same, with the exception of the deferral amounts and deferral periods described in section ___.7(a)(1) and section ___.7(a)(2).

Consolidation.

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[56] As discussed later in this Supplemental Information section, under section ___.6 of the proposed rule, an Agency would be able to require a covered institution with average total consolidated assets greater than or equal to $10 billion and less than $50 billion to comply with some or all of the provisions of section ___.5 and sections ___.7 through___.11, if the Agency determines that the activities, complexity of operations, risk profile, or compensation practices of the covered institution are consistent with those of a Level 1 or Level 2 covered institution.

Generally, the Agencies also propose that covered institutions that are subsidiaries of other covered institutions would be subject to the same requirements, and defined to be the same level, as the parent covered institution,[57] even if the subsidiary covered institution is smaller than the parent covered institution.[58] This approach of assessing risks at the level of the holding company for a consolidated organization recognizes that financial stress or the improper management of risk in one part of an organization has the potential to spread rapidly to other parts of the organization. Large depository institution holding companies increasingly operate and manage their businesses in such a way that risks affect different subsidiaries within the consolidated organization and are managed on a consolidated basis. For example, decisions about business lines including management and resource allocation may be made by executives and employees in different subsidiaries. Integrating products and operations may offer significant efficiencies but can also result in financial stress or the improper management of risk in one part of a consolidated organization and has the potential to spread risk rapidly to other parts of the consolidated organization. Even when risk is assessed at the level of the holding company, risk will also be assessed at individual institutions within that consolidated organization. For example, a bank subsidiary of a large, complex bank holding company might have a different risk profile than the bank holding company. In that situation, a risk assessment would have different results when conducted at the level of the bank and at the level of the bank holding company.

Moreover, in the experience of the Federal Banking Agencies, incentive-based compensation programs generally are designed at the holding company level and are applied

[57] Commenters on the 2011 Proposed Rule questioned how the requirements would apply in the context of consolidated organizations where a parent holding company structure may include one or more subsidiary banks, broker-dealers, or investment advisers each with total consolidated assets either above or below, or somewhere in between, the relevant thresholds. They also expressed concern that the 2011 Proposed Rule could lead to "regulatory overlap" where the parent holding company and individual subsidiaries are regulated by different agencies.

[58] For the U.S. operations of a foreign banking organization, level would be determined by the total consolidated U.S. assets of the foreign banking organization, including the assets of any U.S branches or agencies of the foreign banking organization, any U.S. subsidiaries of the foreign banking organization, and any U.S. operations held pursuant to section 2(h)(2) of the Bank Holding Company Act. In contrast, the level of an OCC-regulated Federal branch or agency of a foreign bank would be determined with reference to the assets of the Federal branch or agency. This treatment is consistent with the determination of the level of a national bank or Federal savings association that is not a subsidiary of a holding company and the OCC's approach to regulation of Federal branches and agencies.

throughout the consolidated organization. Many holding companies establish incentive-based compensation programs in this manner because it can help maintain effective risk management and controls for the entire consolidated organization. More broadly, the expectations and incentives established by the highest levels of corporate leadership set the tone for the entire organization and are important factors of whether an organization is capable of maintaining fully effective risk management and internal control processes. The Board has observed that some large, complex depository institution holding companies have evolved toward comprehensive, consolidated risk management to measure and assess the range of their exposures and the way these exposures interrelate, including in the context of incentive-based compensation programs. In supervising the activities of depository institution holding companies, the Board has adopted and continues to follow the principle that depository institution holding companies should serve as a source of financial and managerial strength for their subsidiary depository institutions.[59]

The proposed rule is designed to reinforce the ability of institutions to establish and maintain effective risk management and controls for the entire consolidated organization with respect to the organization's incentive-based compensation program. Moreover, the structure of the proposed rule is also consistent with the reality that within many large depository institution holding companies, covered persons may be employed by one legal entity but may do work for one or more of that entity's affiliates. For example, an employee of a national bank might also perform certain responsibilities on behalf of an affiliated broker-dealer. Applying the same requirements to all subsidiary covered institutions may reduce the possibility of evasion of the more specific standards applicable to certain individuals at Level 1 or Level 2 covered institutions. Finally, this approach may enable holding company structures to more effectively manage human resources, because applying the same requirements to all subsidiary covered institutions would treat similarly the incentive-based compensation arrangements for similar positions at different subsidiaries within a holding company structure.[60]

[59] See 12 U.S.C. 1831o-1; 12 CFR 225.4(a)(1).
[60] For example, requirements that apply to certain job functions in one part of a consolidated organization but not to the same job function in another operating unit of the same holding company structure could create uneven treatment across the legal entities.

The proposed rule would also be consistent with the requirements of overseas regulators who have examined the role that incentive-based compensation plays in institutions. After examining the risks posed by certain incentive-based compensation programs, many foreign regulators are now requiring that the rules governing incentive-based compensation be applied at the group, parent, and subsidiary operating levels (including those in offshore financial centers).[61]

The Agencies are cognizant that the approach being proposed may have some disadvantages for smaller subsidiaries within a larger depository institution holding company structure by applying the more specific provisions of the proposed rule to these smaller institutions that would not otherwise apply to them but for being a subsidiary of a depository institution holding company. As further discussed below, in an effort to reduce burden, the Board's proposed rule would permit institutions that are subsidiaries of depository institution holding companies and that are subject to the Board's proposed rule to meet the requirements of the proposed rule if the parent covered institution complies with the requirements in such a way that causes the relevant portion of the incentive-based compensation program of the subsidiary covered institution to comply with the requirements.[62]

Similarly, the OCC's proposed rule would allow a covered institution subject to the OCC's proposed rule that is a subsidiary of another covered institution subject to the OCC's proposed rule to meet a requirement of the OCC's proposed rule if the parent covered institution complies with that requirement in a way that causes the relevant portion of the incentive-based compensation program of the subsidiary covered institution to comply with that requirement.

The FDIC's proposed rule would similarly allow a covered institution subject to the FDIC's proposed rule that is a subsidiary of another covered institution subject to the FDIC's proposed rule to meet a requirement of the FDIC's proposed rule if the parent covered institution complies with that requirement in a way that causes the relevant portion of the incentive-based compensation program of the subsidiary covered institution to comply with that requirement.

The SEC is not proposing to require a covered institution under its proposed rule that is a subsidiary of another covered institution under that proposed rule to be subject to the same

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[61] See, e.g., Article 92 of the CRD IV (2013/36/EU).
[62] See section __.3(c) of the proposed rule.

requirements, and defined to be the same levels, as the parent covered institution. In general, the operations, services, and products of broker-dealers and investments advisers are not typically effected through subsidiaries[63] and it is expected that their incentive-based compensation arrangements are typically derived from the activities of the broker-dealers and investment advisers themselves. Because of this, any inappropriate risks for which the incentive-based compensation programs at these firms may encourage should be localized, and the management of these risks similarly should reside at the broker-dealer or investment adviser. Where that is not the case, individuals that are employed by subsidiaries of a broker-dealer or investment adviser may still be considered to be a "significant risk-taker" for the covered institution and, therefore, subject to the proposed rule.[64] In addition, broker-dealers and investment advisers that are subsidiaries of depository institution holding companies would be consolidated on the basis of such depository institution holding companies generally, where there is often a greater integration of products and operations, public interest, and assessment and management of risk (including those related to incentive-based compensation) across the depository institution holding companies and their subsidiaries.[65]

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[63] In addition, the SEC's regulatory regime with respect to broker-dealers and investment advisers generally applies on an entity-by-entity basis. For example, subject to certain exclusions, any person that for compensation is engaged in the business of providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications is subject to the Investment Advisers Act. <u>See</u> 15 U.S.C. 80b-2(a)(11).

[64] The proposed rule also prohibits a covered institution from doing indirectly, or through or by any other person, anything that would be unlawful for such covered institution to do directly. <u>See</u> section 303.12. For example, the SEC has stated that it will, based on facts and circumstances, treat as a single investment adviser two or more affiliated investment advisers that are separate legal entities but are operationally integrated. <u>See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers</u>, Investment Advisers Act Release No. 3222 (Jun. 22, 2011) 76 FR 39,646 (Jul. 6, 2011); <u>In the Matter of TL Ventures, Inc.</u>, Investment Advisers Act Release No. 3859 (June. 20, 2014) (settled action); section 15 U.S.C. 80b-8.

[65] As discussed above in this Supplementary Information, the Agencies propose that covered institutions that are subsidiaries of covered institutions that are depository institution holding companies would be subject to the same requirements, and defined to be the same level, as the parent covered institutions. Because the failure of a depository institution may cause losses to the deposit insurance fund, there is a heightened interest in the safety and soundness of depository institutions and their holding companies. Moreover, as noted above, depository institution holding companies should serve as a source of financial and managerial strength for their subsidiary depository institutions. Additionally, in the experience of the Federal Banking Agencies, incentive-based compensation programs generally are designed at the holding company level and are applied throughout the consolidated organization. The Board has observed that complex depository institution holding companies have evolved toward comprehensive, consolidated risk management to measure and assess the range of their exposures and the way these exposures interrelate, including in the context of incentive-based compensation programs.

Level 1, Level 2, and Level 3 covered institutions.

For purposes of the proposed rule, the Agencies have specified the three levels of covered institutions as:

- In the case of the OCC:
  - A "Level 1 covered institution" means: (i) a covered institution that is a subsidiary of a depository institution holding company with average total consolidated assets greater than or equal to $250 billion; (ii) a covered institution with average total consolidated assets greater than or equal to $250 billion that is not a subsidiary of a covered institution or of a depository institution holding company; and (iii) a covered institution that is a subsidiary of a covered institution with average total consolidated assets greater than or equal to $250 billion.
  - A "Level 2 covered institution" means: (i) a covered institution that is a subsidiary of a depository institution holding company with average total consolidated assets greater than or equal to $50 billion but less than $250 billion; (ii) a covered institution with average total consolidated assets greater than or equal to $50 billion but less than $250 billion that is not a subsidiary of a covered institution or of a depository institution holding company; and (iii) a covered institution that is a subsidiary of a covered institution with average total consolidated assets greater than or equal to $50 billion but less than $250 billion.
  - A "Level 3 covered institution" means: (i) a covered institution with average total consolidated assets greater than or equal to $1 billion but less than $50 billion; and (ii) a covered institution that is a subsidiary of a covered institution with average total consolidated assets greater than or equal to $1 billion but less than $50 billion.
- In the case of the Board:
  - A "Level 1 covered institution" means a covered institution with average total consolidated assets greater than or equal to $250 billion and any subsidiary of a Level 1 covered institution that is a covered institution.

- A “Level 2 covered institution” means a covered institution with average total consolidated assets greater than or equal to $50 billion that is not a Level 1 covered institution and any subsidiary of a Level 2 covered institution that is a covered institution.
- A “Level 3 covered institution” means a covered institution with average total consolidated assets greater than or equal to $1 billion that is not a Level 1 or Level 2 covered institution.

- In the case of the FDIC:
  - A “Level 1 covered institution” means: (i) a covered institution that is a subsidiary of a depository institution holding company with average total consolidated assets greater than or equal to $250 billion; (ii) a covered institution with average total consolidated assets greater than or equal to $250 billion that is not a subsidiary of a depository institution holding company; and (iii) a covered institution that is a subsidiary of a covered institution with average total consolidated assets greater than or equal to $250 billion.
  - A “Level 2 covered institution” means: (i) a covered institution that is a subsidiary of a depository institution holding company with average total consolidated assets greater than or equal to $50 billion but less than $250 billion; (ii) a covered institution with average total consolidated assets greater than or equal to $50 billion but less than $250 billion that is not a subsidiary of a depository institution holding company; and (iii) a covered institution that is a subsidiary of a covered institution with average total consolidated assets greater than or equal to $50 billion but less than $250 billion.
  - A “Level 3 covered institution” means: (i) a covered institution that is a subsidiary of a depository institution holding company with average total consolidated assets greater than or equal to $1 billion but less than $50 billion; (ii) a covered institution with average total consolidated assets greater than or equal to $1 billion but less than $50 billion that is not a subsidiary of a depository institution holding company; and (iii) a covered

institution that is a subsidiary of a covered institution with average total consolidated assets greater than or equal to $1 billion but less than $50 billion.

- In the case of the NCUA:
    - A “Level 1 credit union” means a credit union with average total consolidated assets of $250 billion or more.
    - A “Level 2 credit union” means a credit union with average total consolidated assets greater than or equal to $50 billion that is not a Level 1 credit union.
    - A “Level 3 credit union” means a credit union with average total consolidated assets greater than or equal to $1 billion that is not a Level 1 or Level 2 credit union.
- In the case of the SEC:
    - A “Level 1 covered institution” means: (i) a covered institution with average total consolidated assets greater than or equal to $250 billion; or (ii) a covered institution that is a subsidiary of a depository institution holding company that is a Level 1 covered institution pursuant to 12 CFR 236.2.
    - A “Level 2 covered institution” means: (i) a covered institution with average total consolidated assets greater than or equal to $50 billion that is not a Level 1 covered institution; or (ii) a covered institution that is a subsidiary of a depository institution holding company that is a Level 2 covered institution pursuant to 12 CFR 236.2.
    - A “Level 3 covered institution” means a covered institution with average total consolidated assets greater than or equal to $1 billion that is not a Level 1 covered institution or Level 2 covered institution.
- In the case of FHFA:
    - A “Level 1 covered institution” means a covered institution with average total consolidated assets greater than or equal to $250 billion that is not a Federal Home Loan Bank.

- A "Level 2 covered institution" means a covered institution with average total consolidated assets greater than or equal to $50 billion that is not a Level 1 covered institution and any Federal Home Loan Bank that is a covered institution.
- A "Level 3 covered institution" means a covered institution with average total consolidated assets greater than or equal to $1 billion that is not a Level 1 covered institution or Level 2 covered institution.

The Agencies considered the varying levels of complexity and risks across covered institutions that would be subject to this proposed rule, as well as the general correlation of asset size with those potential risks, in proposing to distinguish covered institutions by their asset size.[66] In general, larger financial institutions have more complex structures and operations. These more complex structures make controlling risk-taking more difficult. Moreover, these larger, more complex institutions also tend to be significant users of incentive-based compensation. Significant use of incentive-based compensation combined with more complex business operations can make it more difficult to immediately recognize and assess risks for the institution as a whole. Therefore, the requirements of the proposed rule are tailored to reflect the size and complexity of each of the three levels of covered institutions identified in the proposed rule. The proposed rule assigns covered institutions to one of three levels, based on each institution's average total consolidated assets.

Additionally, the Agencies considered the exemption in section 956 for institutions with less than $1 billion in assets along with other asset-level thresholds in the Dodd-Frank Act[67] as an indication that Congress views asset size as an appropriate basis for the requirements and prohibitions established under this proposed rule. Consistent with this approach, the Agencies

[66] But see earlier discussion regarding consolidation.

[67] See, e.g., section 116 of the Dodd-Frank Act (12 U.S.C. 5326) (allowing the Financial Stability Oversight Council to require a bank holding company with total consolidated assets of $50 billion or more to submit reports); section 163 of the Dodd-Frank Act (12 U.S.C. 5363) (requiring prior notice to the Board for certain acquisitions by bank holding companies with total consolidated assets of $50 billion or more); section 165 of the Dodd-Frank Act (12 U.S.C. 5365) (requiring enhanced prudential standards for bank holding companies with total consolidated assets of $50 billion or more); section 318(c) of the Dodd-Frank Act (12 U.S.C. 16) (authorizing the Board to collect assessments, fees, and other charges from bank holding companies and savings and loan holding companies with total consolidated assets of $50 billion or more).

also looked to asset size to determine the types of prohibitions that would be necessary to discourage inappropriate risks at covered institutions that could lead to material financial loss.

The Agencies are proposing that more rigorous requirements apply to institutions with $50 billion or more in assets. These institutions with assets of $50 billion or more tend to be significantly more complex and, the risk-taking of these institutions, and their potential failure, implicates greater risks for the financial system and the overall economy. Tailoring application of the requirements of the proposed rule is consistent with other provisions of the Dodd-Frank Act, which distinguish requirements for institutions with $50 billion or more in total consolidated assets. For example, the enhanced supervision and prudential standards for nonbank financial companies and bank holding companies under section 165[68] apply to bank holding companies with total consolidated assets of $50 billion or greater. It is also consistent with the definitions of advanced approaches institutions under the Federal Banking Agencies' domestic capital rules,[69] which are linked to the total consolidated assets of an institution. Other statutory and regulatory provisions recognize this difference.[70]

Most of the requirements of the proposed rule would apply to Level 1 and Level 2 covered institutions in a similar manner. Deferral requirements, however, would be different for Level 1 and Level 2 covered institutions, as discussed further below: incentive-based compensation for senior executive officers and significant risk-takers at covered institutions with average total consolidated assets equal to or greater than $250 billion would be subject to a higher percentage of deferral, and longer deferral periods. In the experience of the Agencies, covered institutions with assets of $250 billion or more tend to be significantly more complex

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[68] 12 U.S.C. 5365.

[69] See 12 CFR 3.100(b)(1) (advanced approaches national banks and Federal savings associations); 12 CFR 324.100(b)(1) (advanced approaches state nonmember banks, state savings associations, and insured branches of foreign banks); 12 CFR 217.100(b)(1) (advanced approaches bank holding companies, savings and loan holding companies, and state member banks).

[70] See, e.g., Board, "Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies," 80 FR 49081 (August 14, 2015); Board, "Single-Counterparty Credit Limits for Large Banking Organizations; Proposed Rule," 81 FR 14327 (March 4, 2016); Board, "Debit Card Interchange Fees and Routing; Final Rule," 76 FR 43393 (July 20, 2011); Board, "Supervision and Regulation Assessments for Bank Holding Companies and Savings and Loan Holding Companies With Total Consolidated Assets of $50 Billion or More and Nonbank Financial Companies Supervised by the Federal Reserve," 78 FR 52391 (August 23, 2013); OCC, Board, FDIC, "Supplementary Leverage Ratio; Final Rule," 79 FR 57725 (September 26, 2014).

and thus exposed to a higher level of risk than those with assets of less than $250 billion. The risk-taking of these institutions, and their potential failure, implicates the greatest risks for the broader economy and financial system. Other statutory and regulatory provisions recognize this difference. For example, the definitions of advanced approaches institutions under the Federal Banking Agencies' domestic capital rules establish a $250 billion threshold for coverage. This approach is similar to that used in the international standards published by the Basel Committee on Banking Supervision, and rules implementing such capital standards, under which banks with consolidated assets of $250 billion or more are subject to enhanced capital and leverage standards.

As noted above, the Agencies propose to designate the Federal Home Loan Banks as covered institutions. Under FHFA's proposed rule, each Federal Home Loan Bank would be a Level 2 covered institution by definition, as opposed to by total consolidated assets. As long as a Federal Home Loan Bank is a covered institution under this part, with average total consolidated assets greater than or equal to $1 billion, it is a Level 2 covered institution. FHFA proposes this approach because generally for the Federal Home Loan Banks, asset size is not a meaningful indicator of risk. The Federal Home Loan Banks all operate in a similar enough manner that treating them differently based on asset size is not justifiable. Because of the scalability of the Federal Home Loan Bank business model, it is possible for a Federal Home Loan Bank to pass back and forth over the asset-size threshold without any meaningful change in risk profile. FHFA proposes to designate the Federal Home Loan Banks as Level 2 covered institutions instead of Level 3 covered institutions because at the time of the proposed rule, at least one Federal Home Loan Bank would be a Level 2 covered institution if determined by asset size, and the regulatory requirements under the proposed rule that seem most appropriate for the Federal Home Loan Banks are those of Level 2 covered institutions.

Similar to the approach used by the Federal Banking Agencies in their general supervision of banking organizations, if the proposed rule were adopted, the Agencies would generally expect to coordinate oversight and, to the extent applicable, supervision for consolidated organizations in order to assess compliance throughout the consolidated organization with any final rule. The Agencies are cognizant that effective and consistent supervision generally requires coordination among the Agencies that regulate the various entities within a consolidated organization. The supervisory authority of each appropriate Federal regulator to examine and review its covered institutions for compliance with the proposed rule would not be affected under this approach.

Affiliate. For the OCC, the Board, the FDIC, and the SEC, the proposed rule would define "affiliate" to mean any company that controls, is controlled by, or is under common control with another company. FHFA's proposed rule would not include a definition of "affiliate." The Federal Home Loan Banks have no affiliates, and affiliates of the Enterprises are included as part of the definition of Enterprise in the Safety and Soundness Act, which is referenced in the definition of regulated entity. The NCUA's proposed rule also would not include a definition of "affiliate." While in some cases, credit union service organizations ("CUSOs") might be considered affiliates of a credit union, NCUA has determined that this rule would not apply to CUSOs.

Average total consolidated assets. Consistent with section 956, the proposed rule would not apply to institutions with less than $1 billion in assets. Additionally, as discussed above, under the proposed rule, more specific requirements would apply to institutions with higher levels of assets. The Agencies propose to use average total consolidated assets to measure assets for the purposes of determining applicability of the requirements of this rule. Whether a covered institution that is a subsidiary of a depository institution holding company is a Level 1, Level 2, or Level 3 covered institution would be based on the average total consolidated assets of the top-tier depository institution holding company. Whether that subsidiary has at least $1 billion will be based on the subsidiary's average total consolidated assets.

For an institution that is not an investment adviser, average total consolidated assets would be determined with reference to the average of the total consolidated assets reported on regulatory reports for the four most recent consecutive quarters. This method is consistent with those used to calculate total consolidated assets for purposes of other rules that have $50 billion thresholds,[71] and it may reduce administrative burden on institutions – particularly Level 3 covered institutions that become Level 2 covered institutions – if average total consolidated assets are calculated in the same way for the proposed rule. For an institution that does not have a regulatory report for each of the four most recent consecutive quarters to reference, average

[71] See, e.g., OCC's Heightened Standards (12 CFR Part 30, Appendix D); 12 CFR 46.3; 12 CFR 225.8; 12 CFR 243.2; 12 CFR 252.30; 2 CFR 252.132; 12 CFR 325.202; 12 CFR 381.2.

total consolidated assets would mean the average of total consolidated assets, as reported on the relevant regulatory reports, for the most recent quarter or consecutive quarters available, as applicable. Average total consolidated assets would be measured on the as-of date of the most recent regulatory report used in the calculation of the average. For a covered institution that is an investment adviser, average total consolidated assets would be determined by the investment adviser's total assets (exclusive of non-proprietary assets) shown on the balance sheet for the adviser's most recent fiscal year end.[72]

The Board's proposed rule would require that savings and loan holding companies that do not file a regulatory report within the meaning of section ___.2(ee)(3) of the Board's proposed rule report their average total consolidated assets to the Board on a quarterly basis. In addition, foreign banking organizations with U.S operations would be required to report their total consolidated U.S. assets to the Board on a quarterly basis. These regulated institutions would be required to report their average total consolidated assets to the Board either because they do not file reports of their total consolidated assets with the Board (in the case of savings and loan holding companies that do not file a regulatory report with the Board within the meaning of section ___.2(ee)(3) of the Board's proposed rule), or because the reports filed do not encompass the full range of assets (in the case of foreign banking organizations with U.S. operations). Asset information concerning the U.S. operations of foreign banking organizations is filed on form FRY-7Q, but the information does not include U.S. assets held pursuant to section 2(h)(2) of the Bank Holding Company Act. Foreign banking organizations with U.S. operations would report their average total consolidated U.S. assets including assets held pursuant to section 2(h)(2) of the Bank Holding Company Act for purposes of complying with the requirements of section ___.2(ee)(3) of the Board's proposed rule. The Board would propose

[72] This proposed method of calculation for investment advisers corresponds to the reporting requirement in Item 1.O. of Part 1A of Form ADV, which currently requires an investment adviser to check a box to indicate if it has assets of $1 billion or more. See Form ADV, Part IA, Item 1.O.; SEC, "Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Release No. IA-3221," 76 FR 42950 (July 19, 2011). Many commenters to the first notice of proposed rulemaking indicated that they understood that the SEC did not intend "total consolidated assets" to include non-proprietary assets, such as client assets under management; others requested clarification that this understanding is correct. The SEC is clarifying in the proposed rule that investment advisers should include only proprietary assets in the calculation—that is, non-proprietary assets, such as client assets under management would not be included, regardless of whether they appear on an investment adviser's balance sheet. The SEC notes that this method is drawn directly from section 956. See section 956(f) (referencing "assets" only).

that reporting forms be created or modified as necessary for these institutions to meet these reporting requirements.

The proposed rule does not specify a method for determining the total consolidated assets of some types of subsidiaries that would be considered covered institutions under the proposed rule, because those subsidiaries do not currently submit regular reports of their asset size to the Agencies. For the subsidiary of a national bank, Federal savings association, or Federal branch or agency of a foreign bank, the OCC would rely on a report of the subsidiary's total consolidated assets prepared by the subsidiary, national bank, Federal savings association, or Federal branch or agency in a form that is acceptable to the OCC. Similarly, for a regulated institution subsidiary of a bank holding company, savings and loan holding company, or foreign banking organization the Board would rely on a report of the subsidiary's total consolidated assets prepared by the bank holding company or savings and loan holding company in a form that is acceptable to the Board.

Control. The definition of control in the proposed rule is similar to the definition of the same term in the Bank Holding Company Act.[73] Any company would have control over a bank or any company if: (1) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank or company; (2) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (3) the appropriate Federal regulator determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

Depository institution holding company. The OCC's, the FDIC's, and the SEC's proposed rules define "depository institution holding company" to mean a top-tier depository institution holding company, where "depository institution holding company" would have the same meaning as in section 3 of the FDIA.[74] In a multi-tiered depository institution holding company, references in the OCC's, FDIC's and SEC's proposed rules to the "depository institution holding company" would mean the top-tier depository institution holding company of the multi-tiered holding company only.

[73] 12 U.S.C. 1841(a)(2).
[74] See 12 U.S.C. 1813(w).

For example, for the purpose of determining whether a state nonmember bank that is a subsidiary of a depository institution holding company and is within a multi-tiered depository institution holding company structure is a Level 1, Level 2, or Level 3 covered institution under the FDIC's proposed rule, the state nonmember would look to the top-tier depository institution holding company's average total consolidated assets. Thus, in a situation in which a state nonmember bank with average total consolidated assets of $35 billion is a subsidiary of a depository institution holding company with average total consolidated assets of $45 billion that is itself a subsidiary of a depository institution holding company with $75 billion in average total consolidated assets, the state nonmember bank would be treated as a Level 2 covered institution because the top-tier depository institution holding company has average total consolidated assets of $75 billion (which is greater than or equal to $50 billion but less than $250 billion). Similarly, state member banks and national banks within multi-tiered depository institution holding company structures would look to the top-tier depository institution holding company's average total consolidated assets when determining if they are a Level 1, Level 2 or Level 3 covered institution under the Board's and the OCC's proposed rules.

Subsidiary. For the OCC, the Board, the FDIC, and the SEC, the proposed rule would define "subsidiary" to mean any company which is owned or controlled directly or indirectly by another company. The Board proposes to exclude from its definition of "subsidiary" any merchant banking investment that is owned or controlled pursuant to 12 U.S.C. 1843(k)(4)(H) and Subpart J of the Board's Regulation Y (12 CFR 225) and any company with respect to which the covered institution acquired ownership or control in the ordinary course of collecting a debt previously contracted in good faith. Depository institution holding companies may hold such investments only for limited periods of time by law. Application of the proposed rule to these institutions directly would not further the purpose of the proposed rule under section 956. The holding company and any nonbanking subsidiary holding these investments would be subject to the proposed rule. For these reasons, the Board is proposing to exclude from the definition of subsidiary companies owned by a holding company as merchant banking investments or through debt previously contracted in good faith. These companies would, therefore, not be required to conform their incentive-based compensation programs to the requirements of the proposed rule.

FHFA's proposed rule would not include a definition of "subsidiary." The Federal Home Loan Banks have no subsidiaries, and any subsidiaries of the Enterprises as defined by other

Agencies under the proposed rule would be included as affiliates as part of the definition of Enterprise in the Safety and Soundness Act, which is referenced in the definition of regulated entity. The NCUA's proposed rule also would not include a definition of "subsidiary." While in some cases, CUSOs might be considered subsidiaries of a credit union, NCUA has determined that this rule would not apply to CUSOs.

2.1. The Agencies invite comment on whether other financial institutions should be included in the definition of "covered institution" and why.

2.2. The Agencies invite comment on whether any additional financial institutions should be included in the proposed rule's definition of subsidiary and why.

2.3. The Agencies invite comment on whether any additional financial institutions (such as registered investment companies) should be excluded from the proposed rule's definition of subsidiary and why.

2.4. The Agencies invite comment on the definition of average total consolidated assets.

2.5. The Agencies invite comment on the proposed rule's approach to consolidation. Are there any additional advantages to the approach? For example, the Agencies invite comment on the advantages of the proposed rule's approach for reinforcing the ability of an institution to establish and maintain effective risk management and controls for the entire consolidated organization and enabling holding company structures to more effectively manage human resources. Are there advantages to the approach of the proposed rule in helping to reduce the possibility of evasion of the more specific standards applicable to certain individuals at Level 1 or Level 2 covered institutions? Are there any disadvantages to the proposed rule's approach to consolidation? For example, the Agencies invite comment on any disadvantages smaller subsidiaries of a larger covered institution may have by applying the more specific provisions of the proposed rule to these smaller institutions that would not otherwise apply to them but for being a subsidiary of a larger institution. Is there another approach that the proposed rule should take? The Agencies invite comment on any advantages and disadvantages of the SEC's proposal to not consolidate subsidiaries of broker-dealers and investment advisers that are not themselves subsidiaries of depository institution holding companies. Are the operations, services, and products of broker-dealers and investment advisers not typically effected through subsidiaries? Should the SEC adopt an express requirement to treat two or more affiliated investment advisers or broker-dealers that are separate legal entities (e.g., investment advisers that are operationally integrated) as a single investment adviser or broker-dealer for purposes of the proposed rule's thresholds?

2.6. The Agencies invite comment on whether the three-level structure would be a workable approach for categorizing covered institutions by asset size and why.

2.7. The Agencies invite comment on whether the asset thresholds used in these definitions would divide covered institutions into appropriate groups based on how they view the competitive marketplace. If asset thresholds are not the appropriate methodology for determining which requirements apply, which other alternative methodologies would be appropriate and why?

2.8. Are there instances where it may be appropriate to modify the requirements of the proposed rule where there are multiple covered institutions subsidiaries within a single parent organization based upon the relative size, complexity, risk profile, or business model, and use of incentive-based compensation of the covered institution subsidiaries within the consolidated organization? In what situations would that be appropriate and why?

2.9. Is the Agencies' assumption that incentive-based compensation programs are generally designed and administered at the holding company level for the organization as a whole correct? Why or why not? To what extent do broker-dealers or investment advisers within a holding company structure apply the same compensation standards as other subsidiaries in the parent company?

2.10. Bearing in mind that section 956 by its terms seeks to address incentive-based compensation arrangements that could lead to material financial loss to a covered institution, commenters are asked to provide comments on the proposed method of determining asset size for investment advisers. Are there instances where it may be appropriate to determine asset size differently, by for example, including client assets under management for investment advisers? In what situations would that be appropriate and why?

2.11. Should the determination of average total consolidated assets for investment advisers exclude non-proprietary assets that are included on a balance sheet under accounting rules, such as certain types of client assets under management required to be included on an investment adviser's balance sheet? Why or why not?

2.12. Should the determination of average total consolidated assets be further tailored for certain types of investment advisers, such as charitable advisers, non-U.S.-domiciled advisers, or insurance companies and, if so, why and in what manner?

2.13. The Agencies invite comment on the methods for determining whether foreign banking organizations and Federal branches and agencies are Level 1, Level 2, or Level 3 covered institutions. Should the same method be used for both foreign banking organizations and Federal branches and agencies? Why or why not?

Definitions pertaining to covered persons.

Covered person. The proposed rule defines "covered person" as any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution.[75] The term "executive officer" would include individuals who are senior executive officers, as defined in the proposed rule, as well as other individuals designated as executive officers by the covered institution. As described further below, section __.4 of the proposed rule would apply requirements and prohibitions on all incentive-based compensation arrangements for covered persons at covered institutions.

Included in the class of covered persons are senior executive officers and significant risk-takers, discussed further below. Senior executive officers and significant risk-takers are covered persons that may have the ability to expose a covered institution to significant risk through their positions or actions. Accordingly, the proposed rule would prohibit the incentive-based compensation arrangements for senior executive officers and significant risk-takers from including certain features that encourage inappropriate risk, consistent with the approach under sections __.5, __.9, __.10, and __.11 of the proposed rule of requiring risk-mitigating features for the incentive-based compensation programs at larger and more complex covered institutions.

For Federal credit unions, only one director, if any, would be considered a covered person because, under section 112 of the Federal Credit Union Act[76] and NCUA's regulations at 12 CFR 701.33, only one director may be compensated as an officer of the board of directors.

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[75] Section 956 requires the Agencies to jointly prescribe regulations or guidelines that prohibit certain incentive-based compensation arrangements or features of such arrangements that encourage inappropriate risk by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits or that could lead to material financial loss to the covered financial institution.

[76] 12 U.S.C. 1761a.

The insurance and indemnification benefits that are excluded from the definition of "compensation" for purposes of 12 CFR 701.33 would not cause a non-compensated director of a credit union to be included under the definition of "covered person" because these benefits would not be "incentive-based compensation" under the proposed rule.

Director. The proposed rule defines "director" as a member of the board of directors of a covered institution. Any member of a covered institution's governing body would be included within this definition.

Principal shareholder. Section 956 applies to principal shareholders as well as executive officers, employees, and directors. The proposed rule defines "principal shareholder" as a natural person who, directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered institution. The 10 percent threshold for identifying principal shareholders is used in a number of bank regulatory contexts.[77] The NCUA's proposed rule does not include this definition because credit unions are not-for-profit financial cooperatives with member owners. The Agencies recognize that some other types of covered institutions, for example, mutual savings associations, mutual savings banks, and some mutual holding companies, do not have principal shareholders.

2.14. The Agencies invite comment on whether the definition of "principal shareholder" reflects a common understanding of who would be a principal shareholder of a covered institution.

Senior executive officer. The proposed rule defines "senior executive officer" as 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 (CEO), 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. As described below, a Level 1 or Level 2 covered institution would be required to defer a portion of the incentive-based compensation of a senior executive officer and subject the incentive-based

[77] See, e.g., 12 CFR 215.2(m), 12 CFR 225.2(n)(2), and 12 CFR 225.41(c)(2).

compensation to forfeiture, downward adjustment, and clawback. The proposed rule would also limit the extent to which options could be used to meet the proposed rule's minimum deferral requirements for senior executive officers. The proposed rule would require a covered institution's board of directors, or a committee thereof, to approve incentive-based compensation arrangements for senior executive officers and any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers. Additionally, Level 1 and Level 2 covered institutions would be required to create and maintain records listing senior executive officers and to document forfeiture, downward adjustment, and clawback decisions for senior executive officers. The proposed rule would limit the extent to which a Level 1 or Level 2 covered institution may award incentive-based compensation to a senior executive officer in excess of the target amount for the incentive-based compensation. Senior executive officers also would not be eligible to serve on the compensation committee of a Level 1 or Level 2 covered institution under the proposed rule.

The 2011 Proposed Rule contained a definition of "executive officer" that included the positions of president, CEO, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, and head of a major business line. It did not include the positions of chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head of a control function. One commenter asserted that the term "executive officer" should not be defined with reference to specific position, but, rather, should be identified by the board of directors of a covered institution. Other commenters asked the Agencies for additional specificity about the types of executive officers that would be covered at large and small covered institutions, particularly with respect to the heads of major business lines. Some commenters encouraged the Agencies to align the definition of "executive officer" with the Securities Exchange Act of 1934 by focusing on individuals with significant policymaking functions. In the alternative, some of these commenters suggested that the definition be revised to conform to the 2010 Federal Banking Agency Guidance.

The definition of "senior executive officer" in the proposed rule retains the list of positions included in the 2011 Proposed Rule and is consistent with other rules and agency guidance. The list includes the minimum positions that are considered "senior executives" under the Federal Banking Agency Safety and Soundness Guidelines.[78] The Agencies also took into account the positions that would be considered "officers" under section 16 of the Securities Exchange Act of 1934.[79]

In addition to the positions listed in the 2011 Proposed Rule, the proposed definition of "senior executive officer" includes the positions of chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, and other heads of a control function. Individuals in these positions do not generally initiate activities that generate risk of material financial loss, but they play an important role in identifying, addressing, and mitigating that risk. Individuals in these positions have the ability to influence the risk measures and other information and judgments that a covered institution uses for risk management, internal control, or financial purposes.[80] Improperly structured incentive-based compensation arrangements could create incentives for individuals in these positions to use their authority in ways that increase, rather than mitigate, risk of material financial loss. Some larger institutions have designated individuals in these positions as "covered persons" for purposes of the 2010 Federal Banking Agency Guidance.

The definition of "senior executive officer" also includes a covered person who performs the function of a senior executive officer for a covered institution, even if the covered person's formal title does not reflect that role or the covered person is employed by a different entity. For example, under the proposed rule, a covered person who is an employee of a bank holding company and also performs the functions of a chief financial officer for the subsidiary bank would, in addition to being a covered person of the bank holding company, also be a senior executive officer of the bank holding company's subsidiary bank. This approach would address attempts to evade being included within the definition of "senior executive officer" by changing an individual's title but not that individual's responsibilities. In some instances, the determination of senior executive officers and compliance with relevant requirements of the

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[78] These minimum positions include "executive officers," within the meaning of Regulation O (12 CFR 215.2(e)(1)) and "named officers" within the meaning of the SEC's rules on disclosure of executive compensation (17 CFR 229.402). In addition to these minimum positions, the Federal Banking Agency Safety and Soundness Guidelines also apply to individuals "who are responsible for oversight of the organization's firm-wide activities or material business lines." 75 FR at 36407.

[79] See 17 CFR 240.16a-1.

[80] See 2010 Federal Banking Agency Guidance, 75 FR at 36411.

proposed rule may be influenced by the covered institution's organizational structure.[81] If a covered institution does not have any covered person who holds the title or performs the function of one or more of the positions listed in the definition of "senior executive officer," the proposed rule would not require the covered institution to designate a covered person to fill such position for purposes of the proposed rule. Similarly, if a senior executive officer at one covered institution also holds the title or performs the function of one of more of the positions listed for a subsidiary that is also a covered institution, then that individual would be a senior executive officer for both the parent and the subsidiary covered institutions.

The list of positions in the proposed definition sets forth the types of positions whose incumbents would be considered senior executive officers. The Agencies are proposing this list to aid covered institutions in identifying their senior executive officers while allowing the covered institutions some degree of flexibility in determining which business lines are major business lines.

2.15. The Agencies invite comment on whether the types of positions identified in the proposed definition of senior executive officer are appropriate, whether additional positions should be included, whether any positions should be removed, and why.

2.16. The Agencies invite comment on whether the term "major business line" provides enough information to allow a covered institution to identify individuals who are heads of major business lines. Should the proposed rule refer instead to a "core business line," as defined in FDIC and FRB rules relating to resolution planning (12 CFR 381.2(d)), to a "principal business unit, division or function," as described in SEC definitions of the term "executive officer" (17 CFR 240.3b-7), or to business lines that contribute greater than a specified amount to the covered institution's total annual revenues or profit? Why?

2.17. Should the Agencies include the chief technology officer ("CTO"), chief information security officer, or similar titles as positions explicitly listed in the definition of "senior executive officer"? Why or why not? Individuals in these positions play a significant role in information technology management.[82] The CTO is generally responsible for the

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[81] See section ___.3(c) of the proposed rule.

[82] See generally Federal Financial Institutions Examination Council ("FFIEC") Information Technology Examination Handbook, available at http://ithandbook.ffiec.gov/it-booklets.aspx.

development and implementation of the information technology strategy to support the institution's business strategy in line with its appetite for risk. In addition, these positions are generally responsible for implementing information technology architecture, security, and business resilience.

Significant risk-taker. The proposed rule's definition of "significant risk-taker" is intended to include individuals who are not senior executive officers but are in the position to put a Level 1 or Level 2 covered institution at risk of material financial loss so that the proposed rule's requirements and prohibitions on incentive-based compensation arrangements apply to such individuals. In order to ensure that incentive-based compensation arrangements for significant risk-takers appropriately balance risk and reward, most of the proposed rule's requirements for Level 1 and Level 2 covered institutions relating to senior executive officers would also apply to significant risk-takers to some degree. These requirements include the disclosure and recordkeeping requirements of section __.5; the deferral, forfeiture, downward adjustment, and clawback requirements of section __.7 (including the related limitation on options); and the maximum incentive-based compensation opportunity limit of section __.8.

The proposed definition of "significant risk-taker" incorporates two tests for determining whether a covered person is a significant risk-taker. A covered person would be a significant risk-taker if either test was met. The first test is based on the amounts of annual base salary and incentive-based compensation of a covered person relative to other covered persons working for the covered institution and its affiliate covered institutions (the "relative compensation test"). This test is intended to determine whether the individual is among the top 5 percent (for Level 1 covered institutions) or top 2 percent (for Level 2 covered institutions) of highest compensated covered persons in the entire consolidated organization, including affiliated covered institutions. The second test is based on whether the covered person has authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution (the "exposure test").[83]

[83] In the proposed rule, the Agencies have tailored the measure of capital to the type of covered institution. For most covered institutions, the exposure test would be based on common equity tier 1 capital. For depository institution holding companies, foreign banking organizations, and affiliates of those institutions that do not report common equity tier 1 capital, the Board would work with covered institutions to determine the appropriate measure of capital. For registered securities brokers or dealers,

The definition of significant risk-taker applies to only Level 1 and Level 2 covered institutions. The definition of significant risk-taker does not apply to senior executive officers. Senior executive officers of Level 1 and Level 2 covered institutions would be separately subject to the proposed rule, as discussed earlier in this Supplemental Information section.

The significant risk-taker definition under either test would be applicable only to covered persons who received annual base salary and incentive-based compensation of which at least one-third is incentive-based compensation (one-third threshold), based on the covered person's annual base salary paid and incentive-based compensation awarded during the last calendar year that ended at least 180 days before the beginning of the performance period for which significant risk-takers are being identified.[84] For example, an individual who received $180,000 in annual base salary during calendar year 2019 and was awarded incentive-based compensation of $120,000 for performance periods that ended during calendar year 2019 could be a significant risk-taker because one-third of the individual's compensation was incentive-based. Specifically, the individual would be a significant risk-taker for a performance period beginning on or after June 28, 2020 if the individual also met the relative compensation test or the exposure test.[85]

Under the proposed rule, in order for covered persons to be designated as significant risk-takers, the covered persons would have to be awarded a level of incentive-based compensation that would be sufficient to influence their risk-taking behavior. In order to ensure that significant risk-takers are only those covered persons who have incentive-based compensation arrangements

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the exposure test would be based on tentative net capital. See 17 CFR 240.15c3-1(c)(15). For Federal Home Loan Banks, the exposure test would be based on regulatory capital. For the Enterprises, the exposure test would be based on minimum capital. For credit unions, the exposure test would be based on net worth or total capital. For simplicity in describing the exposure test in this Supplementary Information section, common equity tier 1 capital, tentative net capital, regulatory capital, minimum capital, net worth, and total capital are referred to generally as "capital." The Agencies expect that a covered institution that is an investment adviser will use common equity tier 1 capital or tentative net capital to the extent it would be a covered institution in another capacity (e.g., if the investment adviser also is a depository institution holding company, a bank, a broker-dealer, or a subsidiary of a depository institution holding company). For an investment adviser that would not be a covered institution in any other capacity, the proposed rule's exposure test would not be measured against the investment adviser's capital.

[84] Incentive-based compensation awarded in a particular calendar year would include any incentive-based compensation awarded with respect to a performance period that ended during that calendar year.

[85] In this example, incentive-based compensation awarded ($120,000) would be 40 percent of the total $300,000 received in annual base salary ($180,000) and incentive-based compensation awarded ($120,000).

that could provide incentives to engage in inappropriate risk-taking, only covered persons who meet the one-third threshold could be significant risk-takers.

The proposed one-third threshold is consistent with the more conservative end of the range identified in industry practice. Institutions in the Board's 2012 LBO Review that would be Level 2 covered institutions under the proposed rule reported that they generally rewarded their self-identified individual risk-takers with incentive-based compensation in the range of 8 percent to 90 percent of total compensation, with an average range of 32 percent to 71 percent. The proposed threshold of one-third or more falls within the lower end of that average range.

The one-third threshold would also be consistent with other standards regarding compensation. Under the Emergency Economic Stabilization Act of 2008 (as amended by section 7001 of the American Recovery and Reinvestment Act of 2009), recipients of financial assistance under Treasury's Troubled Asset Relief Program ("TARP") were prohibited from paying or accruing any bonus, retention award, or incentive compensation except for the payment of long-term restricted stock if that stock had a value that was not greater than one third of the total amount of annual compensation of the employee receiving the stock.[86] In addition, some international regulators also use a threshold of one-third incentive-based compensation for determining the scope of application for certain compensation standards.[87]

The Agencies included the 180-day period in the one-third threshold of annual base salary and incentive-based compensation because, based upon the supervisory experience of the Federal Banking Agencies and FHFA, this period would allow covered institutions an adequate period of time to calculate the total compensation of their covered persons and, for purposes of the relative compensation test, the individuals receiving incentive-based compensation from their affiliate covered institutions over a full calendar year. The Agencies expect, based on the experience of exceptional assistance recipients under TARP,[88] that 180 days would be a

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[86] 12 U.S.C. 5221(b)(3)(D).

[87] PRA, "Supervisory Statement LSS8/13, Remuneration Standards: The Application of Proportionality" (April 2013), at 11, available at http://www.bankofengland.co.uk/publications/Documents/other/pra/policy/2013/remunerationstandardslss8-13.pdf.

[88] The institutions that accepted "exceptional assistance" under TARP were required to submit to the Office of the Special Master for approval the compensation levels and structures for the five named executive officers and the next 20 most highly compensated executive officers ("Top 25") and the

reasonable period of time for Level 1 and Level 2 covered institutions to finalize compensation paid to and awarded to covered persons and to perform the necessary calculations to determine which covered persons are significant risk-takers. This time period would allow covered institutions to make awards following the end of the performance period, calculate the annual base salary and incentive-based compensation for all employees in the consolidated organization, including affiliated covered institutions, and then implement new compensation arrangements for the significant risk-takers identified, if necessary.

The Agencies recognize that the relative compensation test and the exposure test, combined with the one-third threshold, may not identify all covered persons at Level 1 and Level 2 covered institutions who have the ability to expose a covered institution or its affiliated covered institutions to material financial loss. Accordingly, paragraph (2) of the proposed rule's definition of significant risk-taker would allow covered institutions or the Agencies the flexibility to designate additional persons as significant risk-takers. An Agency would be able to designate a covered person as a significant risk-taker if the covered person has the ability to expose the covered institution to risks that could lead to material financial loss in relation to the covered institution's size, capital, or overall risk tolerance. Each Agency would use its own procedures for making such a designation. Such procedures generally would include reasonable advance written notice of the proposed action, including a description of the basis for the proposed action, and opportunity for the covered person and covered institution to respond.

Relative compensation test.

The relative compensation test in paragraphs (1)(i) and (ii) of the proposed definition of "significant risk-taker" would require a covered institution to determine which covered persons received the most annual base salary and incentive-based compensation among all individuals receiving incentive-based compensation from the covered institution and any affiliates of the covered institution that are also subject to the proposed rule.[89] The definition contains two

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compensation structures for the next 75 most highly compensated employees. The requirement for submission of the Top 25 necessitated the collection of the compensation data for executives worldwide and took considerable time and effort on the part of the institutions.

[89] The OCC, Board, FDIC, and SEC's proposed rules include a defined term, "section 956 affiliate," that is intended to function as shorthand for the types of entities that are considered "covered institutions" under the six Agencies' proposed rules. The term "section 956 affiliate" is used only in the definition of

percentage thresholds for measuring whether an individual is a significant risk-taker. For a Level 1 covered institution, a covered person would be a significant risk-taker if the person receives annual base salary and incentive-based compensation for the last calendar year that ended at least 180 days before the performance period that places the person among the highest 5 percent of all covered persons in salary and incentive-based compensation (excluding senior executive officers) of the Level 1 covered institution and, in the cases of the OCC, the Board, the FDIC, and the SEC, any section 956 affiliates of the Level 1 covered institution. For Level 2 covered institutions, the threshold would be 2 percent rather than 5 percent.

For example, if a hypothetical bank holding company were a Level 1 covered institution and had $255 billion in average total consolidated assets might have a subsidiary national bank with $253 billion in average total consolidated assets, a mortgage subsidiary with $1.9 billion in average total consolidated assets, and a wealth management subsidiary with $100 million in average total consolidated assets.[90] The relative compensation test would analyze the annual base salary and incentive-based compensation of all covered persons (other than senior executive officers) who receive incentive-based compensation at the bank holding company, the subsidiary national bank, and the mortgage subsidiary, which are all covered institutions with assets greater than or equal to $1 billion. Individuals at the wealth management subsidiary would not be included because that subsidiary has less than $1 billion in average total consolidated assets. Thus, if the bank holding company, state member bank, and mortgage subsidiary collectively had 150,000 covered persons (excluding senior executive officers), then the covered institution should identify the 7,500 or 5 percent of covered persons (other than senior executive officers)

"significant risk-taker," and it is not intended to affect the scope of any Agency's rule or the entities considered "covered institutions" under any Agency's rule. Given the proposed location of each Agency's proposed rule in the Code of Federal Regulations, the cross-references used in each of the OCC, Board, FDIC, and SEC's proposed rule differ slightly. NCUA's proposed rule does not include a definition of "section 956 affiliate," because credit unions are not affiliated with the entities that are considered "covered institutions" under the other Agencies' rules. Similarly, FHFA's proposed rule does not include a definition of "section 956 affiliate" because its regulated institutions are not affiliated with other Agencies' covered institutions.

[90] Under the proposed rule, all of these subsidiaries in this example other than the wealth management subsidiary would be subject to the same requirements as the bank holding company, including the specific requirements applying to identification of significant risk-takers. The wealth management subsidiary would not be subject to the requirements of the proposed rule because it has less than $1 billion in average total consolidated assets.

who receive the most annual base salary and incentive-based compensation out of those 150,000 covered persons, and identify as significant risk-takers any of those 7,500 persons who received annual base salary and incentive-based compensation for the last calendar year that ended at least 180 days before the beginning of the performance period of which at least one-third is incentive-based compensation.[91] Some of those 7,500 covered persons might receive incentive-based compensation from the bank holding company; others might receive incentive-based compensation from the national bank or the mortgage subsidiary. Each covered person that satisfies all requirements would be considered a significant risk-taker of the covered institution from which they receive incentive-based compensation. This example is provided solely for the purpose of illustrating the calculation of the number of significant risk-takers under the relative compensation test as proposed. It does not reflect any specific institution, nor does it reflect the experience or judgment of the Agencies of the number of covered persons or significant risk-takers at any institution that would be a Level 1 covered institution under the proposed rule.

Annual base salary and incentive-based compensation would be measured based on the last calendar year that ended at least 180 days before the beginning of the performance period for the reasons discussed above.

The Agencies propose that Level 1 and Level 2 covered institutions generally should consider a covered person's annual base salary actually paid during the calendar year. If, for example, a covered person was a manager during the first half of the year, with an annual salary of $100,000, and was then promoted to a senior manager with an annual salary of $150,000 on July 1 of that year, the annual base salary would be the $50,000 that person received as manager for the first half of the year plus the $75,000 received as a senior manager for the second half of the year, for a total of $125,000.

For the purposes of determining significant risk-takers, covered institutions should consider the incentive-based compensation that was awarded for any performance period that ended during a particular calendar year, regardless of when the performance period began. For example, if a covered person is awarded incentive-based compensation relating to (i) a plan with

[91] The Agencies anticipate that covered institutions that are within a depository institution holding company structure would work together to ensure that significant risk-takers are correctly identified under the relative compensation test.

a three-year performance period that began on January 1, 2017, (ii) a plan with a two-year performance period that began on January 1, 2018, and (iii) a plan with a one-year performance period that began on January 1, 2019, then all three of these awards would be included in the calculation of incentive-based compensation for calendar year 2019 because all three performance periods would end on December 31, 2019. The amount of previously deferred incentive-based compensation that vests in a particular year would not affect the measure of a covered person's incentive-based compensation for purposes of the relative compensation test.[92]

To reduce the administrative burden of calculating annual base salary and incentive-based compensation, the calculation would not include fringe benefits such as the value of medical insurance or the use of a company car. For purposes of such calculation, any non-cash compensation, such as stock or options, should be valued as of the date of the award.

In the Agencies' supervisory experience, the amount of a covered person's annual base salary and incentive-based compensation can reasonably be expected to relate to the amount of responsibility that the covered person has within an organization, and covered persons with a higher level of responsibility generally either (1) have a greater ability to expose a covered institution to financial loss or (2) supervise covered persons who have a greater ability to expose a covered institution to financial loss. For this reason, the Agencies are proposing to use the relative compensation test as one basis for identifying significant risk-takers.

Although a large number of covered persons may be able to expose a covered institution to a financial loss, the Agencies have limited the relative compensation test to the most highly compensated individuals in order to focus on those covered persons whose behavior can directly or indirectly expose a Level 1 or Level 2 covered institution to a financial loss that is material. Based on an analysis of public disclosures of large, international banking organizations[93] and on

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[92] Level 1 and Level 2 covered institutions would also use this method of calculating a covered person's incentive-based compensation for a particular calendar year for purposes of determining (1) whether such person received annual base salary and incentive-based compensation of which at least one third was incentive-based compensation and (2) the amount of a covered person's annual base salary and incentive-based compensation under the dollar threshold test.

[93] Agencies examined information available through various public reports, including the FSB's annual Compensation Progress Report. For instance, many international jurisdictions require firms to identify a population of employees who can expose a firm to material amounts of risk (sometimes called material risk takers or key risk takers), who are subject to specific requirements including deferral. In 2014 the

the Agencies' own supervision of incentive-based compensation, the top 5 percent most highly compensated covered persons among the covered institutions in the consolidated structure of Level 1 covered institutions are the most likely to have the potential to encourage inappropriate risk-taking by the covered institution because their compensation is excessive (the first test in section 956) or be the personnel who are able to expose the organization to risk of material financial loss (the second test in section 956).

The Board and the OCC, as a part of their supervisory efforts, reviewed a limited sample of banking organizations with total consolidated assets of $50 billion or more to better understand what types of positions within these organizations would be captured by various thresholds for highly compensated employees. In the review, the Board and the OCC also considered how far below the CEO within the organizational hierarchy the selected thresholds would reach. Generally, at banking organizations that would be Level 1 covered institutions under the proposed rule, a 5 percent threshold would include positions such as managing directors, directors, senior vice presidents, relationship and sales managers, mortgage brokers,

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FSB published information indicating that the average percentage of total global employees identified as risk-takers under these various jurisdictions' requirements at a sample of large firms ranged from 0.01 percent of employees of the global consolidated organization to more than 5 percent. The number varied between, but also within, individual jurisdictions and institutions as a result of factors such as specific institutions surveyed, the size of institution, and the nature of business conducted. See FSB, Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards Third Progress Report (November 2014), at 19, available at http://www.fsb.org/2014/11/fsb-publishes-third-progress-report-on-compensation-practices.

In addition, the Agencies relied to a certain extent on information disclosed on a legal entity basis as a result of Basel Pillar 3 remuneration disclosure requirements, for instance those required under implementing regulations such as Article 450 of the Capital Requirements Regulation (EU No 575/2013) in the European Union. See, e.g., Morgan Stanley, Article 450 of CRR Disclosure: Remuneration Policy (December 31, 2014), available at http://www.morganstanley.com/about-us-ir/pillar3/2014_CRR_450_Disclosure.pdf. Remuneration disclosure requirements apply to "significant" firms. CRD IV defines institutions that are significant "in terms of size, internal organisation and nature, scope and complexity of their activities." Under the EBA Guidance on Sound Remuneration Policies, significant institutions means institutions referred to in Article 131 of Directive 2013/36/EU (global systemically important institutions or 'G-SIIs,' and other systemically important institutions or 'O-SIIs'), and, as appropriate, other institutions determined by the competent authority or national law, based on an assessment of the institutions' size, internal organization and the nature, the scope and the complexity of their activities. Some, but not all, national regulators have provided further guidance on interpretation of that term, including the United Kingdom's FCA which provides a form of methodology to determine if a firm is "significant" – based on quantitative tests of balance sheet assets, liabilities, annual fee commission income, client money and client assets.

financial advisors, and product managers. Such positions generally have the ability to expose the organization to the risk of material financial loss. Based on this review, the Agencies believe it is reasonable to propose a 5 percent threshold under the relative compensation test for Level 1 covered institutions.

At banking organizations that would be Level 2 covered institutions under the proposed rule, a 5 percent threshold yielded results that went much deeper into the organization and identified roles with individuals who might not individually take significant risks for the organization. Additional review of a limited sample of these banking organizations that would be Level 2 covered institutions under the proposed rule showed that, on average, the institutions in the limited sample identified approximately 2 percent of their total global employees as individual employees whose activities may expose the organization to material amounts of risk, as consistent with the 2010 Federal Banking Agency Guidance. A lower percentage threshold for Level 2 covered institutions relative to Level 1 covered institutions also is consistent with the observation that larger covered institutions generally have more complex structures and use incentive-based compensation more significantly than relatively smaller covered institutions. Based on this analysis, the Agencies chose to propose a 2 percent threshold for Level 2 covered institutions. A lower percentage threshold for Level 2 covered institutions relative to Level 1 covered institutions would reduce the burden on relatively smaller covered institutions.

Under the proposed rule, if an Agency determines, in accordance with procedures established by the Agency, that a Level 1 covered institution's activities, complexity of operations, risk profile, and compensation practices are similar to those of a Level 2 covered institution, then the Agency may apply a 2 percent threshold under the relative compensation test rather than the 5 percent threshold that would otherwise apply. This provision is intended to allow an Agency the flexibility to adjust the number of covered persons who are significant risk-takers with respect to a Level 1 covered institution if the Agency determines that, notwithstanding the Level 1 covered institution's average total consolidated assets, its actual activities and risks are similar to those of a Level 2 covered institution, and therefore it would be appropriate for the Level 1 covered institution to have fewer significant risk-takers.

Exposure test.

Under the exposure test, a covered person would be a significant risk-taker with regard to a Level 1 or Level 2 covered institution if the individual may commit or expose[94] 0.5 percent or more of capital of the covered institution or, and, in the cases of the OCC, the Board, the FDIC, and the SEC, any section 956 affiliates of the covered institution, whether or not the individual is employed by that specific legal entity.

The exposure test relates to a covered person's authority to commit or expose significant amounts of an institution's capital, regardless of whether or not such exposures or commitments are realized. The exposure test would relate to a covered person's authority to cause the covered institution to be subject to credit risk or market risk. The exposure test would not relate to the ability of a covered person to expose a covered institution to other types of risk that may be more difficult to measure or quantify, such as compliance risk.

The measure of capital would relate to a covered person's authority over the course of the most recent calendar year, in the aggregate, and would be based on the maximum amount that the person has authority to commit or expose during the year. For example, a Level 1 or Level 2 covered institution might allocate $10 million to a particular covered person as an authorized level of lending for a calendar year. For purposes of the exposure test in the proposed rule, the covered person's authority to commit or expose would be $10 million. This would be true even if the individual only made $8 million in loans during the year or if the covered institution reduced the authorized amount to $7.5 million at some point during the year. It would also be true even if the covered person did not have the authority through any single transaction to lend $10 million, so long as over the course of the year the covered person could lend up to $10 million in the aggregate. If, however, in the course of the year the covered person received authorization for an additional $5 million in lending, $15 million would become the authorization amount for purposes of the exposure test. If a covered person had no specific maximum amount of lending for the year, but instead his or her lending was subject to approval on a rolling basis, then the covered person would be assumed to have an authorized annual lending amount in excess of the 0.5 percent threshold.

[94] An individual may commit or expose capital of a covered institution or affiliate if the individual has the ability to put the capital at risk of loss due to market risk or credit risk.

As an additional example, a Level 1 or Level 2 covered institution could authorize a particular covered person to trade up to $5 million per day in a calendar year. For purposes of the exposure test, the covered person's authorized annual lending amount would be $5 million times the number of trading days in the year (for example, $5 million times 260 days or $1.3 billion). This would be true even if the covered person only traded $1 million per day during the year or if the covered institution reduced the authorized trading amount to $2.5 million per day at some point during the year. If, however, in the course of the year the covered person received authorization for an additional $2 million in trading per day, the covered person's authority to commit or expose capital for purposes of the exposure test would be $1.82 billion ($7 million times 260 days). The Agencies are aware that institutions may not calculate their exposures in this manner and are requesting comment upon it, as set forth below.

The exposure test would also include individuals who are voting members of a committee that has the decision-making authority to commit or expose 0.5 percent or more of the capital of a covered institution or of a section 956 affiliate of a covered institution. For example, if a committee that is comprised of five covered persons has the authority to make investment decisions with respect to 0.5 percent or more of a state member bank's capital, then each voting member of such committee would have the authority to commit or expose 0.5 percent or more of the state member bank's capital for purposes of the exposure test. However, individuals who participate in the meetings of such a committee but who do not have the authority to exercise voting, veto, or similar rights that lead to the committee's decision would not be included.

The exposure test would also cause a covered person to be considered a significant risk-taker if he or she can commit or expose 0.5 percent or more of the capital of any section 956 affiliate of the covered institution by which the covered person is employed. For example, if a covered person of a nonbank subsidiary of a bank holding company has the authority to commit 0.5 percent or more of the bank holding company's capital or the capital of the bank holding company's subsidiary national bank (and received annual base salary and incentive-based compensation for the last calendar year that ended at least 180 days before the beginning of the performance period of which at least one-third is incentive-based compensation), then the covered person would be considered a significant risk-taker of the bank holding company or national bank, whichever is applicable. This would be true even if the covered person is not employed by the bank holding company or the bank holding company's subsidiary national bank, and even if the covered person does not have the authority to commit or expose the capital of the nonbank subsidiary that employs the covered person.

The exposure test would require a Level 1 or Level 2 covered institution to consider the authority of an individual to take an action that could result in significant credit or market risk exposures to the covered institution. The Agencies are proposing the exposure test because individuals who have the authority to expose covered institutions to significant amounts of risk can cause material financial losses to covered institutions. For example, in proposing the exposure test, the Agencies were cognizant of the significant losses caused by actions of individuals, or a trading group, at some of the largest financial institutions during and after the financial crisis that began in 2007.[95]

The exposure test would identify significant risk-takers based on the extent of an individual's authority to expose an institution to market risk or credit risk, measured by reference to 0.5 percent of the covered institution's regulatory capital. Measuring this authority by reference to an existing capital standard would provide a uniform and clearly defined metric to apply among covered persons at Level 1 and Level 2 covered institutions. The Agencies have selected credit and market risks as the most relevant types of exposures because the majority of assets on a covered institution's balance sheet generally give rise to market or credit risk exposure.

In proposing a threshold of 0.5 percent of relevant capital, the Agencies considered both the absolute and relative amount of losses that the threshold would represent for covered institutions, and the fact that incentive-based compensation programs generally apply to numerous employees at a covered institution. In the Agencies' view, the proposed threshold represents a material financial loss within the meaning of section 956 for any institution and multiple losses at the same firm incentivized by a single incentive-based compensation program could impair the firm.

The Agencies considered the cumulative effect of incentive-based compensation arrangements across a covered institution. The Agencies recognize that many covered persons who have the authority to expose a covered institution to risk are subject to similar incentive-

[95] See supra note 14.

based compensation arrangements. The effect of an incentive-based compensation arrangement on a covered institution would be the cumulative effect of the behavior of all covered persons subject to the incentive-based compensation arrangement. If multiple covered persons are incented to take inappropriate risks, their combined risk-taking behavior could lead to a financial loss at the covered institution that is significantly greater than the financial loss that could be caused by any one individual.[96] Although many institutions already have governance and risk management systems to help ensure the commitment of significant amounts of capital is subject to appropriate controls, as noted above, incentive-based compensation arrangements that provide inappropriate risk-taking incentives can weaken those governance and risk management systems. These considerations about the cumulative effect of incentive-based compensation arrangements weigh in favor of a conservative threshold under the exposure test so that large groups of covered persons with the authority to commit a covered institution's capital are not subject to flawed incentive-based compensation arrangements which would incentivize them to subject the covered institution to inappropriate risks.

The Agencies also considered that in another regulatory context, a relatively small decrease in a large institution's capital requires additional safeguards for safety and soundness. Under the capital plan rule in the Board's Regulation Y, well-capitalized bank holding companies with average total consolidated assets of $50 billion or more are subject to prior approval requirements on incremental capital distributions if those distributions, as measured over a one-year period, would exceed pre-approved amounts by more than 1 percent of the bank holding company's tier 1 capital.[97] Relative to the capital plan rule, a lower threshold of capital is appropriate in the context of incentive-based compensation in light of the potential cumulative effect of multiple covered persons with incentives to take inappropriate risks and the possibility that correlated inappropriate risk-taking incentives could, in the aggregate, significantly erode capital buffers at Level 1 and Level 2 covered institutions.

Taking into consideration the cumulative impact of incentive-based compensation arrangements described above, the Agencies have proposed a threshold level for the exposure

[96] See, e.g., the Subcommittee Report.
[97] See 12 CFR 225.8(g). Bank holding companies that are well-capitalized and that meet other requirements under the rule must provide the Board with prior notice for incremental capital distributions, as measured over a one-year period, that represent more than 1 percent of their tier 1 capital. Id.

test of 0.5 percent of capital. The exposure test would be measured on an annual basis to align with the common practice at many institutions of awarding incentive-based compensation on an annual basis, taking into account a covered person's performance and risk-taking over 12 months.

The Agencies also considered international compensation regulations that also use a 0.5 percent threshold, but on a per transaction basis.[98] The Agencies are proposing to apply the threshold on an aggregate annual basis because a per transaction basis could permit an individual to evade designation as a significant risk-taker and the related incentive-based compensation restrictions by keeping his or her individual transactions below the threshold, but completing multiple transactions during the course of the year that, in the aggregate, far exceed the threshold.

Exposure test at certain affiliates.

Paragraph (3) of the definition of significant risk-taker is intended to address potential evasion of the exposure test by a Level 1 or Level 2 covered institution that authorizes an employee of one of its affiliates that is not a covered institution because it has less than $1 billion in average total consolidated assets or is not considered a covered institution under one of the six Agencies' proposed rules, to commit or expose 0.5 percent or more of capital of the Level 1 or Level 2 covered institution. The Agencies are concerned that in such a situation, the employee would be functioning as a significant risk-taker at the affiliated Level 1 or Level 2 covered institution but would not be subject to the requirements of the proposed rule that would be applicable to a significant risk-taker at the affiliated Level 1 or Level 2 covered institution. To address this circumstance, the proposed rule would treat such employee as a significant risk-taker with respect to the affiliated Level 1 or Level 2 covered institution for which the employee may commit or expose capital. That Level 1 or Level 2 covered institution would be required to ensure that the employee's incentive-based compensation arrangement complies with the proposed rule.

[98] See, e.g., EBA, "Regulatory Technical Standards on Criteria to Identify Categories of Staff Whose Professional Activities Have a Material Impact on an Institution's Risk Profile under Article 94(2) of Directive 2013/36/EU" (December 16, 2013), available at https://www.eba.europa.eu/documents/10180/526386/EBA-RTS-2013-11+%28On+identified+staff%29.pdf/c313a671-269b-45be-a748-29e1c772ee0e.

Dollar threshold test.

As an alternative to the relative compensation test, the Agencies also considered using a specific absolute compensation threshold, measured in dollars, to determine whether an individual is a significant risk-taker. Under this test, a covered person who receives annual base salary and incentive-based compensation[99] in excess of a specific dollar threshold would be a significant risk-taker, regardless of how that covered person's annual base salary and incentive-based compensation compared to others in the consolidated organization (the "dollar threshold test"). A dollar threshold test would include adjustments such as for inflation. If the dollar threshold test replaced the relative compensation test, the definition of "significant risk-taker" would still include only covered persons who received annual base salary and incentive-based compensation of which at least one-third was incentive-based compensation, based on the covered person's annual base salary paid and incentive-based compensation awarded during the last calendar year that ended at least 180 days before the beginning of the performance period.

One advantage of a dollar threshold test compared to the relative compensation test is that it could be less burdensome to implement and monitor. With a dollar threshold test covered institutions can determine whether an individual covered person meets the dollar threshold test of the significant risk-taker definition by reviewing the compensation of only that single individual. The dollar threshold test would also allow an institution to implement incentive-based compensation structures, policies, and procedures with some foreknowledge of which employees would be covered by them. However, even with adjustment for inflation, a dollar threshold put in place by regulation would assume that a certain dollar threshold is an appropriate level for all Level 1 and Level 2 covered institutions and covered persons. On the other hand, a dollar threshold could set expectations so that individual employees would know based on their own compensation if they are significant risk-takers.

Based on FHFA's supervisory experience analyzing compensation both at FHFA's regulated entities and at other financial institutions, a dollar threshold would be an appropriate approach to identify individuals with the ability to put the covered institution at risk of material

[99] For purposes of the dollar threshold test, the measure of annual base salary and incentive-based compensation would be calculated in the same way as the measure for the one-third threshold discussed above.

loss. FHFA must prohibit its regulated entities from providing compensation to any executive officer of the regulated entity that is not reasonable and comparable with compensation for employment in other similar businesses (including publicly held financial institutions or major financial services companies) involving similar duties and responsibilities.[100] In order to meet this statutory mandate, FHFA analyzes, assesses, and compares the compensation paid to employees of its regulated entities and compensation paid to employees of other financial institutions of various asset sizes. In performing this analysis, FHFA has observed that the amount of a covered person's annual base salary and incentive-based compensation reasonably relates to the level of responsibility that the covered person has within an organization. A dollar threshold test, if set at the appropriate level, would identify covered persons who either (1) have a greater ability to expose a covered institution to financial loss or (2) supervise covered persons who have a greater ability to expose a covered institution to financial loss.

One disadvantage of the dollar threshold test is that it may not appropriately capture all individuals who subject the firm to significant risks. A dollar threshold put in place by regulation that is static across all Level 1 and Level 2 covered institutions also is not sensitive to the compensation practices of an individual organization. The relative compensation test, while not as easy to implement, could be more sensitive to the compensation structure of an organization because it is based on the relative compensation of individuals that the organization concludes should be the mostly highly compensated.

2.18. For purposes of a designation under paragraph (2) of the definition of significant risk-taker, should the Agencies provide a specific standard for what would constitute "material financial loss" and/or "overall risk tolerance"? If so, how should these terms be defined and why?

2.19. The Agencies specifically invite comment on the one-third threshold in the proposed rule. Is one-third of the total of annual base salary and incentive-based compensation an appropriate threshold level of incentive-based compensation that would be sufficient to influence risk-taking behavior? Is using compensation from the last calendar year that ended

[100] 12 U.S.C. 4518(a).

at least 180 days before the beginning of the performance period for calculating the one-third threshold appropriate?

2.20. The Agencies specifically invite comment on the percentages of employees proposed to be covered under the relative compensation test. Are 5 percent and 2 percent reasonable levels? Why or why not? Would 5 percent and 2 percent include all of the significant risk-takers or include too many covered persons who are not significant risk-takers?

2.21. The Agencies specifically invite comment on the time frame needed to identify significant risk-takers under the relative compensation test. Is using compensation from the last calendar year that ended at least 180 days before the beginning of the performance period appropriate? The Agencies invite comment on whether there is another measure of total compensation that would be possible to measure closer in time to the performance period for which a covered person would be identified as a significant risk-taker.

2.22. The Agencies invite comment on all aspects of the exposure test, including potential costs and benefits, the appropriate exposure threshold and capital equivalent, efficacy at identifying those non-senior executive officers who have the authority to place the capital of a covered institution at risk, and whether an exposure test is a useful complement to the relative compensation test. If so, what specific types of activities or transactions, and at what level of exposure, should the exposure test cover? The Agencies also invite comment on whether the exposure test is workable and why. What, if any, additional details would need to be specified in order to make the exposure test workable, such as further explanation of the meanings of “commit” or “expose”? In addition to committees, should the exposure test apply to groups of persons, such as traders on a desk? If so, how should it be applied?

2.23. With respect to the exposure test, the Agencies specifically invite comment on the proposed capital commitment levels. Is 0.5 percent of capital of a covered institution a reasonable proxy for material financial loss, or are there alternative levels or dollar thresholds that would better achieve the statutory objectives? If alternative methods would better achieve the statutory objectives, what are the advantages and disadvantages of those alternatives compared to the proposed level? For depository institution holding company organizations with multiple covered institutions, should the capital commitment level be consistent across all such institutions or should it vary depending on specified factors and why? For example, should the levels for covered institutions that are subsidiaries of a parent who is also a covered institution vary depending on: (1) the size of those subsidiaries relative to the parent; and/or (2) whether the entity would be subject to comparable restrictions if it were not affiliated with the parent? What are the advantages and disadvantages of any such variation, and what would be the appropriate levels? The Agencies recognize that certain covered institutions under the Board's, the OCC's, the FDIC's, and the SEC's proposed rules, such as Federal and state branches and agencies of foreign banks and investment advisers that are not also depository institution holding companies, banks, or broker-dealers or subsidiaries of those institutions, are not otherwise required to calculate common equity tier 1 capital or tentative net capital, as applicable. How should the capital commitment level be determined under the Board's, the OCC's, the FDIC's, and the SEC's proposed rules for those covered institutions? Is there a capital or other measure that the Agencies should consider for those covered institutions that would achieve similar objectives to common equity tier 1 capital or tentative net capital? If so, what are the advantages and disadvantages of such a capital or other measure?

2.24. The Agencies invite comment on whether it is appropriate to limit the exposure test to market risk and credit risk and why. What other types of risk should be included, if any and how would such exposures be measured? Should the Agencies prescribe a method for measurement of market risk and credit risk? Should exposures be measured as notional amounts or is there a more appropriate measure? If so, what would it be? Should the exposure test take into account hedging? How should the exposure test be applied to an individual in a situation where a firm calculates an exposure limit for a trading desk comprised of a group of people? Should a de minimis threshold be introduced for any transaction counted toward the 0.5 percent annual exposure test?

2.25. Should the exposure test consider the authority of a covered person to initiate or structure proposed product offerings, even if the covered person does not have final decision-making authority over such product offerings? Why or why not? If so, are there specific types of products with respect to which this approach would be appropriate and why?

2.26. Should the exposure test measure a covered person's authority to commit or expose (a) through one transaction or (b) as currently proposed, through multiple transactions in the aggregate over a period of time? What would be the benefits and disadvantages of applying the test on a per-transaction versus aggregate basis over a period of time? If measured on an aggregate basis, what period of time is appropriate and why? For example, should paragraph (1)(iii) of the definition of significant risk-taker read: "A covered person of a covered institution who had the authority to commit or expose in any single transaction during the previous calendar year 0.5 percent or more of the capital[101] of the covered institution or of any section 956 affiliate of the covered institution, whether or not the individual is a covered person of that specific legal entity"? Why or why not?

2.27. If the exposure test were based on a single transaction, would 0.5 percent of capital be the appropriate threshold for significant risk-taker status? Why or why not? If not, what would be the appropriate percentage of capital to include in the exposure test and why?

2.28. Should the Agencies introduce an absolute exposure threshold in addition to a percentage of capital test if a per-transaction test was introduced instead of the annual exposure test? Why or why not? For example, would a threshold formulated as "the lesser of 0.5 percent of capital or $100 million" help to level the playing field across Level 1 covered institutions and the smallest Level 2 covered institutions and better ensure that the right set of activities is being considered by all institutions? The Agencies' supervisory experience indicates that many large institutions, for example, require additional scrutiny of significant transactions, which helps to ensure that the potential risks posed by large transactions are adequately considered before such transactions are approved. Would $100 million be the appropriate level at which additional approval procedures are required before a transaction is approved, or would a lower threshold be appropriate if an absolute dollar threshold were combined with the capital equivalent threshold?

2.29. Should the exposure test measure exposures or commitments actually made, or should the authority to make an exposure or commitment be sufficient to meet the test and why? For example, should paragraph (1)(iii) of the definition of significant risk-taker read: "A covered person of a covered institution who committed or exposed in the aggregate during the previous calendar year 0.5 percent or more of the common equity tier 1 capital, or in the case

[101] Under this alternative language, each Agency's rule text would include the relevant capital metrics for its covered institutions.

of a registered securities broker or dealer, 0.5 percent or more of the tentative net capital, of the covered institution or of any section 956 affiliate of the covered institution, whether or not the individual is a covered person of that specific legal entity"?

2.30. Would a dollar threshold test, as described above, achieve the statutory objectives better than the relative compensation test? Why or why not? If using a dollar threshold test, and assuming a mechanism for inflation adjustment, would $1 million be the right threshold or should it be higher or lower? For example, would a threshold of $2 million dollars be more appropriate? Why or why not? How should the threshold be adjusted for inflation? Are there other adjustments that should be made to ensure the threshold remains appropriate? What are the advantages and disadvantages of a dollar threshold test compared to the proposed relative compensation test?

2.31. The Agencies specifically invite comment on replacement of the relative compensation test in paragraphs (1)(i) and (ii) of the definition of significant risk-taker with a dollar threshold test, as follows: "a covered person of a Level 1 or Level 2 covered institution who receives annual base salary and incentive-based compensation of $1 million or more in the last calendar year that ended at least 180 days before the beginning of the performance period." Under this alternative, the remaining language in the definition of "significant risk-taker" would be unchanged.

2.32. The Agencies invite comment on all aspects of a dollar threshold test, including potential costs and benefits, the appropriate amount, efficacy at identifying those non-senior executive officers who have the ability to place the institution at risk, time frame needed to identify significant risk-takers, and comparison to a relative compensation test such as the one proposed. Is the last calendar year that ended at least 180 days before the beginning of the performance period an appropriate time frame or for the dollar threshold test or would using compensation from the performance period that ended in the most recent calendar year be appropriate? The Agencies specifically invite comment on whether to use an exposure test if a dollar threshold test replaces the relative compensation test and why.

2.33. The Agencies invite comment on all aspects of the definition of "significant risk-taker." The Agencies specifically invite comment on whether the definition should rely solely on the relative compensation test, solely on the exposure test, or on both tests, as proposed. What are the advantages and disadvantages of each of these options?

2.34. In addition to the tests outlined above, are there alternative tests of, or proxies for, significant risk-taking that would better achieve the statutory objectives? What are the advantages and disadvantages of alternative approaches? What are the implementation burdens of any of the approaches, and how could they be addressed?

2.35. How many covered persons would likely be identified as significant risk-takers under the proposed rule? How many covered persons would likely be identified under only the relative compensation test with the one-third threshold? How many covered persons would likely be identified under only the exposure test as measured on an annual basis with the one-third threshold? How many covered persons would be identified under only an exposure test formulated on a per transaction basis with the one-third threshold? How many covered persons would be identified under only the dollar threshold test, assuming the dollar threshold is $1 million, with the one-third threshold? How many covered persons would be identified under each test individually without a one-third threshold?

Other definitions.

To award. The proposed rule defines "to award" as to make a final determination, conveyed to a covered person, of the amount of incentive-based compensation payable to the covered person for performance over a performance period.

The Agencies acknowledge that some covered institutions use the term "award" to refer to the decisions that covered institutions make about incentive-based compensation structures and performance measure targets before or soon after the relevant performance period begins. However, in the interest of clarity and consistency, the proposed rule uses the phrase "to award" only with reference to final determinations about incentive-based compensation amounts that an institution makes and communicates to the covered person who could receive the award under an incentive-based compensation arrangement for a given performance period.

In most cases, incentive-based compensation will be awarded near the end of the performance period. Neither the length of the performance period nor the decision to defer some or all incentive-based compensation would affect the determination of when incentive-based compensation is awarded for purposes of the proposed rule. For example, at the beginning of a one-year performance period, a covered institution might inform a covered person of the amount of incentive-based compensation that the covered person could earn at the end of the performance period if certain measures and other criteria are met. The covered institution might also inform the covered person that a portion of the covered person's incentive-based compensation will be deferred for a four-year period. The covered person's incentive-based compensation for that performance period – including both the portion that is deferred and the portion that vests immediately – would be "awarded" when the covered institution determines what amount of incentive-based compensation the covered person has earned based on his or her performance during the performance period.

For equity-like instruments, such as stock appreciation rights and options, the date when incentive-based compensation is awarded may be different than from the date when the instruments vest, are paid out, or can be exercised. For example, a covered institution could determine at the end of a performance period that a covered person has earned options on the basis of performance during that performance period, and the covered institution could provide that the covered person cannot exercise the options for another five years. The options would be considered to have been "awarded" at the end of the performance period, even if they cannot be exercised for five years.

Under the proposed rule, covered institutions would have the flexibility to decide how the determination of the amount of incentive-based compensation would be conveyed to a covered person. For example, some covered institutions may choose to inform covered persons of their award amounts in writing or by electronic message. Others may choose to allow managers to orally inform covered persons of their award amounts.

2.36. The Agencies invite comment on whether the proposed rule's definition of "to award" should include language on when incentive-based compensation is awarded for purposes of the proposed rule. Specifically, the Agencies invite comment on whether the definition should read: "To award incentive-based compensation means to make a final determination, conveyed to a covered person, at the end of the performance period, of the amount of incentive-based compensation payable to the covered person for performance over that performance period." Why or why not?

Board of directors. The proposed rule defines "board of directors" as the governing body of a covered institution that oversees the activities of the covered institution, often referred to as the board of directors or board of managers. Under the Board's proposed rule, for a foreign banking organization, "board of directors" would mean the relevant oversight body for the institution's state insured or uninsured branch, agency, or operations, consistent with the foreign banking organization's overall corporate and management structure. Under the FDIC's proposed rule, for a state insured branch of a foreign bank, "board of directors" would refer to the relevant oversight body for the state insured branch consistent with the foreign bank's overall corporate and management structure. Under the OCC's proposed rule, for a Federal branch or agency of a foreign bank, "board of directors" would refer to the relevant oversight body for the Federal branch or agency, consistent with its overall corporate and management structure. The OCC would work closely with Federal branches and agencies to determine the appropriate person or committee to undertake the responsibilities assigned to the oversight body. NCUA's proposed rule defines "board of directors" as the governing body of a credit union.

Clawback. The term "clawback" under the proposed rule refers specifically to a mechanism that allows a covered institution to recover from a senior executive officer or significant risk-taker incentive-based compensation that has vested if the covered institution determines that the senior executive officer or significant risk-taker has engaged in fraud or the types of misconduct or intentional misrepresentation described in section ___.7(c) of the proposed rule. Clawback would not apply to incentive-based compensation that has been awarded but is not yet vested. As used in the proposed rule, the term "clawback" is distinct from the terms "forfeiture" and "downward adjustment," in that clawback provisions allow covered institutions to recover incentive-based compensation that has already vested. In contrast, forfeiture applies only after incentive-based compensation is awarded but before it vests. Downward adjustment occurs only before incentive-based compensation is awarded.

Compensation, fees, or benefits. The proposed rule defines "compensation, fees, or benefits" to mean all direct and indirect payments, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered institution. The form of payment would not affect whether such payment meets the definition of "compensation, fees, or benefits." The term would include, among other things, payments or benefits pursuant to an employment contract, compensation, pension, or benefit agreements, fee arrangements, perquisites, options, post-employment benefits, and other compensatory arrangements. The term is defined broadly under the proposed rule in order to include all forms of incentive-based compensation.

The term "compensation, fees, or benefits" would exclude reimbursement for reasonable and proper costs incurred by covered persons in carrying out the covered institution's business.

Control function. The proposed rule defines "control function" as a compliance, risk management, internal audit, legal, human resources, accounting, financial reporting, or finance role responsible for identifying, measuring, monitoring, or controlling risk-taking.[102] The term would include loan review and Bank Secrecy Act roles. Section ___.9(b) of the proposed rule would require a Level 1 or Level 2 covered institution to provide individuals engaged in control functions with the authority to influence the risk-taking of the business areas they monitor and ensure that covered persons engaged in control functions are compensated in accordance with the achievement of performance objectives linked to their control functions and independent of the performance of the business areas they monitor. As described below, section ___.11 of the proposed rule would also require that a Level 1 or Level 2 covered institution's policies and procedures provide an appropriate role for control function personnel in the covered institution's incentive-based compensation program. The heads of control functions would also be considered senior executive officers for purposes of the proposed rule, because such employees can individually affect the risk profile of a covered institution.

Although covered persons in control functions generally do not perform activities designed to generate revenue or reduce expenses, they may nonetheless have the ability to expose covered institutions to risk of material financial loss. For example, individuals in human resources and risk management roles contribute to the design and review of performance measures used in incentive-based compensation arrangements, which may allow them to influence the activities of risk-takers in a covered institution. For that reason, the proposed rule would treat covered persons who are the heads of control functions as senior executive officers who would be subject to certain additional requirements under the proposed rule as described further below.

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[102] The term "control function" would serve a different purpose than, and is not intended to affect the interpretation of, the term "front line unit," as used in the OCC's Heightened Standards.

2.37. The Agencies invite comment on whether and in what circumstances, the proposed definition of "control function" should include additional individuals and organizational units that (a) do not engage in activities designed to generate revenue or reduce expenses; (b) provide operational support or servicing to any organizational unit or function; or (c) provide technology services.

Deferral. The proposed rule defines "deferral" as the delay of vesting of incentive-based compensation beyond the date on which the incentive-based compensation is awarded. As discussed below in this Supplementary Information section, under the proposed rule, a Level 1 or Level 2 covered institution would be required to defer a portion of the incentive-based compensation of senior executive officers and significant risk-takers. The Agencies would not consider compensation that has vested, but that the covered person then chooses to defer, e.g., for tax reasons, to be deferred incentive-based compensation for purposes of the proposed rule because it would not be subject to forfeiture.

The Agencies note that the deferral period under the proposed rule would not include any portion of the performance period, even for incentive-based compensation plans that have longer performance periods. Deferral involves a "look-back" period that is intended as a stand-alone interval that follows the performance period and allows time for ramifications (such as losses or other adverse consequences) of, and other information about, risk-taking decisions made during the performance period to become apparent.

If incentive-based compensation is paid in the form of options, the period of time between when an option vests and when the option can be exercised would not be considered deferral under the proposed rule. As with other types of incentive-based compensation, an option would count toward the deferral requirement only if it has been awarded but has not yet vested, regardless of when the option could be exercised.[103]

2.38. To the extent covered institutions are already deferring incentive-based compensation, does the proposed definition of deferral reflect current practice? If not, in what way does it differ?

[103] Section ___.7(a)(4)(ii) of the proposed rule limits the portion of the proposed rule's minimum deferral requirements that can be met in the form of options.

Deferral period. The proposed rule defines "deferral period" as the period of time between the date a performance period ends and the last date on which the incentive-based compensation that is awarded for such performance period vests. A deferral period and a performance period that both relate to the same incentive-based compensation award could not occur concurrently. Because sections___.7(a)(1)(iii) and (a)(2)(iii) of the proposed rule would allow for pro rata vesting of deferred amounts during a deferral period, some deferred incentive-based compensation awarded for a performance period could vest before the end of the deferral period following that performance period. As a result, the deferral period would be considered to end on the date that the last tranche of incentive-based compensation awarded for a performance period vests.

Downward adjustment. The proposed rule defines "downward adjustment" as a reduction of the amount of a covered person's incentive-based compensation not yet awarded for any performance period that has already begun, including amounts payable under long-term incentive plans, in accordance with a forfeiture and downward adjustment review under section __7(b) of the proposed rule. As explained above, downward adjustment is distinct from clawback and forfeiture because downward adjustment affects incentive-based compensation that has not yet been awarded. It is also distinct from performance-based adjustments that covered institutions might make in determining the amount of incentive-based compensation to award to a covered person, absent or separate from a forfeiture or downward adjustment review. Depending on the results of a forfeiture and downward adjustment review under section ___.7(b) of the proposed rule, a covered institution could adjust downward incentive-based compensation that has not yet been awarded to a senior executive officer or significant risk-taker such that the senior executive officer or significant risk-taker is awarded none, or only some, of the incentive-based compensation that could otherwise have been awarded to such senior executive officer or significant risk-taker.

Equity-like instrument. The proposed rule defines "equity-like instrument" as (1) equity in the covered institution or of any affiliate of the covered institution; or (2) a form of compensation (i) payable at least in part based on the price of the shares or other equity instruments of the covered institution or of any affiliate of the covered institution; or (ii) that requires, or may require, settlement in the shares of the covered institution or any affiliate of the covered institution. The value of an equity-like instrument would be related to the value of the covered institution's shares.[104] The definition includes three categories. Shares are an example of the first category, "equity." Examples of the second category, "a form of compensation payable at least in part based on the price of the shares or other equity instruments of the covered institution or any affiliate of the covered institution," include restricted stock units (RSUs), stock appreciation rights, and other derivative instruments that settle in cash. Examples of the third category, "a form of compensation that requires, or may require, settlement in the shares of the covered institution or of any affiliate of the covered institution," include options and derivative securities that settle, either mandatorily or permissively, in shares. An RSU that offers a choice of settlement in either cash or shares is also an example of this third category. The definition of equity-like instrument would include shares in the holding company of a covered institution, or instruments the value of which is dependent on the value of shares in the holding company of a covered institution. For example, the definition would include incentive-based compensation paid in the form of shares in a bank holding company, even if that incentive-based compensation were provided by a national bank subsidiary of that bank holding company. Covered institutions would determine the specific terms and conditions of the equity-like instruments they award to covered persons.

NCUA's proposed rule does not include the definition of "equity-like instrument" because credit unions do not have these types of instruments.

2.39. Are there any financial instruments that are used for incentive-based compensation and have a value that is dependent on the performance of a covered institution's shares, but are not captured by the definition of "equity-like instrument"? If so, what are they, and should such instruments be added to the definition? Why or why not?

Forfeiture. The proposed rule defines "forfeiture" as a reduction of the amount of deferred incentive-based compensation awarded to a covered person that has not vested.[105]

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[104] The definition of "equity-like instrument" in the proposed rule is similar to "share-based payment" in Topic 718 of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (formerly FAS 123(R)). Paragraph 718-10-30-20, FASB Accounting Standards Codification.

[105] Forfeiture is similar to the concept of "malus" common at some covered institutions. Malus is defined in the CEBS Guidelines as "an arrangement that permits the institution to prevent vesting of all or part of the amount of a deferred remuneration award in relation to risk outcomes or performance." See CEBS Guidelines. The 2011 Proposed Rule did not define the term "forfeiture," but the concept was implicit in the discussion of adjustments during the deferral period. See 76 FR at 21179, "Deferred payouts may be

Depending on the results of a forfeiture and downward adjustment review under section ___.7(b) of the proposed rule, a covered institution could reduce a significant risk-taker or senior executive officer's unvested incentive-based compensation such that none, or only some, of the deferred incentive-based compensation vests. As discussed below in this Supplementary Information section, a Level 1 or Level 2 covered institution would be required to place at risk of forfeiture all unvested deferred incentive-based compensation, including amounts that have been awarded and deferred under long-term incentive plans.

<u>Incentive-based compensation.</u> The proposed rule defines "incentive-based compensation" as any variable compensation, fees, or benefits that serve as an incentive or reward for performance. The Agencies propose a broad definition to provide flexibility as forms of compensation evolve. Compensation earned under an incentive plan, annual bonuses, and discretionary awards are all examples of compensation that could be incentive-based compensation. The form of payment, whether cash, an equity-like instrument, or any other thing of value, would not affect whether compensation, fees, or benefits meet the definition of "incentive-based compensation."

In response to a similar definition in the 2011 Proposed Rule, commenters asked for clarification about the components of incentive-based compensation. The proposed definition clarifies that compensation, fees, and benefits that are paid for reasons other than to induce performance would not be included. For example, compensation, fees, or benefits that are awarded solely for, and the payment of which is solely tied to, continued employment (<u>e.g.</u>, salary or a retention award that is conditioned solely on continued employment) would not be considered incentive-based compensation. Likewise, payments to new employees at the time of hiring (signing or hiring bonuses) that are not conditioned on performance achievement would not be considered incentive-based compensation because they generally are paid to induce a

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altered according to risk outcomes either formulaically or based on managerial judgment, though extensive use of judgment might make it more difficult to execute deferral arrangements in a sufficiently predictable fashion to influence the risk-taking behavior of a covered person. To be most effective in ensuring balance, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from the covered person's activities, and the measures of loss should be clearly explained to covered persons and closely tied to their activities during the relevant performance period."

prospective employee to join the institution, not to influence future performance of such employee.

Similarly, a compensation arrangement that provides payments solely for achieving or maintaining a professional certification or higher level of educational achievement would not be considered incentive-based compensation under the proposed rule. In addition, the Agencies do not intend for this definition to include compensation arrangements that are determined based solely on the covered person's level of fixed compensation and that do not vary based on one or more performance measures (e.g., employer contributions to a 401(k) retirement savings plan computed based on a fixed percentage of an employee's salary). Neither would the proposed definition include dividends paid and appreciation realized on stock or other equity-like instruments that are owned outright by a covered person. However, stock or other equity-like instruments awarded to a covered person under a contract, arrangement, plan, or benefit would not be considered owned outright while subject to any vesting or deferral arrangement (regardless of whether such deferral is mandatory).

2.40. The Agencies invite comment on the proposed definition of incentive-based compensation. Should the definition be modified to include additional or fewer forms of compensation and in what way? Is the definition sufficiently broad to capture all forms of incentive-based compensation currently used by covered institutions? Why or why not? If not, what forms of incentive-based compensation should be included in the definition?

2.41. The Agencies do not expect that most pensions would meet the proposed rule's definition of "incentive-based compensation" because pensions generally are not conditioned on performance achievement. However, it may be possible to design a pension that would meet the proposed rule's definition of "incentive-based compensation." The Agencies invite comment on whether the proposed rule should contain express provisions addressing the status of pensions in relation to the definition of "incentive-based compensation." Why or why not?

Incentive-based compensation arrangement, incentive-based compensation plan, and incentive-based compensation program. The proposed rule defines three separate, but related, terms describing how covered institutions provide incentive-based compensation.[106] Under the proposed rule, "incentive-based compensation arrangement" would mean an agreement between a covered institution and a covered person, under which the covered institution provides incentive-based compensation to the covered person, including incentive-based compensation delivered through one or more incentive-based compensation plans. An individual employment agreement would be an incentive-based compensation arrangement.

"Incentive-based compensation plan" is defined as a document setting forth terms and conditions governing the opportunity for and the delivery of incentive-based compensation payments to one or more covered persons. An incentive-based compensation plan may cover, among other things, specific roles or job functions, categories of individuals, or forms of payment. A covered person may be compensated under more than one incentive-based compensation plan.

"Incentive-based compensation program" means a covered institution's framework for incentive-based compensation that governs incentive-based compensation practices and establishes related controls. A covered institution's incentive-based compensation program would include all of the covered institution's incentive-based compensation arrangements and incentive-based compensation plans.

Long-term incentive plan. The proposed rule defines "long-term incentive plan" as a plan to provide incentive-based compensation that is based on a performance period of at least three years. Any incentive-based compensation awarded to a covered person for a performance period of less than three years would not be awarded under a long-term incentive plan, but instead would be considered "qualifying incentive-based compensation" as that term is defined under the proposed rule.[107]

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[106] The use of these terms under the proposed rule is consistent with how the same terms are used in the 2010 Federal Banking Agency Guidance.

[107] In the 2011 Proposed Rule, the Agencies did not define the term "long-term incentive plan," but the 2011 Proposed Rule discussed "longer performance periods" as one of four methods used to make compensation more sensitive to risk. 76 FR at 21179 ("Under this method of making incentive-based compensation risk sensitive, the time period covered by the performance measures used in determining a covered person's award is extended (for example, from one year to two years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes associated with a covered person's activities are realized or better known.").

Long-term incentive plans are forward-looking plans designed to reward employees for performance over a multi-year period. These plans generally provide an award of cash or equity at the end of a performance period if the employee meets certain individual or institution-wide performance measures. Because they have longer performance periods, long-term incentive plans allow more time for information about a covered person's performance and risk-taking to become apparent, and covered institutions can take that information into account to balance risk and reward. Under current practice, the performance period for a long-term incentive plan is typically three years.[108]

2.42. The Agencies invite comment on whether the proposed definition of "long-term incentive plan" is appropriate for purposes of the proposed rule. Are there incentive-based compensation arrangements commonly used by financial institutions that would not be included within the definition of "long-term incentive plan" under the proposed rule but that, given the scope and purposes of section 956, should be included in such definition? If so, what are the features of such incentive-based compensation arrangements, why should the definition include such arrangements, and how should the definition be modified to include such arrangements?

Option. The proposed rule defines an "option" as an instrument through which a covered institution provides a covered person with the right, but not the obligation, to buy a specified number of shares representing an ownership stake in a company at a predetermined price within

[108] See Compensation Advisory Partners, "Large Complex Banking Organizations: Trends, Practices, and Outlook" (June 2012), available at http://www.capartners.com/uploads/news/id90/capartners.com-capflash-issue31.pdf; Pearl Meyer & Partners, "Trends in Incentive Compensation: How the Federal Reserve is Influencing Pay" (2013), available at https://pearlmeyer.com/pearl/media/pearlmeyer/articles/pmp-art-fedreserveinfluencingpay-so-bankdirector-5-14-2013.pdf; Meridian Compensation Partners, LLC, "Executive Compensation in the Banking Industry: Emerging Trends and Best Practices, 2014-2015" (June 22, 2015), available at https://www.meridiancp.com/wp-content/uploads/Executive-Compensation-in-the-Banking-Industry.pdf; Compensation Advisory Partners, "Influence of Federal Reserve on Compensation Design in Financial Services: An Analysis of Compensation Disclosures of 23 Large Banking Organizations" (April 24, 2013), available at http://www.capartners.com/uploads/news/id135/capartners.com-capflash-issue45.pdf; "The 2014 Top 250 Report: Long-term Incentive Grant Practices for Executives" ("Cook Report") (October 2014), available at http://www.fwcook.com/alert_letters/The_2014_Top_250_Report_Long-Term_Incentive_Grant_Practices_for_Executives.pdf; "Study of 2013 Short- and Long-term Incentive Design Criterion Among Top 200 S&P 500 Companies" (December 2014), available at http://www.ajg.com/media/1420659/study-of-2013-short-and-long-term-incentive-design-criterion-among-top-200.pdf.

a set time period or on a date certain, or any similar instrument, such as a stock appreciation right. Typically, covered persons must wait for a specified time period to conclude before obtaining the right to exercise an option.[109] The definition of option would also include option-like instruments that mirror some or all of the features of an option. For example, the proposed rule would include stock appreciation rights under the definition of option because the value of a stock appreciation right is based on a stock's price on a future date. As mentioned above, an option would be considered an equity-like instrument, as that term is defined in the proposed rule. NCUA's proposed rule does not include a definition of "option" because credit unions do not issue options.

Performance period. The proposed rule defines "performance period" as the period during which the performance of a covered person is assessed for purposes of determining incentive-based compensation. The Agencies intend for the proposed rule to provide covered institutions with flexibility in determining the length and the start and end dates of their employees' performance periods. For example, under the proposed rule, a covered institution could choose to have a performance period that coincided with a calendar year or with the covered institution's fiscal year (if the calendar year and fiscal year were different). A covered institution could also choose to have a performance period of one year for some incentive-based compensation and a performance period of three years for other incentive-based compensation.

2.43. Does the proposed rule's definition of "performance period" meet the goal of providing covered institutions with flexibility in determining the length and start and end dates of performance periods? Why or why not? Would a prescribed performance period, for example, periods that correspond to calendar years, be preferable? Why or why not?

Qualifying incentive-based compensation. The proposed rule defines "qualifying incentive-based compensation" as the amount of incentive-based compensation awarded to a covered person for a particular performance period, excluding amounts awarded to such covered person for that particular performance period under a long-term incentive plan. With the exception of long-term incentive plans, all forms of compensation, fees, and benefits that qualify as "incentive-based compensation," including annual bonuses, would be included in the amount

[109] As explained above in the definition of "deferral," the time period after the option vests but before it may be exercised is not considered part of the deferral period.

of qualifying incentive-based compensation. The deferral requirements of section ___.7(a) of the proposed rule would require a Level 1 or Level 2 covered institution to defer a specified percentage of any qualifying incentive-based compensation awarded to a significant risk-taker or senior executive officer for each performance period.

Regulatory report. Each Agency has included a definition of "regulatory report" in its version of the proposed rule that explains which regulatory reports would be required to be used by each of that Agency's covered institutions for the purposes of measuring average total consolidated assets under the proposed rule.

For a national bank, state member bank, state nonmember bank, federal savings association, and state savings association, "regulatory report" would mean the consolidated Reports of Condition and Income ("Call Report").[110] For a U.S. branch or agency of a foreign bank, "regulatory report" would mean the Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks—FFIEC 002. For a bank holding company, "regulatory report" would mean Consolidated Financial Statements for Bank Holding Companies ("FR Y–9C"). For a savings and loan holding company, "regulatory report" would mean FR Y-9C; if a savings and loan holding company is not required to file an FR Y-9C, Quarterly Savings and Loan Holding Company Report ("FR 2320"), if the savings and loan holding company reports consolidated assets on the FR 2320. For a savings and loan holding company that does not file a regulatory report within the meaning of the preceding sentence, "regulatory report" would mean a report of average total consolidated assets filed with the Board on a quarterly basis. For an Edge or Agreement Corporation, "regulatory report" would mean the Consolidated Report of Condition and Income for Edge and Agreement Corporations ("FR 2886b"). For the U.S. operations of a foreign banking organization, "regulatory report" would mean a report of average total consolidated U.S. assets filed with the Board on a quarterly basis. For subsidiaries of national banks, Federal savings associations, and Federal branches or agencies of foreign banking organizations that are not brokers, dealers, persons providing insurance, investment companies, or investment advisers, "regulatory report" would mean a report of the subsidiary's total consolidated assets prepared by the subsidiary, national bank, Federal savings association, or Federal branch or agency in a form that is acceptable to the OCC. For a regulated institution that

[110] Specifically, the OCC will refer to item RCFD 2170 of Schedule RC.

is a subsidiary of a bank holding company, savings and loan holding company, or a foreign banking organization, "regulatory report" would mean a report of the subsidiary's total consolidated assets prepared by the bank holding company, savings and loan holding company, or subsidiary in a form that is acceptable to the Board.

For FHFA's proposed rule, "regulatory report" would mean the Call Report Statement of Condition.

For a natural person credit union, "regulatory report" would mean the 5300 Call Report. For corporate credit unions, "regulatory report" would mean the 5310 Call Report.

For a broker or dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o), "regulatory report" would mean the FOCUS Report.[111] For an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act, and as discussed above, total consolidated assets would be determined by the investment adviser's total assets (exclusive of non-proprietary assets) shown on the balance sheet for the adviser's most recent fiscal year end.[112]

Vesting. Under the proposed rule, "vesting" of incentive-based compensation means the transfer of ownership[113] of the incentive-based compensation to the covered person to whom the incentive-based compensation was awarded, such that the covered person's right to the incentive-based compensation is no longer contingent on the occurrence of any event. Amounts awarded under an incentive-based compensation arrangement may vest immediately—for example, when the amounts are paid out to a covered person immediately and are not subject to deferral and forfeiture. As explained above, before amounts awarded to a covered person vest,

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[111] 17 CFR 240.17a-5(a); 17 CFR 249.617.

[112] The proposed rule would not apply the concept of a regulatory report and the attendant mechanics provided in section __.3 of the proposed rule to covered institutions that are investment advisers because such institutions are not currently required to report the amount of total consolidated assets to any Federal regulators in their capacities as investment advisers. *See* proposed definition of "average total consolidated assets" for the proposed method by which an investment adviser would determine its asset level for purposes of the proposed rule.

[113] Compensation awarded to a trust or other entity at the direction of, or for the benefit of, a covered person would be treated as compensation awarded to that covered person. If incentive-based compensation awarded to the entity cannot be reduced by forfeiture, the amounts would be treated as having vested at the time of the award.

the amounts could also be deferred and at risk of forfeiture. After amounts awarded to a covered person vest, the amounts could be subject to clawback, but they would not be at risk of forfeiture.

As described below in this Supplementary Information section, for incentive-based compensation to be counted toward the minimum deferral amount as discussed in section ___.7(a) of the proposed rule, a sufficient amount of time must elapse between the end of the performance period and the time when the deferred incentive-based compensation vests (and is no longer subject to forfeiture). During that deferral period, the award would be at risk of forfeiture.

If, after the award date, the covered institution had the right to require forfeiture of the shares or units awarded, then the award would not be considered vested. If, after the award date, the covered institution does not have the right to require forfeiture of the shares or units awarded, then the award would be vested and therefore would not be able to be counted toward the minimum deferral amount even if the shares or units have not yet been transferred to the covered person. For example, a covered institution could award an employee 100 shares of stock appreciation rights that pay out five years after the award date. In other words, five years after the award date, the covered institution will pay the employee the difference between the value of 100 shares of the covered institution's stock on the award date and the value of 100 shares of the covered institution's stock five years later. The amount the covered institution pays the employee could vary based on the value of the institution's shares. If the covered institution does not have the right to adjust the number of shares of stock appreciation rights before the payout, the stock appreciation rights would be considered vested as of the award date (even if the amount paid out could vary based on the value of the institution's shares). If, however, the covered institution has the right to adjust the number of shares of stock appreciation rights until payout to account for risk outcomes that occur after the award date (for example, by reducing the number of shares of stock appreciation rights from 100 to 50 based on a failure to comply with the institution's risk management policies), the stock appreciation rights would not be considered vested until payout. Similarly, amounts paid to a covered person pursuant to a dividend equivalent right would vest when the number of dividend equivalent rights cannot be adjusted by the covered institution on the basis of risk outcomes.

2.44. The Agencies invite comment generally on the proposed rule's definitions.

Relationship between defined terms.

The relationship between some of these defined terms can best be explained chronologically. Under the proposed rule, a covered institution's incentive-based compensation timeline would be as follows:

- Performance period. A covered person may have incentive-based compensation targets based on performance measures that would apply during a *performance period*. A covered person's performance or the performance of the covered institution during this period would influence the amount of incentive-based compensation *awarded* to the covered person. Before incentive-based compensation is *awarded* to a covered person, it should be subject to risk adjustments to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance, as described in section __.4(d) of the proposed rule. In addition, at any time during the performance period, incentive-based compensation could be subject to *downward adjustment*, as described in section __.7(b) of the proposed rule.

- Downward adjustment (if needed). Downward adjustment could occur at any time during a performance period if a Level 1 or Level 2 covered institution conducts a forfeiture and downward adjustment review under section ___.7(b) of the proposed rule and the Level 1 or Level 2 covered institution determines that incentive-based compensation not yet awarded for the current performance period should be reduced. In other words, downward adjustment applies to plans where the performance period has not yet ended.

- Award. At or near the end of a *performance period*, a covered institution would evaluate the covered person's or institution's performance, taking into account adjustments described in section __.4(d)(3) of the proposed rule, and determine the amount of incentive-based compensation, if any, to be awarded to the covered person for that *performance period*. At that time, the covered institution would determine what portion of the incentive-based compensation that is awarded will be *deferred*, as well as the *vesting* schedule for that deferred incentive-based compensation. A Level 1 or Level 2 covered institution could reduce the amount of incentive-based compensation payable to a senior executive officer or significant risk-taker depending on the outcome of a forfeiture and downward adjustment review, as described in section ___.7(b) of the proposed rule.

- Deferral period. The *deferral period* for incentive-based compensation awarded for a particular performance period would begin at the end of such *performance period*, regardless of when a covered institution *awards* incentive-based compensation to a covered person for that *performance period*. At any time during a *deferral period*, a covered institution could require *forfeiture* of some or all of the incentive-based compensation that has been *awarded* to the covered person but has not yet *vested*.

- Forfeiture (if needed). *Forfeiture* could occur at any time during the *deferral period* (after incentive-based compensation has been *awarded* but before it *vests*). A Level 1 or Level 2 covered institution could require forfeiture of unvested deferred incentive-based compensation payable to a senior executive officer or significant risk-taker based on the result of a forfeiture and downward adjustment review, as described in section ___.7(b) of the proposed rule. Depending on the outcome of a forfeiture and downward adjustment review under section ___.7(b) of the proposed rule, a covered institution could reduce, or eliminate, the unvested deferred incentive-based compensation of a senior executive officer or significant risk-taker.

- Vesting. *Vesting* could occur annually, on a pro rata basis, throughout a deferral period. *Vesting* could also occur at a slower than pro rata schedule, such as entirely at the end of a deferral period (vesting entirely at the end of a deferral period is sometimes called "cliff vesting"). The *deferral period* for a particular performance period would end when all incentive-based compensation awarded for that performance period has *vested*. A covered institution may also evaluate information that has arisen over the deferral period about financial losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance of the covered person at the time of *vesting* to determine if the amount that has been deferred should *vest* in full or should be reduced through forfeiture.

- Clawback (if needed). Clawback could be used to recover incentive-based compensation that has already *vested*. Clawback could be used after a *deferral period* has ended, and it also could be used to recover any portion of incentive-based compensation that *vests* before the end of a *deferral period*. A Level 1 or Level 2 covered institution would be required to include clawback provisions in incentive-based compensation arrangements for senior executive officers and significant risk-takers, as described in section ___.7(c) of the proposed rule.

2.45. Is the interplay of the award date, vesting date, performance period, and deferral period clear? If not, why not?

2.46. Have the Agencies made clear the distinction between the proposed definitions of clawback, forfeiture, and downward adjustment? Do these definitions align with current industry practice? If not, in what way do they differ and what are the implications of such differences for both the operations of covered institutions and the effective supervision of compensation practices?

§ ___.3 Applicability

Section ___.3 describes which provisions of the proposed rule would apply to an institution that is subject to the proposed rule when an increase or decrease in average total consolidated assets causes it to become a covered institution, transition to another level, or no longer meet the definition of covered institution. This process may differ somewhat depending on whether the institution is a subsidiary of, or affiliated with, another covered institution.

As discussed above, for an institution that is not an investment adviser, average total consolidated assets would be determined by reference to the average of the total consolidated assets reported on regulatory reports for the four most recent consecutive quarters. The Agencies are proposing this calculation method because it is also used to calculate total consolidated assets for purposes of other rules that have $50 billion thresholds,[114] and it is therefore expected to result in lower administrative burden on some institutions – particularly when those institutions move from Level 3 to Level 2 – if the proposed rule requires total consolidated assets to be calculated in the same way as existing rules.

As discussed above, average total consolidated assets for a covered institution that is an investment adviser would be determined by the investment adviser's total assets (exclusive of

[114] See, e.g., OCC's Heightened Standards; 12 CFR 46.3; 12 CFR 225.8; 12 CFR 243.2; 12 CFR 252.30; 2 CFR 252.132; 12 CFR 325.202; 12 CFR 381.2.

non-proprietary assets) shown on the balance sheet for the adviser's most recent fiscal year end. The proposed rule would not apply the concept of a regulatory report and the attendant mechanics provided in section __.3 of the proposed rule to covered institutions that are investment advisers because such institutions are not currently required to report the amount of total consolidated assets to any Federal regulators in their capacities as investment advisers.

(a) When average total consolidated assets increase.

Section ___.3(a) of the proposed rule describes how the proposed rule would apply to institutions that are subject to the proposed rule when average total consolidated assets increase. It generally provides that an institution that is not a subsidiary of another covered institution becomes a Level 1, Level 2, or Level 3 covered institution when its average total consolidated assets increase to an amount that equals or exceeds $250 billion, $50 billion, or $1 billion, respectively. For subsidiaries of other covered institutions, the Agencies would generally look to the average total consolidated assets of the top-tier parent holding company to determine whether average total consolidated assets have increased.

Given the unique characteristics of the different types of covered institutions subject to each Agency's proposed rule, each Agency's proposed rule contains specific language for subsidiaries that is consistent with the same general approach. For example, under the Board's proposed rule, a regulated institution would become a Level 1, Level 2, or Level 3 covered institution when its average total consolidated assets or the average total consolidated assets of any of its affiliates, equals or exceeds $250 billion, $50 billion, or $1 billion, respectively. Under the OCC's proposed rule, a national bank that is a subsidiary of a bank holding company would become a Level 1, Level 2, or Level 3 covered institution when the top-tier bank holding company's average total consolidated assets equals or exceeds $250 billion, $50 billion, or $1 billion, respectively. Because the Federal Home Loan Banks have no subsidiaries, and subsidiaries of the Enterprises are included as affiliates as part of the definition of the Enterprises, FHFA's proposed rule does not include specific language to address subsidiaries. Because the NCUA's rule does not cover subsidiaries of credit unions and credit unions are not subsidiaries of other types of institutions, NCUA's proposed rule does not include specific language to address subsidiaries. More detail on each Agency's proposed approach to subsidiaries is provided in the above discussion of definitions relating to covered institutions.

For covered institutions other than investment advisers and the Federal Home Loan Banks, using a rolling average for asset size, rather than measuring asset size at a single point in time, should minimize the frequency with which an institution may fall into or out of a covered institution level. As explained above, if a covered institution has fewer than four regulatory reports, the institution would be required to use the average of its total consolidated assets from its existing regulatory reports for purposes of determining average total consolidated assets. If a covered institution has a mix of two or more different types of regulatory reports covering the relevant period, those would be averaged for purposes of determining average total consolidated assets.

Section ___.3(a)(2) of the proposed rule provides a transition period for institutions that were not previously considered covered institutions and for covered institutions moving from a lower level to a higher level due to an increase in average total consolidated assets. Such covered institutions would be required to comply with the requirements for their new level not later than the first day of the first calendar quarter that begins at least 540 days after the date on which they become Level 1, Level 2, or Level 3 covered institutions. Prior to such date, the institutions would be required to comply with the requirements of the proposed rule, if any, that were applicable to them on the day before they became Level 1, Level 2, or Level 3 covered institutions as a result of the increase in assets. For example, if a Level 3 covered institution that is not a subsidiary of a depository institution holding company has average total consolidated assets that increase to more than $50 billion on December 31, 2015, then such institution would become a Level 2 covered institution on December 31, 2015. However, the institution would not be required to comply with the requirements of the proposed rule that are applicable to a Level 2 covered institution until July 1, 2017. Prior to July 1, 2017, (the compliance date), the institution would remain subject to the requirements of the proposed rule that are applicable to a Level 3 covered institution. The covered institution’s controls, risk management, and corporate governance also would be required to comply with the provisions of the proposed rule that are applicable to a Level 2 covered institution no later than July 1, 2017. The Agencies are proposing this delay between the date when a covered institution’s average total consolidated assets increase and the date when the covered institution becomes subject to the requirements related to its new level to provide covered institutions with sufficient time to comply with the new requirements.

The same general rule would apply to covered institutions that are subsidiaries (or, in the case of the Board's proposed rule, affiliates) of other covered institutions. For example, a Level 3 state savings association that is a subsidiary of a Level 3 savings and loan holding company, and a Level 3 subsidiary of that state savings association, would become a Level 2 covered institution on December 31, 2015, if the average total consolidated assets of the savings and loan holding company increased to more than $50 billion on December 31, 2015, and would not be required to comply with the requirements of the proposed rule that are applicable to a Level 2 covered institution until July 1, 2017.

Section ___.3(a)(3) of the proposed rule provides that incentive-based compensation plans with performance periods that begin before the compliance date described in section ___.3(a)(2) would not be required to comply with the requirements of the proposed rule that become applicable to the covered institution on the compliance date as a result of the change in its status as a Level 1, Level 2, or Level 3 covered institution. Incentive-based compensation plans with a performance period that begins on or after the compliance date described in section ___.3(a)(2) would be required to comply with the rules for the covered institution's new level. In the example described in the previous paragraph, any incentive-based compensation plan with a performance period that begins before July 1, 2017, would not be required to comply with the requirements of the proposed rule that are applicable to a Level 2 covered institution (although any such plan would be required to comply with the requirements of the proposed rule that are applicable to a Level 3 covered institution).

The Agencies have included this grandfathering provision so that covered institutions would not be required to modify incentive-based compensation plans that are already in place when a covered institution's average total consolidated assets increase such that it moves to a higher level. However, incentive-based compensation plans with performance periods that begin after the compliance date would be subject to the rules that apply to the covered institution's new level. In the previous example, any incentive-based compensation plan for a senior executive officer with a performance period that begins on or after July 1, 2017, would be required to comply with the requirements of the proposed rule that are applicable to a Level 2 covered institution, such as the deferral, forfeiture, downward adjustment, and clawback requirements contained in section ___.7 of the proposed rule.

Because institutions that would be covered institutions under the proposed rule commonly use long-term incentive plans with overlapping performance periods or incentive-based compensation plans with performance periods of one year, the Agencies do not anticipate that the grandfathering provision would unduly delay the application of the proposed rule to individual incentive-based compensation arrangements.

3.1. The Agencies invite comment on whether a covered institution's average total consolidated assets (a rolling average) is appropriate for determining a covered institution's level when its total consolidated assets increase. Why or why not? Will 540 days provide covered institutions with adequate time to adjust incentive-based compensation programs to comply with different requirements? If not, why not? In the alternative, is 540 days too long to give covered institutions time to comply with the requirements of the proposed rule? Why or why not?

3.2. The Agencies invite comment on whether the date described in section ___.3(a)(2) should instead be the beginning of the first performance period that begins at least 365 days after the date on which the regulated institution becomes a Level 1, Level 2, or Level 3 covered institution in order to have the date on which the proposed rule's corporate governance, policies, and procedures requirements begin coincide with the date on which the requirements applicable to plans begin. Why or why not?

(b) When total consolidated assets decrease.

Section ___.3(b) of the proposed rule describes how the proposed rule would apply to an institution when assets decrease. A covered institution (other than an investment adviser) that is not a subsidiary of another covered institution would cease to be a Level 1, Level 2, or Level 3 covered institution if its total consolidated assets, as reported on its regulatory reports, fell below the relevant total consolidated assets threshold for Level 1, Level 2, or Level 3 covered institutions, respectively, for four consecutive quarters. The calculation would be effective on the as-of date of the fourth consecutive regulatory report. For example, a bank holding company that is a Level 2 covered institution with total consolidated assets of $55 billion on January 1, 2016, might report total consolidated assets of $48 billion for the first quarter of 2016, $49 billion for the second quarter of 2016, $49 billion for the third quarter of 2016, and $48 billion for the fourth quarter of 2016. On the as-of date of the Y-9C submitted for the fourth quarter of

2016, that bank holding company would become a Level 3 covered institution because its total consolidated assets were less than $50 billion for four consecutive quarters. In contrast, if that same bank holding company reported total consolidated assets of $48 billion for the first quarter of 2016, $49 billion for the second quarter of 2016, $49 billion for the third quarter of 2016, and $51 billion for the fourth quarter of 2016, it would still be considered a Level 2 covered institution on the as-of date of the Y-9C submitted for the fourth quarter of 2016 because it had total consolidated assets of less than $50 billion for only 3 consecutive quarters. If the bank holding company had total consolidated assets of $49 billion in the first quarter of 2017, it still would not become a Level 3 covered institution at that time because it would not have four consecutive quarters of total consolidated assets of less than $50 billion. The bank holding company would only become a Level 3 covered institution if it had four consecutive quarters with total consolidated assets of less than $50 billion *after* the fourth quarter of 2016.

As with section ___.3(a), a Level 1, Level 2, or Level 3 covered institution that is a subsidiary of another Level 1, Level 2, or Level 3 covered institution would cease to be a Level 1, Level 2, or Level 3 covered institution when the top-tier parent covered institution ceases to be a Level 1, Level 2, or Level 3 covered institution. As with section __.3(a), each Agency's proposed rule takes a slightly different approach that is consistent with the same general principle. For example, if a broker-dealer with less than $50 billion in average total consolidated assets is a Level 2 covered institution because its parent bank holding company has more than $50 billion in average total consolidated assets, the broker-dealer would become a Level 3 covered institution if its parent bank holding company had less than $50 billion in total consolidated assets for four consecutive quarters, thus causing the parent bank holding company itself to become a Level 3 covered institution.

The proposed rule would not require any transition period when a decrease in a covered institution's total consolidated assets causes it to become a Level 2 or Level 3 covered institution or to no longer be a covered institution. The Agencies are not proposing to include a transition period in this case because the new requirements would be less stringent than the requirements that were applicable to the covered institution before its total consolidated assets decreased, and therefore a transition period should be unnecessary. Instead, the covered institution would immediately be subject to the provisions of the proposed rule, if any, that are applicable to it as a result of the decrease in its total consolidated assets. For example, if as a result of having four consecutive regulatory reports with total consolidated assets less than $50 billion, a bank holding company that was previously a Level 2 covered institution becomes a Level 3 covered institution as of June 30, 2017, then as of June 30, 2017 that bank holding company would no longer be subject to the requirements of the proposed rule that are applicable to Level 2 covered institutions. It would instead be subject to the requirements of the proposed rule that are applicable to Level 3 covered institutions.

A covered institution that is an investment adviser would cease to be a Level 1, Level 2, or Level 3 covered institution effective as of the most recent fiscal year end in which its total consolidated assets fell below the relevant asset threshold for Level 1, Level 2, or Level 3 covered institutions, respectively. For example, an investment adviser that is a Level 1 covered institution during 2015 would cease to be a Level 1 covered institution effective on December 31, 2015 if its total assets (exclusive of non-proprietary assets) shown on its balance sheet for the year ended December 31, 2015 (assuming the investment adviser had a calendar fiscal year) were less than $250 billion.

3.3. The Agencies invite comment on whether four consecutive quarters is an appropriate period for determining a covered institution's level when its total consolidated assets decrease. Why or why not?

3.4. Should the determination of total consolidated assets for covered institutions that are investment advisers be by reference to a periodic report or similar concept? Why or why not? Should there be a concept of a rolling average for asset size for covered institutions that are investment advisers and, if so, how should this be structured?

3.5. Should the transition period for an institution that changes levels or becomes a covered institution due to a merger or acquisition be different than an institution that changes levels or becomes a covered institution without a change in corporate structure? If so, why? If so, what transition period would be appropriate and why?

3.6. The Agencies invite comment on whether covered institutions transitioning from Level 1 to Level 2 or Level 2 to Level 3 should be permitted to modify incentive-based compensation plans with performance periods that began prior to their transition in level in such a way that would cause the plans not to meet the requirements of the proposed rule that were applicable to the covered institution at the time when the performance periods for the plans commenced. Why or why not?

(c) Compliance of covered institutions that are subsidiaries of covered institutions.

Section __.3(c) of the Board's, OCC's, or FDIC's proposed rules provide that a covered institution that is subject to the Board's, OCC's, or FDIC's proposed rule, respectively, and that is a subsidiary of another covered institution may meet any requirement of the proposed rule if the parent covered institution complies with such requirement in a way that causes the relevant portion of the incentive-based compensation program of the subsidiary covered institution to comply with the requirement. The Board, the OCC, and the FDIC have included this provision in their proposed rules in order to reduce the compliance burden on subsidiaries that would be subject to the Board's, OCC's, and FDIC's proposed rules and in recognition of the fact that holding companies, national banks, Federal savings associations, state nonmember banks, and state savings associations may perform certain functions on behalf of such subsidiaries.

Subsidiary covered institutions subject to the Board's, OCC's, or FDIC's proposed rule could rely on this provision to comply with, for example, the corporate governance or policies and procedures requirements of the proposed rule. For example, if a parent bank holding company has a compensation committee that performs the requirements of section __.4(e) of the proposed rule with respect to a subsidiary of the parent bank holding company that is a covered institution under the Board's rule by (1) conducting oversight of the subsidiary's incentive-based compensation program, (2) approving incentive-based compensation arrangements for senior executive officers of the subsidiary (including any individuals who are senior executive officers of the subsidiary but not senior executive officers of the parent bank holding company), and (3) approving any material exceptions or adjustments to incentive-based compensation policies or arrangements for such senior executive officers of the subsidiary, then the subsidiary would be deemed to have complied with the requirements of section __.4(e) of the proposed rule. Similarly, under the OCC's proposed rule, if an operating subsidiary of a national bank that is a Level 1 or Level 2 covered institution subject to the OCC's proposed rule uses the policies and procedures for its incentive-based compensation program of its parent national bank that is also a Level 1 or Level 2 covered institution subject to the OCC's proposed rule, and such policies and procedures satisfy the requirements of section __.11 of the proposed rule, then the OCC would consider the subsidiary to have satisfied section __.11 of the proposed rule. Under the FDIC's proposed rule, if a subsidiary of a state nonmember bank or state savings association that is a covered institution subject to the FDIC's proposed rule uses the policies and procedures for its incentive-based compensation program of its parent state nonmember bank or state savings association that is a Level 1 or Level 2 covered institution subject to the FDIC's proposed rule, and such policies and procedures satisfy the requirements of section __.11 of the proposed rule, then the FDIC would consider the subsidiary to have satisfied section __.11 of the proposed rule.

Many parent holding companies, particularly larger banking organizations, design and administer incentive-based compensation programs and associated policies and procedures. Smaller covered institutions that operate within a larger holding company structure may realize efficiencies by incorporating or relying upon their parent company's incentive-based compensation program or certain components of the program, to the extent that the program or its components establish governance, risk management, and recordkeeping frameworks that are appropriate to the smaller covered institutions and support incentive-based compensation arrangements that appropriately balance risks to the smaller covered institution and rewards for its covered persons. Therefore, it may be less burdensome for covered institution subsidiaries with risk profiles that are similar to those of their parent holding companies to use their parent holding companies' program rather than their own.

The Agencies recognize that the authority of each appropriate Federal regulator to examine and review compliance with the proposed rule, along with requiring corrective action when they deem appropriate, would not be affected by section __.3(c) of the Board's, OCC's, or FDIC's proposed rule. Each appropriate Federal regulator would be responsible for examining, reviewing, and enforcing compliance with the proposed rule by their covered institutions, including any that are owned or controlled by a depository institution holding company. For example, in the situation where a parent holding company controls a subsidiary national bank, state nonmember bank, or broker-dealer, it would be expected that the board of directors of the subsidiary will ensure that the subsidiary is in compliance with the proposed rule. Likewise, the board of directors of a broker-dealer operating subsidiary of a national bank would be expected to ensure that the broker-dealer operating subsidiary is in compliance with the proposed rule.

§ ___.4 Requirements and Prohibitions Applicable to All Covered Institutions

Section ___.4 sets forth the general requirements that would be applicable to all covered institutions. Later sections establish more specific requirements that would be applicable for Level 1 and Level 2 covered institutions.

Under the proposed rule, all covered institutions would be prohibited from establishing or maintaining incentive-based compensation arrangements, or any features of any such arrangements, that encourage inappropriate risks by the covered institution (1) by providing covered persons with excessive compensation, fees, or benefits or (2) that could lead to material financial loss to the covered institution. Section ___.4 includes considerations for determining whether an incentive-based compensation arrangement provides excessive compensation, fees, or benefits, as required by section 956(a)(1). Section ___.4 also establishes requirements that would apply to all covered institutions designed to prevent inappropriate risks that could lead to material financial loss, as required by section 956(a)(2).[115] The general standards and requirements set forth in sections ___.4(a), (b), and (c) of the proposed rule would be consistent with the general standards and requirements set forth in sections ___.5(a) and (b) of the 2011 Proposed Rule.

The Agencies do not intend to establish a rigid, one-size-fits-all approach to the design of incentive-based compensation arrangements. Thus, under the proposed rule, the structure of incentive-based compensation arrangements at covered institutions would be expected to reflect the proposed requirements set forth in section ___.4 of the proposed rule in a manner tailored to the size, complexity, risk tolerance, and business model of the covered institution. Subject to supervisory oversight, as applicable, each covered institution would be responsible for ensuring that its incentive-based compensation arrangements appropriately balance risk and reward. The methods by which this is achieved at one covered institution may not be effective at another, in part because of the importance of integrating incentive-based compensation arrangements and practices into the covered institution's own risk-management systems and business model. The effectiveness of methods may differ across business lines and operating units as well, so the proposed rule would provide for considerable flexibility in how individual covered institutions

[115] In addition to the requirements outlined in section __.4, Level 1 and Level 2 covered institutions would have to meet additional requirements set forth in section __.5 and sections __.7 through __.11.

approach the design and implementation of incentive-based compensation arrangements that appropriately balance risk and reward.

(a) In general.

Section ___.4(a) of the proposed rule is derived from the text of section 956(b) which requires the Agencies to jointly prescribe regulations or guidelines that prohibit any type of incentive-based payment arrangement, or any feature of any such arrangement, that the Agencies determine encourages inappropriate risks by covered institutions (1) by providing an executive officer, employee, director, or principal shareholder of the covered institution with excessive compensation, fees, or benefits or (2) that could lead to material financial loss to the covered institution.

(b) Excessive compensation.

Section ___.4(b) of the proposed rule specifies that compensation, fees, and benefits would be considered excessive for purposes of section __.4(a)(1) when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into account all relevant factors. Section 956(c) directs the Agencies to "ensure that any standards for compensation established under subsections (a) or (b) are comparable to the standards established under section [39] of the Federal Deposit Insurance Act (12 U.S.C. 2 [sic] 1831p-1) for insured depository institutions." Under the proposed rule, the factors for determining whether an incentive-based compensation arrangement provides excessive compensation would be comparable to the Federal Banking Agency Safety and Soundness Guidelines that implement the requirements of section 39 of the FDIA.[116] The proposed factors

[116] The Federal Banking Agency Safety and Soundness Guidelines provide:
Compensation shall be considered excessive when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder, considering the following:

1. The combined value of all cash and non-cash benefits provided to the individual;
2. The compensation history of the individual and other individuals with comparable expertise at the institution;
3. The financial condition of the institution;
4. Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;
5. For postemployment benefits, the projected total cost and benefit to the institution;

would include: (1) the combined value of all compensation, fees, or benefits provided to the covered person; (2) the compensation history of the covered person and other individuals with comparable expertise at the covered institution; (3) the financial condition of the covered institution; (4) compensation practices at comparable covered institutions, based upon such factors as asset size, geographic location, and the complexity of the covered institution's operations and assets; (5) for post-employment benefits, the projected total cost and benefit to the covered institution; and (6) 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. The inclusion of these factors is consistent with the requirement under section 956(c) that any standards for compensation under section 956(a) or (b) must be comparable to the standards established for insured depository institutions under the FDIA and that the Agencies must take into consideration the compensation standards described in section 39(c) of the FDIA.

In response to similar language in the 2011 Proposed Rule, some commenters indicated that this list of factors should include additional factors or allow covered institutions to consider other factors that they deem appropriate. The proposed rule clarifies that all relevant factors would be taken into consideration, and that the list of factors in section __.4(b) would not be exclusive.

Commenters on the 2011 Proposed Rule expressed concern that it would be difficult for some types of institutions, such as grandfathered unitary savings and loan holding companies with retail operations, mutual savings associations, mutual savings banks, and mutual holding companies, to identify comparable covered institutions. Those commenters also expressed concern that it would be difficult for these institutions to identify the compensation practices of comparable institutions that are not public companies or that do not otherwise make public information about their compensation practices. The Agencies intend to work closely with these institutions to identify comparable institutions to help ensure compliance with the proposed rule.

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6. Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and

7. Any other factors the Agencies determines to be relevant.

See 12 CFR part 30, Appendix A, III.A; 12 CFR part 364, Appendix A, III.A; 12 CFR part 208, Appendix D-1. These factors are drawn directly from section 39(c)(2) of the FDIA (12 U.S.C. 1831p-1(c)(2)).

(c) Material financial loss.

Section 956(b)(2) of the Act requires the Agencies to adopt regulations or guidelines that prohibit any type of incentive-based payment arrangement, or any feature of any such arrangement, that the Agencies determine encourages inappropriate risks by a covered financial institution that could lead to material financial loss to the covered institution. In adopting such regulations or guidelines, the Agencies are required to ensure that any standards established under this provision of section 956 are comparable to the standards under Section 39 of the FDIA, including the compensation standards. However, section 39 of the FDIA does not include standards for determining whether compensation arrangements may encourage inappropriate risks that could lead to material financial loss.[117] Accordingly, as in the 2011 Proposed Rule, the Agencies have considered the language and purpose of section 956, existing supervisory guidance that addresses incentive-based compensation arrangements that may encourage inappropriate risk-taking,[118] the FSB Principles and Implementation Standards, and other relevant material in considering how to implement this aspect of section 956.

A commenter argued that the provisions of the 2011 Proposed Rule relating to incentive-based compensation arrangements that could encourage inappropriate risks that could lead to material financial loss were not comparable to the standards established under section 39 of the FDIA. More specifically, the commenter believed that the requirements of the 2011 Proposed Rule, including the mandatory deferral requirement, were more "detailed and prescriptive" than the standards established under section 39 of the FDIA.

The Agencies intend that the requirements of the proposed rule implementing section 956(b)(2) of the Act would be comparable to the standards established under section 39 of the FDIA. Section 956(b)(2) of the Act requires that the Agencies prohibit incentive-based compensation arrangements that encourage inappropriate risks by covered institutions that could lead to material financial loss, a requirement that is not discussed in the standards established under section 39 of the FDIA, which, as discussed above, provide guidelines to determine when

[117] Section 39 of the FDIA requires only that the Federal banking agencies prohibit as an unsafe and unsound practice any employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement that could lead to a material financial loss. See 12 U.S.C. 1831p-1(c)(1)(B). The Federal Banking Agency Safety and Soundness Guidelines satisfy this requirement.

[118] 2010 Federal Banking Agency Guidance.

compensation paid to a particular executive officer, employee, director or principal shareholder would be excessive. In enacting section 956, Congress referred specifically to the standards established under section 39 of the FDIA, and was presumably aware that in the statute there were no such standards articulated that provide guidance for determining whether compensation arrangements could lead to a material financial loss. The provisions of the proposed rule implementing section 956(b)(2) reflect the Agencies' intent to comply with the statutory mandate under section 956, while ensuring that the proposed rule is comparable to section 39 of the FDIA, which states that compensatory arrangements that could lead to a material financial loss are an unsafe and unsound practice.

Section ___.4(c) of the proposed rule sets forth minimum requirements for incentive-based compensation arrangements that would be permissible under the proposed rule, because arrangements without these attributes could encourage inappropriate risks that could lead to material financial loss to a covered institution. These requirements reflect the three principles for sound incentive-based compensation policies contained in the 2010 Federal Banking Agency Guidance: (1) balanced risk-taking incentives; (2) compatibility with effective risk management and controls; and (3) effective corporate governance.[119] Similarly, section __.4(c) of the proposed rule provides that an incentive-based compensation arrangement at a covered institution could encourage inappropriate risks that could lead to material financial loss to the covered institution, unless the arrangement: (1) appropriately balances risk and reward; (2) is compatible with effective risk management and controls; and (3) is supported by effective governance.

An example of a feature that could encourage inappropriate risks that could lead to material financial loss would be the use of performance measures that are closely tied to short-term revenue or profit of business generated by a covered person, without any adjustments for the longer-term risks associated with the business generated. Similarly, if there is no mechanism for factoring risk outcomes over a longer period of time into compensation decisions, traders who have incentive-based compensation plans with performance periods that end at the end of the calendar year, could have an incentive to take large risks towards the end of the calendar year to either make up for underperformance earlier in the performance period or to maximize their

[119] See 75 FR 36407-36413.

year-end profits. The same result could ensue if the performance measures themselves are poorly designed or can be manipulated inappropriately by the covered persons receiving incentive-based compensation.

Incentive-based compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for a covered institution. However, short-run revenue or profit can often diverge sharply from actual long-run profit because risk outcomes may become clear only over time. Activities that carry higher risk typically have the potential to yield higher short-term revenue, and a covered person who is given incentives to increase short-term revenue or profit, without regard to risk, would likely be attracted to opportunities to expose the covered institution to more risk that could lead to material financial loss.

Section ___.4(c)(1) of the proposed rule would require all covered institutions to ensure that incentive-based compensation arrangements appropriately balance risk and reward. Incentive-based compensation arrangements achieve balance between risk and financial reward when the amount of incentive-based compensation ultimately received by a covered person depends not only on the covered person's performance, but also on the risks taken in achieving this performance. Conversely, an incentive-based compensation arrangement that provides financial reward to a covered person without regard to the amount and type of risk produced by the covered person's activities would not be considered to appropriately balance risk and reward under the proposed rule.[120] Incentive-based compensation arrangements should balance risk and financial rewards in a manner that does not encourage covered persons to expose a covered institution to inappropriate risk that could lead to material financial loss.

The incentives provided by an arrangement depend on how all features of the arrangement work together. For instance, how performance measures are combined, whether they take into account both current and future risks, which criteria govern the use of risk adjustment before the awarding and vesting of incentive-based compensation, and what form incentive-based compensation takes (i.e., equity-based vehicles or cash-based vehicles) can all

[120] For example, a covered person who makes a high-risk loan may generate more revenue in the short run than one who makes a low-risk loan. Incentive-based compensation arrangements that reward covered persons solely on the basis of short-term revenue might pay more to the covered person taking more risk, thereby incentivizing employees to take more, and sometimes inappropriate, risk. See 2011 FRB Report at 11.

affect risk-taking incentives and generally should be considered when covered institutions create such arrangements.

The 2010 Federal Banking Agency Guidance outlined four methods that can be used to make compensation more sensitive to risk—risk adjustments of awards, deferral of payment, longer performance periods, and reduced sensitivity to short-term performance.[121] Consistent with the 2010 Federal Banking Agency Guidance, under the proposed rule, an incentive-based compensation arrangement generally would have to take account of the full range of current and potential risks that a covered person's activities could pose for a covered institution. Relevant risks would vary based on the type of covered institution, but could include credit, market (including interest rate and price), liquidity, operational, legal, strategic, and compliance risks. Performance and risk measures generally should align with the broader risk management objectives of the covered institution and could be incorporated through use of a formula or through the exercise of judgment. Performance and risk measures also may play a role in setting amounts of incentive-based compensation pools (bonus pools), in allocating pools to individuals' incentive-based compensation, or both. The effectiveness of different types of adjustments varies with the situation of the covered person and the covered institution, as well as the thoroughness with which the measures are implemented.

The analysis and methods for ensuring that incentive-based compensation arrangements appropriately balance risk and reward should also be tailored to the size, complexity, business strategy, and risk tolerance of each institution. The manner in which a covered institution seeks to balance risk and reward in incentive-based compensation arrangements should account for the differences between covered persons—including the differences between senior executive officers and significant risk-takers and other covered persons. Activities and risks may vary significantly both among covered institutions and among covered persons within a particular covered institution. For example, activities, risks, and incentive-based compensation practices may differ materially among covered institutions based on, among other things, the scope or complexity of activities conducted and the business strategies pursued by the institutions. These differences mean that methods for achieving incentive-based compensation arrangements that

[121] See 2010 Federal Banking Agency Guidance, 75 FR at 36396.

appropriately balance risk and reward at one institution may not be effective in restraining incentives to engage in imprudent risk-taking at another institution.

The proposed rule would require that incentive-based compensation arrangements contain certain features. Section ___.4(d) sets out specific requirements that would be applicable to arrangements for all covered persons at all covered institutions and that are intended to result in incentive-based compensation arrangements that appropriately balance risk and reward. Sections ___.7 and ___.8 of the proposed rule provide more specific requirements that would be applicable to arrangements at Level 1 and Level 2 covered institutions.

While the proposed rule would require incentive-based compensation arrangements for senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions to have certain features (such as a certain percentage of the award deferred), those features alone would not be sufficient to balance risk-taking incentives with reward. The extent to which additional balancing methods are required would vary with the size and complexity of a covered institution and with the nature of a covered person's activities.

Section __.4(c)(2) of the proposed rule provides that an incentive-based compensation arrangement at a covered institution would encourage inappropriate risks that could lead to material financial loss to the covered institution unless the arrangement is compatible with effective risk management and controls. A covered institution's risk management processes and internal controls would have to reinforce and support the development and maintenance of incentive-based compensation arrangements that appropriately balance risk and reward required under section __.4(c)(1) of the proposed rule.

One of the reasons risk management is important is that covered persons may seek to evade the processes established by a covered institution to achieve incentive-based compensation arrangements that appropriately balance risk and reward in an effort to increase their own incentive-based compensation. For example, a covered person might seek to influence the risk measures or other information or judgments that are used to make the covered person's incentive-based compensation sensitive to risk. Such actions may significantly weaken the effectiveness of a covered institution's incentive-based compensation arrangements in restricting inappropriate risk-taking and could have a particularly damaging effect if they result in the manipulation of measures of risk, information, or judgments that the covered institution uses for other risk-management, internal control, or financial purposes. In such cases, the covered person's actions may weaken not only the balance of the covered institution's incentive-based compensation arrangements but also the risk-management, internal controls, and other functions that are supposed to act as a separate check on risk-taking.

All covered institutions would have to have appropriate controls surrounding the design, implementation, and monitoring of incentive-based compensation arrangements to ensure that processes for achieving incentive-based compensation arrangements that appropriately balance risk and reward are followed, and to maintain the integrity of their risk-management and other control functions. The nature of controls likely would vary by size and complexity of the covered institution as well as the activities of the covered person. For example, under the proposed rule, controls surrounding incentive-based compensation arrangements at smaller covered institutions likely would be less extensive and less formalized than at larger covered institutions. Level 1 and Level 2 covered institutions would be more likely to have a systematic approach to designing and implementing their incentive-based compensation arrangements, and their incentive-based compensation programs would more likely be supported by formalized and well-developed policies, procedures, and systems. Level 3 covered institutions, on the other hand, might maintain less extensive and detailed incentive-based compensation programs. Section ___.9 of the proposed rule provides additional, specific requirements that would be applicable to Level 1 and Level 2 covered institutions designed to result in incentive-based compensation arrangements at Level 1 and Level 2 covered institutions that are compatible with effective risk management and controls.

Incentive-based compensation arrangements also would have to be supported by an effective governance framework. Section ___.4(e) sets forth more detail on requirements for boards of directors of all covered institutions that would be designed to result in incentive-based compensation arrangements that are supported by effective governance, while section ___.10 of the proposed rule provides more specific requirements that would be applicable to Level 1 and Level 2 covered institutions.

The proposed requirement for effective governance is an important foundation of incentive-based compensation arrangements that appropriately balance risk and reward. The involvement of the board of directors in oversight of the covered institution's overall incentive-based compensation program should be scaled appropriately to the scope of the covered institution's incentive-based compensation arrangements and the number of covered persons who have incentive-based compensation arrangements.

(d) Performance measures.

The performance measures used in an incentive-based compensation arrangement have an important effect on the incentives provided to covered persons and thus affect the potential for the incentive-based compensation arrangement to encourage inappropriate risk-taking that could lead to material financial loss. Under section __.4(d) of the proposed rule, an incentive-based compensation arrangement would not be considered to appropriately balance risk and reward unless: (1) it includes financial and non-financial measures of performance that are relevant to a covered person's role and to the type of business in which the covered person is engaged and that are appropriately weighted to reflect risk-taking; (2) it is designed to allow non-financial measures of performance to override financial measures when appropriate; and (3) any amounts to be awarded under the arrangement are subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance. Each of these requirements is described more fully below.

First, the arrangements would be required to include both financial and non-financial measures of performance. Financial measures of performance generally are measures tied to the attainment of strategic financial objectives of the covered institution, or one of its operating units, or to the contributions by covered persons towards attainment of such objectives, such as measures related to corporate sales, profit, or revenue targets. Non-financial measures of performance, on the other hand, could be assessments of a covered person's risk-taking or compliance with limits on risk-taking. These may include assessments of compliance with the covered institution's policies and procedures, adherence to the covered institution's risk framework and conduct standards, or compliance with applicable laws. These financial and non-financial measures of performance should include considerations of risk-taking, and be relevant to a covered person's role within the covered institution and to the type of business in which the covered person is engaged. They also should be appropriately weighted to reflect the nature of such risk-taking. The requirement to include both financial and non-financial measures of performance would apply to forms of incentive-based compensation that set out performance measure goals and related amounts near the beginning of a performance period (such as long-term incentive plans) and to forms that do not necessarily specify performance measure goals and related amounts in advance of performance (such as certain bonuses). For example, a senior executive officer may have his or her performance evaluated based upon quantitative financial measures, such as return on equity, and on qualitative, non-financial measures, such as the extent to which the senior executive officer promoted sound risk management practices or provided strategic leadership through a difficult merger. The senior executive officer's performance also may be evaluated on several qualitative non-financial measures that in some instances span multiple calendar and performance years.

Incentive-based compensation should support prudent risk-taking, but should also allow covered institutions to hold covered persons accountable for inappropriate behavior. Reliable quantitative measures of risk and risk outcomes, where available, may be particularly useful in both developing incentive-based compensation arrangements that appropriately balance risk and reward and assessing the extent to which incentive-based compensation arrangements properly balance risk and reward. However, reliable quantitative measures may not be available for all types of risk or for all activities, and in many cases may not be sufficient to fully assess the risks that the activities of covered persons may pose to covered institutions. Poor performance, as assessed by non-financial measures such as quality of risk management, could pose significant risks for the covered institution and may itself be a source of potential material financial loss at a covered institution. For this reason, non-financial performance measures play an important role in reinforcing expectations on appropriate risk, control, and compliance standards and should form a significant part of the performance assessment process.

Under certain circumstances, it may be appropriate for non-financial performance measures, which are the primary measures that relate to risk-taking behavior, to override considerations of financial performance measures. An override might be appropriate when, for example, a covered person conducts trades or other transactions that increase the covered institution's profit but that create an inappropriate compliance risk for the covered institution. In such a case, an incentive-based compensation arrangement should allow for the possibility that the non-financial measure of compliance risk could override the financial measure of profit when the amount of incentive-based compensation to be awarded to the covered person is determined.

The effective balance of risks and rewards may involve the use of both formulaic arrangements and discretion. At most covered institutions, management retains a significant amount of discretion when awarding incentive-based compensation. Although the use of discretion has the ability to reinforce risk balancing, when improperly utilized, discretionary decisions can undermine the goal of incentive-based compensation arrangements to appropriately balance risk and reward. For example, an incentive-based compensation arrangement that has a longer performance period that could allow risk events to manifest and for awards to be adjusted to reflect risk could be less effective if management makes a discretionary award decision that does not account for, or mitigates, the future impact of those risk events.[122]

Section __.4(d)(3) of the proposed rule would also require that any amounts to be awarded under an incentive-based compensation arrangement be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance. It is important that incentive-based compensation arrangements be balanced in design and implemented so that awards and actual amounts that vest actually vary based on risks or risk outcomes. If, for example, covered persons are awarded or paid substantially all of their potential incentive-based compensation even when they cause a covered institution to take a risk that is inappropriate given the institution's size, nature of operations, or risk profile, or cause the covered institution to fail to comply with legal or regulatory obligations, then covered persons will have less incentive to avoid activities with substantial risk of financial loss or non-compliance with legal or regulatory obligations.

(e) Board of directors.

Under section __.4(e) of the proposed rule, the board of directors, or a committee thereof, would be required to: (1) conduct oversight of the covered institution's incentive-based compensation program; (2) approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and (3) approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

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[122] For Level 1 and Level 2 covered institutions, section ___.11 of the proposed rule would require policies and procedures that address the institution's use of discretion.

Section __.4(e)(1) of the proposed rule would require the board of directors, or a committee thereof, of a covered institution to conduct oversight of the covered institution's incentive-based compensation program. Such oversight generally should include overall goals and purposes. For example, boards of directors, or a committee thereof, of covered institutions generally should oversee senior management in the development of an incentive-based compensation program that incentivizes behaviors consistent with the long-term health of the covered institution, and provide sufficient detail to enable senior management to translate the incentive-based compensation program into objectives, plans, and arrangements for each line of business and control function. Such oversight also generally should include holding senior management accountable for effectively executing the covered institution's incentive-based compensation program and for communicating expectations regarding acceptable behaviors and business practices to covered persons. Boards of directors should actively engage with senior management, including challenging senior management's incentive-based compensation assessments and recommendations when warranted.

In addition to the general program oversight requirement set forth in section __.4(e)(1) of the proposed rule, a board of directors, or a committee thereof, would also be required by sections __.4(e)(2) and __.4(e)(3) to approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and payouts, at the time of vesting, under such arrangements, and to approve any material exceptions or adjustments to those arrangements.

Although risk-adjusting incentive-based compensation for senior executive officers responsible for the covered institution's overall risk posture and performance may be challenging given that quantitative measures of institution-wide risk are difficult to produce and allocating responsibility among the senior executive team for achieving risk objectives can be a complex task, the role of senior executive officers in managing the overall risk-taking activities of an institution is important. Accordingly the proposed rule would require the board of directors, or a committee thereof, to approve compensation arrangements involving senior executive officers. When a board of directors, or a committee thereof, is considering an award or a payout, it should consider risks to ensure that the award or payout is consistent with broader risk management and strategic objectives.

(f) Disclosure and Recordkeeping Requirements and (g) Rule of Construction.

Section ___.4(f) of the proposed rule would establish disclosure and recordkeeping requirements for all covered institutions, as required by section 956(a)(1).[123] Under the proposed rule, each covered institution would be required to create and maintain records that document the structure of all of the institution's incentive-based compensation arrangements and demonstrate compliance with the proposed rule, and to disclose these records to the appropriate Federal regulator upon request. The proposed rule would require covered institutions to create such records on an annual basis and to maintain such records for at least seven years after they are created. The Agencies recognize that the exact timing for recordkeeping will vary from institution to institution, but this requirement would ensure that covered institutions create such records for their incentive-based compensation arrangements at least once every 12 months. The requirement to maintain records for at least seven years generally aligns with the clawback period described in section __.7(c) of the proposed rule.

The proposed rule would require that the records maintained by a covered institution, at a minimum, include copies of all incentive-based compensation plans, a list of who is subject to each plan, and a description of how the covered institution's incentive-based compensation program is compatible with effective risk management and controls. These records would be the minimum required information to determine whether the structure of the covered institution's incentive-based compensation arrangements provide covered persons with excessive compensation or could lead to material financial loss to the covered institution. As specified in section 956(a)(2) and section ___.4(g) of the proposed rule, a covered institution would not be required to report the actual amount of compensation, fees, or benefits of individual covered persons as part of this requirement.[124]

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[123] 12 U.S.C. 5641(a)(1).

[124] The Agencies note that covered institutions may be required to report actual compensation under other provisions of law. For example, corporate credit unions must disclose compensation of certain executive officers to their natural person credit union members under NCUA's corporate credit union rule. 12 CFR 704.19. The proposed rule would not affect the requirements in 12 CFR 704.19 or in any other reporting provision under any other law or regulation.

The SEC requires an issuer that is subject to the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to disclose information regarding the compensation of its principal executive officer, principal financial officer, and three other most highly

The 2011 Proposed Rule would have implemented section 956(a)(1) by requiring all covered financial institutions to submit an annual report to their appropriate Federal regulator, in a format specified by their appropriate Federal regulator, that described in narrative form the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and the policies governing such arrangements.[125] Some commenters on the 2011 Proposed Rule favored annual reporting requirements, while other commenters opposed any requirement for institutions to make periodic submissions of information about incentive-based compensation arrangements to regulators, noting concerns about burden, particularly for smaller covered financial institutions. A few commenters requested an annual certification requirement instead of a reporting requirement. While there is value in receiving reports, the burden of producing them would potentially be great on smaller covered institutions. Accordingly, the Agencies determined not to include a requirement for covered institutions to submit annual narrative reports.

Given the variety of covered institutions and asset sizes, the Agencies are not proposing a specific format or template for the records that must be maintained by all covered institutions. According to the Agencies' supervisory experience, as discussed further above, many covered institutions already maintain information about their incentive-based compensation programs comparable to the types of information described above (e.g., in support of public company filings).

Several commenters on the 2011 Proposed Rule expressed concern regarding the confidentiality of the reported compensation information. In light of the nature of the information that would be provided to the Agencies under section ___.4(f) of the proposed rule, and the purposes for which the Agencies are requiring the information, the Agencies would view the information disclosed to the Agencies as nonpublic and expect to maintain the confidentiality

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compensated executive officers, as well as its directors, in the issuer's proxy statement, its annual report on Form 10-K, and registration statements for offerings of securities. The requirements are generally found in Item 402 of Regulation S-K (17 CFR 229.402).

[125] See 2011 Proposed Rule, at 21177. The 2011 Proposed Rule also would have set forth additional more detailed requirements for covered financial institutions with total consolidated assets of $50 billion or more.

of that information, to the extent permitted by law.[126] When providing information to one of the Agencies pursuant to the proposed rule, covered institutions should request confidential treatment by that Agency.

4.1. The Agencies invite comment on the requirements for performance measures contained in section __.4(d) of the proposed rule. Are these measures sufficiently tailored to allow for incentive-based compensation arrangements to appropriately balance risk and reward? If not, why?

4.2. The Agencies invite comment on whether the terms "financial measures of performance" and "non-financial measures of performance" should be defined. If so, what should be included in the defined terms?

4.3. Would preparation of annual records be appropriate or should another method be used? Would covered institutions find a more specific list of topics and quantitative information for the content of required records helpful? Should covered institutions be required to maintain an inventory of all such records and to maintain such records in a particular format? If so, why? How would such specific requirements increase or decrease burden?

4.4. Should covered institutions only be required to create new records when incentive-based compensation arrangements or policies change? Should the records be updated more frequently, such as promptly upon a material change? What should be considered a "material change"?

4.5. Is seven years a sufficient time to maintain the records required under section ___.4(f) of the proposed rule? Why or why not?

4.6. Do covered institutions generally maintain records on incentive-based compensation arrangements and programs? If so, what types of records and related information are

[126] For example, Exemption 4 of the Freedom of Information Act ("FOIA") provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 6 provides an exemption for information about individuals in "personnel and medical files and similar files" when the disclosure of such information "would constitute a clearly unwarranted invasion of personal privacy." 5 U.S.C. 552(b)(6). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

maintained and in what format? What are the legal or institutional policy requirements for maintaining such records?

4.7. For covered institutions that are investment advisers or broker-dealers, is there particular information that would assist the SEC in administering the proposed rule? For example, should the SEC require its reporting entities to report whether they utilize incentive-based compensation or whether they are Level 1, Level 2 or Level 3 covered institutions?

§ ___.5 Additional Disclosure and Recordkeeping Requirements for Level 1 and Level 2 Covered Institutions.

Section ___.5 of the proposed rule would establish additional and more detailed recordkeeping requirements for Level 1 and Level 2 covered institutions.

Under section ___.5(a) of the proposed rule, a Level 1 or Level 2 covered institution would be required to create annually, and maintain for at least seven years, records that document: (1) its senior executive officers and significant risk-takers listed by legal entity, job function, organizational hierarchy, and line of business; (2) the incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on percentage of incentive-based compensation deferred and form of award; (3) any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and (4) any material changes to the covered institution's incentive-based compensation arrangements and policies.

The proposed recordkeeping and disclosure requirements at Level 1 and Level 2 covered institutions would assist the appropriate Federal regulator in monitoring whether incentive-based compensation structures, and any changes to such structures, could result in Level 1 and Level 2 covered institutions maintaining incentive-based compensation structures that encourage inappropriate risks by providing excessive compensation, fees, or benefits or could lead to material financial loss. The more detailed reporting requirement for Level 1 and Level 2 covered institutions under section ___.5(a) of the proposed rule reflects the information that would assist the appropriate Federal regulator in most effectively evaluating the covered institution's compliance with the proposed rule and identifying areas of potential concern with respect to the structure of the covered institution's incentive-based compensation arrangements.

For example, the recordkeeping requirement in section ___.5(a)(2) of the proposed rule regarding amounts of incentive-based compensation deferred and the form of payment of incentive-based compensation for senior executive officers and significant risk-takers would help Federal regulators determine compliance with the requirement in section ___.7(a) of the proposed rule for certain amounts of incentive-based compensation of senior executive officers and significant risk-takers to be deferred for specific periods of time. Similarly, the recordkeeping requirement in section ___.5(a)(3) of the proposed rule would require Level 1 and Level 2 covered institutions to document the rationale for decisions under forfeiture and downward adjustment reviews and to keep timely and accurate records of the decision. This documentation would provide information useful to Federal regulators for determining compliance with the requirements in sections___.7(b) and (c) of the proposed rule regarding specific forfeiture and clawback policies at Level 1 and Level 2 covered institutions that are further discussed below.

The proposed recordkeeping requirements in section ___.5(a) of the proposed rule relate to the proposed substantive requirements in section ___.7 of the proposed rule and would help the appropriate Federal regulator to closely monitor incentive-based compensation payments to senior executive officers and significant risk-takers and to determine whether those payments have been adjusted to reflect risk outcomes. This approach also would be responsive to comments received on the 2011 Proposed Rule suggesting that specific qualitative and quantitative information, instead of a narrative description, be the basis of a reporting requirement for larger covered institutions.

Section ___.5(b) of the proposed rule would require a Level 1 or Level 2 covered institution to create and maintain records sufficient to allow for an independent audit of incentive-based compensation arrangements, policies, and procedures, including those required under section __.11 of the proposed rule. A standard which reflects the level of detail required in order to perform an independent audit of incentive-based compensation would be appropriate given the importance of regular monitoring of incentive-based compensation programs by independent control functions. Such a standard also would be consistent with the monitoring requirements set out in section ___.11 of the proposed rule.

As with the requirements applicable to all covered institutions under section ___.4(f) of the proposed rule, the Agencies are not proposing to require that a Level 1 or Level 2 covered institution annually file a report with the appropriate Federal regulator. Instead, section ___.5(c) of the proposed rule would require a Level 1 or Level 2 covered institution to disclose its records to the appropriate Federal regulator in such form and with such frequency as requested by the appropriate Federal regulator. The required form and frequency of recordkeeping may vary among the Agencies and across categories of covered institutions, although the records described in section ___.5(a) of the proposed rule, along with any other records a covered institution creates to satisfy the requirements of section ___.5(f) of the proposed rule, would be required to be created at least annually. Some Agencies may require Level 1 and Level 2 covered institutions to provide their records on an annual basis, alone or with a standardized form of report. Level 1 and Level 2 covered institutions should seek guidance concerning the reporting requirement from their appropriate Federal regulator.

Generally, the Agencies would expect the volume and detail of information disclosed by a covered institution under section ___.5 of the proposed rule to be tailored to the nature and complexity of business activities at the covered institution, and to the scope and nature of its use of incentive-based compensation arrangements. The Agencies recognize that smaller covered institutions with less complex and less extensive incentive-based compensation arrangements likely would not create or retain records that are as extensive as those that larger covered institutions with relatively complex programs and business activities would likely create. The tailored recordkeeping and disclosure provisions for Level 1 and Level 2 covered institutions in the proposed rule are designed to provide the Agencies with streamlined and well-focused records that would allow the Agencies to promptly and effectively identify and address any areas of concern.

Similar to the provision of information under section ___.4(f) of the proposed rule, the Agencies expect to treat the information provided to the Agencies under section __.5 of the proposed rule as nonpublic and to maintain the confidentiality of that information to the extent permitted by law.[127] When providing information to one of the Agencies pursuant to the proposed rule, covered institutions should request confidential treatment by that Agency.

[127] See supra note 126.

5.1. Should the level of detail in records created and maintained by Level 1 and Level 2 covered institutions vary among institutions regulated by different Agencies? If so, how? Or would it be helpful to use a template with a standardized information list?

5.2. In addition to the proposed records, what types of information should Level 1 and Level 2 covered institutions be required to create and maintain related to deferral and to forfeiture, downward adjustment, and clawback reviews?

§ ___.6 Reservation of Authority for Level 3 Covered Institutions.

Section ___.6 of the proposed rule would allow the appropriate Federal regulator to require certain Level 3 covered institutions to comply with some or all of the more rigorous requirements applicable to Level 1 and Level 2 covered institutions. Specifically, an Agency would be able to require a covered institution with average total consolidated assets greater than or equal to $10 billion and less than $50 billion to comply with some or all of the more rigorous provisions of section ___.5 and sections___.7 through___.11 of the proposed rule, if the appropriate Federal regulator determined that the covered institution's complexity of operations or compensation practices are consistent with those of a Level 1 or Level 2 covered institution, based on the covered institution's activities, complexity of operations, risk profile, or compensation practices. In such cases, the Agency that is the Level 3 covered institution's appropriate Federal regulator, in accordance with procedures established by the Agency, would notify the institution in writing that it must satisfy the requirements and other standards contained in section ___.5 and sections___.7 through___.11 of the proposed rule. As with the designation of significant risk-takers discussed above, each Agency's procedures generally would include reasonable advance written notice of the proposed action, including a description of the basis for the proposed action, and opportunity for the covered institution to respond.

As noted previously, the Agencies have determined that it may be appropriate to apply only basic prohibitions and disclosure requirements to Level 3 covered institutions, in part because these institutions generally have less complex operations, incentive-based compensation practices, and risk profiles than Level 1 and Level 2 covered institutions.[128] However, the Agencies recognize that there is a wide spectrum of business models and risk profiles within the

[128] See section 3 of Part II of this Supplementary Information for more discussions on Level 1, Level 2, and Level 3 covered institutions.

$10 to $50 billion range and believe that some Level 3 covered institutions with between $10 and $50 billion in total consolidated assets may have incentive-based compensation practices and operational complexity comparable to those of a Level 1 or Level 2 covered institution. In such cases, it may be appropriate for the Agencies to provide a process for determining that such institutions should be held to the more rigorous standards.

The Agencies are proposing $10 billion as the appropriate threshold for the low end of this range based upon the general complexity of covered institutions above this size. The threshold is also used in other statutory and regulatory requirements. For example, the stress testing provisions of the Dodd-Frank Act require banking organizations with total consolidated assets of more than $10 billion to conduct annual stress tests.[129] For deposit insurance assessment purposes, the FDIC distinguishes between small and large banks based on a $10 billion asset size.[130] For supervisory purposes, the Board defines community banks by reference to the $10 billion asset size threshold.[131]

The Agencies would consider the activities, complexity of operations, risk profile, and compensation practices to determine whether a Level 3 covered institution's operations or compensation practices warrant application of additional standards pursuant to the proposed rule. For example, a Level 3 covered institution could have significant levels of off-balance sheet activities, such as derivatives that may entail complexities of operations and greater risk than balance sheet measures would indicate, making the institution's risk profile more akin to that of a Level 1 or Level 2 covered institution. Additionally, a Level 3 covered institution might be involved in particular high-risk business lines, such as lending to distressed borrowers or investing or trading in illiquid assets, and make significant use of incentive-based compensation to reward risk-takers. Still other Level 3 covered institutions might have or be part of a complex organizational structure, such as operating with multiple legal entities in multiple foreign jurisdictions.

Section ___.6 of the proposed rule would permit the appropriate Federal regulator of a Level 3 covered institution with total consolidated assets of between $10 and $50 billion to

[129] 12 U.S.C. 5365(i)(2).
[130] See 12 CFR 327.8(e) and (f).
[131] See Federal Reserve SR Letter 12-7, "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets" (May 14, 2012).

require the institution to comply with some or all of the provisions of section ___.5 and sections___.7 through___.11 of the proposed rule. This approach would allow the Agencies to take a flexible approach in the proposed rule provisions applicable to all Level 3 covered institutions while retaining authority to apply more rigorous standards where the Agencies determine appropriate based on the Level 3 covered institution's complexity of operations or compensation practices. The Agencies expect they only would use this authority on an infrequent basis. This approach has been used in other rules for purposes of tailoring the application of requirements and providing flexibility to accommodate the variations in size, complexity, and overall risk profile of financial institutions.[132]

6.1. The Agencies invite general comment on the reservation of authority in section ___.6 of the proposed rule.

6.2. The Agencies based the $10 billion dollar floor of the reservation of authority on existing similar reservations of authority that have been drawn at that level. Did the Agencies set the correct threshold or should the floor be set lower or higher than $10 billion? If so, at what level and why?

6.3. Are there certain provisions in section ___.5 and sections___.7 through___.11 of the proposed rule that would not be appropriate to apply to a covered institution with total consolidated assets of $10 billion or more and less than $50 billion regardless of its complexity of operations or compensation practices? If so, which provisions and why?

6.4. The Agencies invite comment on the types of notice and response procedures the Agencies should use in determining that the reservation of authority should be used. The SEC invites comment on whether notice and response procedures based on the procedures for a proceeding

[132] For example, the OCC, FDIC, and Board's domestic capital rules include a reservation of authority whereby the agency may require an institution to hold an amount of regulatory capital greater than otherwise required under the capital rules. 12 CFR 3.1(d) (OCC); 12 CFR 324.1(d)(1) through (6) (FDIC); 12 CFR 217.1(d) (Board). The OCC, FDIC, and the Board's Liquidity Coverage Ratio rule includes a reservation of authority whereby each agency may impose heightened standards on an institution. 12 CFR 50.2 (OCC); 12 CFR 329.2 (FDIC); 12 CFR 249.2 (Board). The FDIC's stress testing rules include a reservation of authority to require a $10 billion to $50 billion covered bank to use reporting templates for larger banks. 12 CFR 325.201.

initiated upon the SEC's own motion under Advisers Act rule 0-5 would be appropriate for this purpose.

6.5. What specific features of incentive-based compensation programs or arrangements at a Level 3 covered institution should the Agencies consider in determining such institution should comply with some or all of the more rigorous requirements within the rule and why? What process should be followed in removing such institution from the more rigorous requirements?

§ ___.7 Deferral, Forfeiture and Downward Adjustment, and Clawback Requirements for Level 1 and Level 2 Covered Institutions

As discussed above, allowing covered institutions time to measure results with the benefit of hindsight allows for a more accurate assessment of the consequences of risks to which the institution has been exposed. This approach may be particularly relevant, for example, where performance is difficult to measure because performance results and risks take time to observe (e.g., assessing the future repayment prospects of loans written during the current year).

In order to achieve incentive-based compensation arrangements that appropriately balance risk and reward, including closer alignment between the interests of senior executive officers and significant risk-takers within the covered institution and the longer-term interests of the covered institution itself, it is important for information on performance, including information on misconduct and inappropriate risk-taking, to affect the incentive-based compensation amounts received by covered persons. Covered institutions may use deferral, forfeiture and downward adjustment, and clawback to address information about performance that comes to light after the conclusion of the performance period, so that incentive-based compensation arrangements are able to appropriately balance risk and reward. Section ___.7 of the proposed rule would require Level 1 and Level 2 covered institutions to incorporate these tools into the incentive-based compensation arrangements of senior executive officers and significant risk-takers.

Under the proposed rule, an incentive-based compensation arrangement at a Level 1 or Level 2 covered institution would not be considered to appropriately balance risk and reward, as would be required by section ___.4(c)(1), unless the deferral, forfeiture, downward adjustment, and clawback requirements of section ___.7 are met. These requirements would apply to incentive-based compensation arrangements provided to senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions. Institutions may, of course, take additional steps to address risks that may mature after the performance period.

The requirements of section ___.7 of the proposed rule would apply to Level 1 and Level 2 covered institutions; that is, to covered institutions with $50 billion or more in average total consolidated assets. The requirements of section ___.7 would not be applicable to Level 3 covered institutions.[133] As discussed above, the Agencies recognize that larger covered institutions have more complex business activities and generally rely more on incentive-based compensation programs, and, therefore, it is appropriate to impose specific deferral, forfeiture and downward adjustment reviews and clawback requirements on these institutions. It has been recognized that larger financial institutions can present greater potential systemic risks. The Board, for example, has expressed the view that institutions with more than $250 billion in total consolidated assets are more likely than other institutions to pose systemic risk to U.S. financial stability.[134] Because of these risks that could be created by excessive risk-taking at the largest covered institutions, additional safeguards are needed against inappropriate risk-taking at Level 1 covered institutions. For these reasons, the Agencies are proposing a required minimum deferral percentage and a required minimum deferral period for Level 1 covered institutions that are greater than those for Level 2 covered institutions.

The requirements of section ___.7 of the proposed rule would apply to incentive-based compensation arrangements for senior executive officers and significant risk-takers of Level 1 and Level 2 covered institutions. The decisions of senior executive officers can have a significant impact on the entire consolidated organization and often involve substantial strategic or other risks that can be difficult to measure and model—particularly at larger covered institutions— during or at the end of the performance period, and therefore can be difficult to

[133] As explained earlier in this Supplementary Information section, the appropriate Federal regulator of a Level 3 covered institution with average total consolidated assets greater than or equal to $10 billion and less than $50 billion may require the covered institution to comply with some or all of the provisions of section __.5 and sections __.7 through __.11 of the proposed rule if the Agency determines that the complexity of operations or compensation practices of the Level 3 covered institution are consistent with those of a Level 1 or 2 covered institution.
[134] Board, Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 FR 49082, 49084 (August 14, 2015).

address adequately by risk adjustments in the awarding of incentive-based compensation.[135] Supervisory experience and a review of the academic literature[136] suggest that incentive-based compensation arrangements for the most senior decision-makers and risk-takers at the largest institutions appropriately balance risk and reward when a significant portion of the incentive-based compensation awarded under those arrangements is deferred for an adequate amount of time.

As discussed above, in addition to the institution's senior executive officers, the significant risk-takers at Level 1 and Level 2 covered institutions may have the ability to expose the institution to the risk of material financial loss. In order to help ensure that the incentive-based compensation arrangements for these individuals appropriately balance risk and reward and do not encourage them to engage in inappropriate risk-taking that could lead to material financial loss, the proposed rule would extend the deferral requirement to significant risk-takers at Level 1 and Level 2 covered institutions. Deferral for significant risk-takers as well as executive officers helps protect against material financial loss at the largest covered institutions.

§__.7(a) Deferral.

As a tool to balance risk and reward, deferral generally consists of four components: the proportion of incentive-based compensation required to be deferred, the time horizon of the deferral, the speed at which deferred incentive-based compensation vests, and adjustment during the deferral period to reflect risks or inappropriate conduct that manifest over that period of time.

Section ___.7(a) of the proposed rule would require Level 1 and Level 2 covered institutions, at a minimum, to defer the vesting of a certain portion of all incentive-based compensation awarded (the deferral amount) to a senior executive officer or significant risk-taker for at least a specified period of time (the deferral period). The minimum required deferral

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[135] This premise was identified in the 2010 Federal Banking Agency Guidance, 75 FR at 36409, and was highlighted in the 2011 FRB White Paper. The report reiterated the recommendation that "[a] substantial fraction of incentive compensation awards should be deferred for senior executives of the firm because other methods of balancing risk taking incentives are less likely to be effective by themselves for such individuals." 2011 FRB White Paper, at 15.

[136] Gopalan, Milbourn, Song and Thakor, "Duration of Executive Compensation" (December 18, 2012), at 29-30, available at http://apps.olin.wustl.edu/faculty/thakor/Website%20Papers/Duration%20of%20Executive%20Compensation.pdf.

amount and minimum required deferral period would be determined by the size of the covered institution, by whether the covered person is a senior executive officer or significant risk-taker, and by whether the incentive-based compensation was awarded under a long-term incentive plan or is qualifying incentive-based compensation. Minimum required deferral amounts range from 40 percent to 60 percent of the total incentive-based compensation award, and minimum required deferral periods range from one year to four years, as detailed below.

Deferred incentive-based compensation of senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions would also be required to meet the following other requirements:

- Vesting of deferred amounts may occur no faster than on a pro rata annual basis beginning on the one-year anniversary of the end of the performance period;
- Unvested deferred amounts may not be increased during the deferral period;
- For most Level 1 and Level 2 covered institutions, substantial portions of deferred incentive-based compensation must be paid in the form of both equity-like instruments and deferred cash;
- Vesting of unvested deferred amounts may not be accelerated except in the case of death or disability;[137] and
- All unvested deferred amounts must be placed at risk of forfeiture and subject to a forfeiture and downward adjustment review pursuant to section ___.7(b).

Except for the prohibition against accelerated vesting, the prohibitions and requirements in section ___.7(a) of the proposed rule would apply to all unvested deferred incentive-based compensation, regardless of whether the deferral of the incentive-based compensation was necessary to meet the requirements of the proposed rule. For example, if a covered institution chooses to defer incentive-based compensation above the amount required to be deferred under the rule, the additional amount would be required to be subject to forfeiture. In another example, if a covered institution would be required to defer a portion of a particular covered person's

[137] For covered persons at credit unions, NCUA's rule also permits acceleration of payment if the covered person must pay income taxes on the entire amount of an award, including deferred amounts, at the time of award.

incentive-based compensation for four years, but chooses to defer that compensation for ten years, the deferral would be subject to forfeiture during the entire ten-year deferral period. Applying the requirements and prohibitions of section ___.7(a) to all unvested deferred incentive-based compensation is intended to maximize the balancing effect of deferred incentive-based compensation, to make administration of the requirements and prohibitions easier for covered institutions, and to facilitate the Agencies' supervision for compliance.

Compensation that is not incentive-based compensation and is deferred only for tax purposes would not be considered "deferred incentive-based compensation" for purposes of the proposed rule.

§__.7(a)(1) and §__.7(a)(2) Minimum deferral amounts and deferral periods for qualifying incentive-based compensation and incentive-based compensation awarded under a long-term incentive plan.

The proposed rule would require a Level 1 covered institution to defer at least 60 percent of each senior executive officer's qualifying incentive-based compensation[138] for at least four years, and at least 60 percent of each senior executive officer's incentive-based compensation awarded under a long-term incentive plan for at least two years beyond the end of that plan's performance period. A Level 1 covered institution would be required to defer at least 50 percent of each significant risk-taker's qualifying incentive-based compensation for at least four years, and at least 50 percent of each significant risk-taker's incentive-based compensation awarded under a long-term incentive plan for at least two years beyond the end of that plan's performance period.

Similarly, the proposed rule would require a Level 2 covered institution to defer at least 50 percent of each senior executive officer's qualifying incentive-based compensation for at least three years, and at least 50 percent of each senior executive officer's incentive-based compensation awarded under a long-term incentive plan for at least one year beyond the end of that plan's performance period. A Level 2 covered institution would be required to defer at least 40 percent of each significant risk-taker's qualifying incentive-based compensation for at least three years, and at least 40 percent of each significant risk-taker's incentive-based compensation

[138] As described above, incentive-based compensation that is not awarded under a long-term incentive plan would be defined as qualifying incentive-based compensation under the proposed rule.

awarded under a long-term incentive plan for at least one year beyond the end of that plan's performance period.

In practice, a Level 1 or Level 2 covered institution typically evaluates the performance of a senior executive officer or significant risk-taker during and after the performance period. As the performance period comes to a close, the covered institution determines an amount of incentive-based compensation to award the covered person for that performance period. Senior executive officers and significant risk-takers may be awarded incentive-based compensation at a given time under multiple incentive-based compensation plans that have performance periods that come to a close at that time. Although they end at the same time, those performance periods may have differing lengths, and therefore may not completely overlap. For example, long-term incentive plans, which have a minimum performance period of three years, would consider performance in at least two years prior to the year the performance period ends, while annual incentive plans would only consider performance in the year of the performance period.

For purposes of determining the amount of incentive-based compensation that would be required to be deferred and the actual amount that would be deferred, a Level 1 or Level 2 covered institution generally should use the present value of the incentive-based compensation at the time of the award. In determining the value of awards for this purpose, Level 1 and Level 2 covered institutions generally should use reasonable valuation methods consistent with methods used in other contexts.[139]

Pro rata vesting.

The requirements of this section would permit the covered institution to immediately pay, or allow to vest, all of the incentive-based compensation that is awarded that is not required to be deferred. All incentive-based compensation that is deferred would be subject to a deferral period that begins only once the performance period comes to a close. During this deferral period, indications of inappropriate risk-taking may arise, leading the covered institution to consider whether the covered person should not be paid the entire amount originally awarded.

[139] See, e.g., Topic 718 of the FASB Accounting Standards Codification (formerly FAS 123(R); Black-Scholes method for valuing options.

The incentive-based compensation that would be required by the rule to be deferred would not be permitted to vest faster than on a pro rata annual basis beginning no earlier than the first anniversary of the end of the performance period for which the compensation was awarded. In other words, a covered institution would be allowed to make deferred incentive-based compensation eligible for vesting during the deferral period on a schedule that paid out equal amounts on each anniversary of the end of the relevant performance period. A covered institution would also be permitted to make different amounts eligible for vesting each year, so long as the cumulative total of the deferred incentive-based compensation that has been made eligible for vesting on each anniversary of the end of the performance period is not greater than the cumulative total that would have been eligible for vesting had the covered institution made equal amounts eligible for vesting each year.

For example, if a Level 1 covered institution is required to defer $100,000 of a senior executive officer's incentive-based compensation for four years, the covered institution could choose to make $25,000 available for vesting on each anniversary of the end of the performance period for which the $100,000 was awarded. The Level 1 covered institution could also choose to make different amounts available for vesting at different times during the deferral period, as long as: the total amount that is made eligible for vesting on the first anniversary is not more than $25,000; the total amount that has been made eligible for vesting by the second anniversary is not more than $50,000; and the total amount that has been made eligible for vesting by the third anniversary is not more than $75,000. In this example, the Level 1 covered institution would be permitted to make eligible for vesting $10,000 on the first anniversary, $30,000 on the second anniversary (bringing the total for the first and second anniversaries to $40,000), $30,000 on the third anniversary (bringing the total for the first, second, and third anniversaries to $70,000), and $30,000 on the fourth anniversary.

A Level 1 or Level 2 covered institution should consider the vesting schedule at the time of the award, and the present value at time of award of each form of incentive-based compensation, for the purposes of determining compliance with this requirement. Level 1 and Level 2 covered institutions generally should use reasonable valuation methods consistent with methods used in other contexts in valuing awards for purposes of this rule.

This approach would provide a covered institution with some flexibility in administering its specific deferral program. For example, a covered institution would be permitted to make the full deferred amount of incentive-based compensation awarded for any given year eligible for vesting in a lump sum at the conclusion of the deferral period (i.e., “cliff vesting”). Alternatively, a covered institution would be permitted to make deferred amounts eligible for vesting in equal increments at the end of each year of the deferral period. Except in the case of acceleration allowed in sections ___.7(a)(1)(iii)(B) and ___.7(a)(2)(iii)(B), the proposed rule does not allow for vesting of amounts required to be deferred (1) faster than on a pro rata annual basis; or (2) beginning earlier than the first anniversary of the award date.

The Agencies recognize that some or all of the incentive-based compensation awarded to a senior executive officer or significant risk-taker may be forfeited before it vests. For an example of how these requirements would work in practice, please see Appendix A of this Supplementary Information section.

This restriction is intended to prevent covered institutions from defeating the purpose of the deferral requirement by allowing vesting of most of the required deferral amounts immediately after the award date. In addition, the proposed approach aligns with both what the Agencies understand is common practice in the industry and with the requirements of many foreign supervisors.

Acceleration of payments.

The Agencies propose that the acceleration of vesting and subsequent payment of incentive-based compensation that is required to be deferred under this proposed rule generally be prohibited for covered persons at Level 1 and Level 2 covered institutions. This restriction would apply to all deferred incentive-based compensation required to be deferred under the proposed rule, whether it was awarded as qualifying incentive-based compensation or under a long-term incentive plan. This prohibition on acceleration would not apply to compensation that the employee or the employer elects to defer in excess of the amounts required under the proposed rule or for time periods that exceed the required deferral periods or in certain other limited circumstances, such as the death or disability of the covered person.

NCUA’s proposed rule would permit acceleration of payment if covered persons at credit unions were subject to income taxes on the entire amount of an incentive-based compensation award even before deferred amounts vest. Incentive-based compensation for executives of not-for-profit entities is subject to income taxation under a different provision of the Internal Revenue Code[140] than that applicable to executives of other covered institutions. The result is that credit union executives' incentive-based compensation awards may be subject to immediate taxation on the entire award, even deferred amounts.[141] The ability to accelerate payment would be a limited exception only applicable to income tax liability and would only apply to the extent credit union executives must pay income tax on unvested amounts during the deferral period. Also, any amounts advanced to pay income tax liabilities for deferrals must be taken in proportion to the vesting schedule. For example, a credit union executive may have deferrals of $200,000 for each of three years ($600,000 total) and a total tax liability of $240,000 for the deferred amount of an award. The advanced tax payments would result in an annual reduction of $80,000 per deferred payment, resulting in a new vesting amount of $120,000 for each year of the deferral period.

Many institutions currently allow for accelerated vesting in the case of death or disability. Some current incentive-based compensation arrangements, such as separation agreements, between covered persons and covered institutions provide for accelerated vesting and payment of deferred incentive-based compensation that has not yet vested upon the occurrence of certain events.[142] Many institutions also currently provide for the accelerated vesting of deferred incentive-based compensation awarded to their senior executive officers, particularly compensation awarded in the form of equity, in connection with a change in control of the company[143] (sometimes as part of a "golden parachute"). Shareholder proxy firms and

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[140] 26 U.S.C. 457(f).

[141] The Agencies understand that the taxation of unvested deferred awards of covered persons at other covered institutions is based on other provisions of the Internal Revenue Code. See, e.g., 26 U.S.C. 409A.

[142] Several commenters argued that the 2011 Proposed Rule's deferral requirements should not apply upon the death, disability, retirement, or acceptance of government employment of covered persons, or a change in control of the covered institution, effectively arguing for the ability of covered institutions to accelerate incentive-based compensation under these circumstances.

[143] See, e.g., Equilar, "Change-in-Control Equity Acceleration Triggers" (March 19, 2014), available at http://www.equilar.com/reports/8-change-in-control-equity-acceleration-triggers.html (Noting that although neither Institutional Shareholder Services (ISS) nor Glass Lewis state that a single trigger plan will automatically result in an "against" recommendation, both make it clear that they view the single versus double trigger issue as an important factor in making their decisions. ISS, in particular, suggests in its policies that double trigger vesting of equity awards is currently the best market practice).

some institutional investors have raised concerns about such golden parachutes,[144] and golden parachutes are restricted by law under certain circumstances, including if an institution is in troubled condition.[145] Finally, in current incentive-based compensation arrangements, events triggering acceleration commonly include leaving the employment of a covered institution for a new position (either any new position or only certain new positions, such as employment at a government agency), an acquisition or change in control of the covered institution, or upon the death or disability of the employee.[146]

The Federal Banking Agencies have found that the acceleration of deferred incentive-based compensation to covered persons is generally inappropriate because it weakens the balancing effect of deferral and eliminates the opportunity for forfeiture during the deferral period as information concerning risks taken during the performance period becomes known. The acceleration of vesting and payment of deferred incentive-based compensation in other circumstances, such as when the covered person voluntarily leaves the institution, could also provide covered persons with an incentive to retire or leave a covered institution if the covered person is aware of risks posed by the covered person's activities that are not yet apparent to or fully understood by the covered institution. Acceleration of payment could skew the balance of risk-taking incentives provided to the covered person if the circumstances under which acceleration is allowed are within the covered person's control. The proposed rule would prohibit acceleration of deferred compensation that is required to be deferred under this proposed rule in most circumstances given the potential to undermine risk balancing mechanisms.

In contrast, the circumstances under which the Agencies would allow acceleration of payment, namely death or disability of the covered person, generally are not subject to the covered person's control, and, therefore, are less likely to alter the balance of risk-taking

[144] Institutional Shareholders Services, "2015 U.S. Compensation Policies, Frequently Asked Questions" (February 9, 2015) ("ISS Compensation FAQs"), available at https://www.issgovernance.com/file/policy/2015-us-comp-faqs.pdf; and Institutional Shareholders Services, "U.S. Corporate Governance Policy: 2013 Updates" (November 16, 2012), available at https://www.issgovernance.com/file/files/2013USPolicyUpdates.pdf

[145] See 12 U.S.C. 1828(k) and 12 CFR Part 359 (generally applicable to banks and holding companies).

[146] See, e.g., 2012 James F. Reda & Associates, "Study of Executive Termination Provisions Among Top 200 Public Companies (December 2012), available at www.jfreda.com; Equilar, "Change-in-Control Equity Acceleration Triggers" (March 19, 2014), available at http://www.equilar.com/reports/8-change-in-control-equity-acceleration-triggers.html.

incentives provided to the covered person. In other cases where acceleration is permitted, effective governance and careful assessment of potential risks, as well as specific facts and circumstances are necessary in order to protect against creating precedents that could undermine more generally the risk balancing effects of deferral. Therefore, the Agencies have proposed to permit only these limited exceptions.

Under the proposed rule, the prohibition on acceleration except in cases of death or disability would apply only to deferred amounts that are required by the proposed rule so as not to discourage additional deferral, or affect institutions that opt to defer incentive-based compensation exceeding the requirements. For example, if an institution defers compensation until retirement as a retention tool, but the institution then merges into another company and ceases to exist, retention may not be a priority. Thus, acceleration would be permitted for any deferred incentive-based compensation amounts above the amount required to be deferred or that was deferred longer than the minimum deferral period to allow those amounts to be paid out closer in time to the merger.

Similarly, the acceleration of payment NCUA's rule permits if a covered person of a credit union faces up-front income tax liability on the deferred amounts of an award is not an event subject to the covered person's control. This exception will not apply unless the covered person is actually subject to income taxes on deferred amounts for which the covered person has not yet received payment, and equalizes the effect of deferral for covered persons at credit unions and covered persons at most other covered institutions. This limited exception is not intended to alter the balance of risk-taking incentives.

Qualifying incentive-based compensation and incentive-based compensation awarded under a long-term incentive plan

The minimum required deferral amounts would be calculated separately for qualifying incentive-based compensation and incentive-based compensation awarded under a long-term incentive plan, and those amounts would be required to be deferred for different periods of time. For the purposes of calculating qualifying incentive-based compensation awarded for any performance period, a covered institution would aggregate incentive-based compensation awarded under any incentive-based compensation plan that is not a long-term incentive plan. The required deferral percentage (40, 50, or 60 percent) would be multiplied by that total amount to determine the minimum deferral amount. In a given year, if a senior executive officer or significant risk-taker is awarded qualifying incentive-based compensation under multiple plans that have the same performance period (which is less than three years), the award under each plan would not be required to meet the minimum deferral requirement, so long as the total amount that is deferred from all of the amounts awarded under those plans meets the minimum required percentage of total qualifying incentive-based compensation relevant to that covered person.

For example, under the proposal, a significant risk-taker at a Level 2 covered institution might be awarded $60,000 under a plan with a one-year performance period that applies to all employees in her line of business and $40,000 under a plan with a one-year performance period that applies to all employees of the covered institution. For that performance period, the significant risk-taker has been awarded a total of $100,000 in qualifying incentive-based compensation, so she would be required to defer a total of $40,000. The covered institution could defer amounts awarded under either plan or under both plans, so long as the total amount deferred was at least $40,000. For example, the covered institution could choose to defer $20,000 from the first plan and $20,000 from the second plan. The covered institution could also choose to defer nothing awarded under the first plan and the entire $40,000 awarded under the second plan.

For a full example of how these requirements would work in the context of a more complete incentive-based compensation arrangement, please see Appendix A of this preamble.

In contrast, the minimum required deferral percentage would apply to all incentive-based compensation awarded under each long-term incentive plan separately. In a given year, if a senior executive officer or significant risk-taker is awarded incentive-based compensation under multiple long-term incentive plans that have performance periods of three years or more, each award under each plan would be required to meet the minimum deferral requirement.[147] Based

[147] For example, if a Level 1 covered institution awarded a senior executive officer $100,000 under one long-term incentive plan and $200,000 under another long-term incentive-plan, the covered institution would be required to defer at least $60,000 of the amount awarded under the first long-term incentive plan and at least $120,000 of the amount awarded under the second long-term incentive plan. The Level 1 covered institution would not be permitted to meet the deferral requirements by deferring, for example, $10,000 awarded under the first long-term incentive plan and $170,000 awarded under the second long-term incentive plan.

on supervisory experience, the Federal Banking Agencies have found that it would be extremely rare for a covered person to be awarded incentive-based compensation under multiple long-term incentive plans in one year.

The proposed rule would require deferral for the same percentage of qualifying incentive-based compensation as of incentive-based compensation awarded under a long-term incentive plan. However, the proposed rule would require that deferred qualifying incentive-based compensation meet a longer minimum deferral period than deferred incentive-based compensation awarded under a long-term incentive plan. As with the shorter performance period for qualifying incentive-based compensation, the period over which performance is measured under a long-term incentive plan is not considered part of the deferral period.

Under the proposed rule, both deferred qualifying incentive-based compensation and deferred incentive-based compensation awarded under a long-term incentive plan would be required to meet the vesting requirements separately. In other words, deferred qualifying incentive-based compensation would not be permitted to vest faster than on a on a pro rata annual basis, even if deferred incentive-based compensation awarded under a long-term incentive plan vested on a slower than pro rata basis. Each deferred portion is bound by the pro rata requirement.

For an example of how these requirements would work in practice, please see Appendix A of this Supplementary Information section.

Incentive-based compensation provides an inducement for a covered person at a covered institution to advance the strategic goals and interests of the covered institution while enabling the covered person to share in the success of the covered institution. Incentive-based compensation may also encourage covered persons to take undesirable or inappropriate risks, or to sell unsuitable products in the hope of generating more profit and thereby increasing the amount of incentive-based compensation received. Covered persons may also be tempted to manipulate performance results in an attempt to make performance measurements look better or to understate the actual risks such activities impose on the covered institution's balance sheet.[148]

[148] For example, towards the end of the performance period, covered persons who have not yet met the target performance measures could be tempted to amplify risk taking or take other actions to meet those

Incentive-based compensation should therefore also provide incentives for prudent risk-taking in the long term and for sound risk management.

Deferral of incentive-based compensation awards involves a delay in the vesting and payout of an award to a covered person beyond the end of the performance period. The deferral period allows for amounts of incentive-based compensation to be adjusted for actual losses to the covered institution or for other aspects of performance that become clear during the deferral period before those amounts vest or are paid. These aspects include inappropriate risk-taking and misconduct on the part of the covered person. More generally, deferral periods that lengthen the time between the award of incentive-based compensation and vesting, combined with forfeiture, are important tools for aligning the interests of risk-takers with the longer-term interests of covered institutions.[149] Deferral periods that are sufficiently long to allow for a substantial portion of the risks from the covered person's activities to manifest are likely to be most effective in ensuring that risks and rewards are adequately balanced.[150]

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targets and receive the maximum incentive-based compensation. Without deferral, there would be no additional review applied to the risk-taking activities that were taken during the defined performance period to achieve those target performance measures.

[149] There have been a number of academic papers that argue that deferred compensation provides incentives for executives to consider the long-term health of the firm. For example, Eaton and Rosen (1983) note that delaying compensation is a way of bonding executives to the firm and providing incentives for them to focus on long-term performance of the firm. See Eaton and Rosen, "Agency, Delayed Compensation, and the Structure of Executive Remuneration," 38 Journal of Finance 1489, at 1489-1505; see also Park and Sturman, "How and What You Pay Matters: The Relative Effectiveness of Merit Pay, Bonus, and Long-Term Incentives on Future Job Performance" (2012), available at http://scholarship.sha.cornell.edu/cgi/viewcontent.cgi?article=1121&context=articles.

[150] The length of the deferral period has been a topic of discussion in the literature. Edmans (2012) argues that deferral periods of two to three years are too short. He also argues that deferral should be longer for institutions where the decisions of the executives have long-term consequences. Bebchuk et al (2010) argue that deferral provisions alone will not prevent executives from putting emphasis on short-term prices because executives that have been in place for many years will have the opportunity to regularly cash out. They argue that executives should be required to hold a substantial number of shares and options until retirement. See also Edmans, Alex, "How to Fix Executive Compensation," The Wall Street Journal (February 27, 2012); Bebchuk, Lucian, Cohen, and Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008," 27 Yale Journal on Regulation 257, 257–282 (2010); Bhagat, Sanjai, Bolton and Romano, "Getting Incentives Right: Is Deferred Bank Executive Compensation Sufficient?," 31 Yale Journal on Regulation 523 (2014); Bhagat, Sanjai and Romano, "Reforming Financial Executives' Compensation for the Long Term," Research Handbook on Executive Pay (2012); Bebchuk and Fried, "Paying for Long-Term Performance," 158 University of Pennsylvania Law Review, 1915 (2010).

Deferral periods allow covered institutions an opportunity to more accurately judge the nature and scale of risks imposed on covered institutions' balance sheets by a covered person's performance for which incentive-based compensation has been awarded, and to better understand and identify risks that result from such activities as they are realized. These include risks imposed by inappropriate risk-taking or misconduct, and risks that may manifest as a result of lapses in risk management or risk oversight. For example, the risks associated with some business lines, such as certain types of lending, may require many years before they materialize.

Though it is difficult to set deferral periods that perfectly match the time it takes risks undertaken by the covered persons of covered institutions to become known, longer periods allow more time for incentive-based compensation to be adjusted between the time of award and the time incentive-based compensation vests.[151] At the same time, deferral periods that are inordinately long may reduce the effectiveness of incentive-based compensation arrangements because employees more heavily discount the potential impact of such arrangements. Thus, it is important to strike a reasonable balance between providing effective incentives and allowing sufficient time to validate performance measures over a reasonable period of deferral. The specific deferral periods and amounts proposed in the proposed rule are also consistent with current practice at many institutions that would be Level 1 or Level 2 covered institutions, and with compensation requirements in other countries.[152] In drafting the requirements in sections

[151] Some empirical literature has found a link between the deferral of compensation and firm value, firm performance, risk, and the manipulation of earnings. Gopalan et al (2014) measure the duration of executive compensation by accounting for the vesting schedules in compensation. They argue that the measure is a proxy for the executives' horizon. They find that longer duration of compensation is present at less risky institutions and institutions with better past stock performance. They also find that longer duration is associated with less manipulation of earnings. Chi and Johnson (2009) find that longer vesting periods for stocks and options are related to higher firm value. See Gopalan, Radhakrishnan, Milbourn, Song and Thakor, "Duration of Executive Compensation," 59 The Journal of Finance 2777 (2014); Chi, Jianxin, and Johnson, "The Value of Vesting Restrictions on Managerial Stock and Option Holdings" (March 9, 2009) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1136298.

[152] Moody's Investor Service, "Global Investment Banks: Reformed Pay Policies Still Pose Risks to Bondholders" ("Moody's Report") (December 9, 2014); McLagan, "Mandatory Deferrals in Incentive Programs" (March 2013), available at http://www.mclagan.com/crb/downloads/McLagan_Mandatory_Deferral_Flash_Survey_Report_3-29-2013.pdf.

___.7(a)(1) and ___.7(a)(2), the Agencies took into account the comments received regarding similar requirements in the 2011 Proposed Rule.[153]

The Agencies have proposed the three- and four-year minimum deferral periods because these deferral periods, taken together with the typically one-year performance period, would allow a Level 1 or Level 2 covered institution four to five years, or the majority of a traditional business cycle, to identify outcomes associated with a senior executive officer's or significant risk-taker's performance and risk-taking activities. The business cycle reflects periods of economic expansion or recession, which typically underpin the performance of the financial sector. The Agencies recognize that credit cycles, which revolve around access to and demand for credit and are influenced by various economic and financial factors, can be longer.[154]

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[153] Commenters on the 2011 Proposed Rule expressed differing views on the proposed deferral requirements and the deferral-related questions posed by the Agencies. For example, some commenters expressed the view that the deferral requirements for incentive-based compensation awards for executive officers were appropriate. Some commenters argued that deferral would create a longer-term focus for executives and help to ensure they are not compensated on the basis of short-term returns that fail to account for long-term risks. Many commenters also argued that the deferral requirements should be strengthened by extending the required minimum deferral period or minimum percentage of incentive compensation deferred. For example, these commenters urged the Agencies to require a five-year deferral period, instead of the three-year period that was proposed, or to disallow "pro rata" payments within the proposed three-year deferral period. These commenters also expressed the view that the Agencies' proposal to require covered financial institutions to defer 50 percent of their annual compensation would result in an insufficient amount of incentive-based compensation being at risk of potential adjustment, because the risks posed by those executive officer can take longer to become apparent. Other commenters argued that all covered institutions subject to this rulemaking should comply with the deferral requirements regardless of their size.

On the other hand, many commenters recommended that deferral not be required or argued that, if deferral were to be required, the three-year and 50 percent deferral minimums provided in the 2011 Proposed Rule were sufficient. Some commenters recommended that the deferral requirements not be applied to smaller covered institutions. Some commenters also suggested that unique aspects of certain types of covered institutions, such as investment advisers or smaller banks within a larger consolidated organization, should be considered when imposing deferral and other requirements on incentive-based compensation arrangements. A number of commenters suggested that applying a prescriptive deferral requirement, together with other requirements under the 2011 Proposed Rule, would make it more difficult for covered institutions to attract and retain key employees in comparison to the ability of organizations not subject to such requirements to recruit and retain the same employees.

[154] From 1945 to 2009, the average length of the business cycle in the U.S. was approximately 5.7 years. See The National Bureau of Economic Research, "U.S. Business Cycle Expansions and Contractions, available at http://www.nber.org/cycles/cyclesmain.html. Many researchers have found that credit cycles are longer than business cycles. For example, Drehmann et al (2012) estimate an average duration of credit cycles from 10 to 20 years. See Drehmann, Mathias, Borio and Tsatsaronis, "Characterising the Financial Cycle: Don't Lose Sight of the Medium Term!" Bank for International Settlements, Working Paper, No. 380 (June 2012), available at http://www.bis.org/publ/work380.htm. Aikman et al (2015)

However, the Agencies are also concerned with striking the right balance between allowing covered persons to be fairly compensated and not encouraging inappropriate risk-taking. The Agencies are concerned that extending deferral periods for too long may lead to a covered person placing little or no value on the incentive-based compensation that only begins to vest far out in the future. This type of discounting of the value of long-deferred awards may be less effective as an incentive, positive or negative, and consequently for balancing the benefit of these types of awards.[155]

As described above, since the Agencies proposed the 2011 Proposed Rule, the Agencies have gained significant supervisory experience while encouraging covered institutions to adopt improved incentive-based compensation practices. The Federal Banking Agencies note in particular improvements in design of incentive-based compensation arrangements that help to more appropriately balance risk and reward. Regulatory requirements for sound incentive-based compensation arrangements at financial institutions have continued to evolve, including those being implemented by foreign regulators. Consideration of international practices and standards is particularly relevant in developing incentive-based compensation standards for large financial institutions because they often compete for talented personnel internationally.

Based on supervisory experience, although exact amounts deferred may vary across employee populations at large covered institutions, the Federal Banking Agencies have observed that, since the financial crisis that began in 2007, most deferral periods at financial institutions range from three to five years, with three years being the most common deferral period.[156] Consistent with this observation, the FSB standards suggest deferral periods "not less than three years," and the average deferral period at significant institutions in FSB member countries is now between three and four years.[157] The PRA requires deferral of seven years for senior

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found that the credit cycle ranges from eight to 20 years. See Aikman, Haldane, and Nelson, "Curbing the Credit Cycle," 125 The Economic Journal 1072 (June 2015).

[155] See Pepper and Gore, "The Economic Psychology of Incentives: An International Study of Top Managers," 49 Journal of World Business 289 (2014); PRA, Consultation Paper PRA CP15/14 / FCA CP14/14: Strengthening the alignment of risk and reward: new remuneration rules (July 2014) available at http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1514.pdf.

[156] See 2011 FRB White Paper, at 15.

[157] FSB, Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Fourth Progress Report ("2015 FSB Compensation Progress Report") (2015), available at http://www.fsb.org/2015/11/fsb-publishes-fourth-progress-report-on-compensation-practices.

managers as defined under the Senior Managers Regime, five years for risk managers as defined under the EBA regulatory technical standard on identification of material risk-takers, and three to five years as per the CRD IV minimum for all other material risk-takers.[158] CRD IV sets a minimum deferral period of "at least three to five years." For senior management, significant institutions[159] are expected to apply deferral of "at least five years."[160] Swiss regulations[161] require that for members of senior management, persons with relatively high total remuneration, and persons whose activities have a significant influence on the risk profile of the firm, the time period for deferral should last "at least three years."

The requirements in the proposed rule regarding amounts deferred are also consistent with observed better practices and the standards established by foreign regulators. The Board's summary overview of findings during the early stages of the 2011 FRB White Paper [162] observed that "deferral fractions set out in the FSB Principles and Implementation Standards[163] are sometimes used as a benchmark (60 percent or more for senior executives, 40 percent or more for other individual "material risk takers," which are not the same as "covered employees") and concluded that deferral fractions were at or above these benchmarks at both the U.S. banking organizations and foreign banking organizations that participated in the horizontal review.

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[158] See UK Remuneration Rules. The United Kingdom deferral standards apply on a group-wide basis and apply to banks, building societies, and PRA-designated investment firms, but do not currently cover investment advisors outside of consolidated firms.

[159] CRD IV defines institutions that are significant "in terms of size, internal organisation and nature, scope and complexity of their activities." Under the EBA Guidance on Sound Remuneration Policies, significant institutions means institutions referred to in Article 131 of Directive 2013/36/EU (global systemically important institutions or 'G-SIIs,' and other systemically important institutions or 'O- SIIs'), and, as appropriate, other institutions determined by the competent authority or national law, based on an assessment of the institutions' size, internal organisation and the nature, the scope and the complexity of their activities. Some, but not all, national regulators have provided further guidance on interpretation of that term, including the FCA which provides a form of methodology to determine if a firm is "significant" based on quantitative tests of balance sheet assets, liabilities, annual fee commission income, client money and client assets.

[160] See EBA Remuneration Guidelines.

[161] See FINMA Remuneration Circular 2010

[162] See FRB 2011 Report, at 31.

[163] Specifically, the FSB Implementation Standards encourage that "a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years" and that "proportions should increase significantly along with the level of seniority and/or responsibility…for the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, for instance, above 60 percent."

The proportion of incentive-based compensation awards observed to be deferred at financial institutions during the Board's horizontal review was substantial. For example, on average senior executives report more than 60 percent of their incentive-based compensation is deferred,[164] and some of the most senior executives had more than 80 percent of their incentive-based compensation deferred with additional stock retention requirements after deferred stock vests. Most institutions assigned deferral rates to employees using a fixed schedule or "cash/stock table" under which employees that received higher incentive-based compensation awards generally were subject to higher deferral rates, although deferral rates for the most senior executives were often set separately and were higher than those for other employees.[165] The proposed rule's higher deferral rates for senior executive officers would be consistent with this observed industry practice of requiring higher deferral rates for the most senior executives. Additionally, by their very nature, senior executive officer positions tend to have more responsibility for strategic decisions and oversight of multiple areas of operations, and these responsibilities warrant requiring higher percentages of deferral and longer deferral periods to safeguard against inappropriate risk-taking.

This proposed rule is also consistent with standards being developed internationally. The PRA expects that "where any employee's variable remuneration component is £500,000 or more, at least 60 percent should be deferred."[166] European Union regulations require that "institutions should set an appropriate portion of remuneration that should be deferred for a category of identified staff or a single identified staff member at or above the minimum proportion of 40 percent or respectively 60 percent for particularly high amounts."[167] The EU also publishes a report on *Benchmarking of Remuneration Practices at Union Level and Data on High Earners*[168] that provides insight into amounts deferred across various lines of business within significant institutions across the European Union. While amounts varied by areas of operations, average

[164] "Deferral" for these reports is defined by the institutions and may include long-term incentive plans without additional deferral.
[165] See 2011 FRB White Paper, at 15.
[166] See PRA, Supervisory Statement SS27/15: Remuneration (June 2015), available at http://www.bankofengland.co.uk/pra/Documents/publications/ss/2015/ss2715.pdf.
[167] See EBA Remuneration Guidelines.
[168] See, e.g., EBA, Benchmarking of Remuneration Practices at Union Level and Data on High Earners, at 39, Figure 46 (September 2015), available at http://www.eba.europa.eu/-/eba-updates-on-remuneration-practices-and-high-earners-data- for-2013-across-the-eu.

deferral levels for identified staff range from 54 percent in retail banking to more than 73 percent in investment banking.

The proposed rule's enhanced requirements for Level 1 institutions are consistent with international standards. Many regulators apply compensation standards in a proportional or tiered fashion. The PRA, for example, classifies three tiers of firms based on asset size and applies differentiated standards across this population. Proportionality Level 1 includes firms with greater than £50 billion in consolidated assets; Proportionality Level 2 includes firms with between £15 billion and £50 billion in consolidated assets; and Proportionality Level 3 includes firms with less than £15 billion in consolidated assets. The PRA also recognizes "significant" firms. Proportionality Level 3 firms are typically not subject to provisions on retained shares, deferral, or performance adjustment.

Under the proposed rule, incentive-based compensation awarded under a long-term incentive plan would be treated separately and differently than amounts of incentive-based compensation awarded under annual performance plans (and other qualifying incentive-based compensation) for the purposes of the deferral requirements. Deferral of incentive-based compensation and the use of longer performance periods (which is the hallmark of a long-term incentive plan) both are useful tools for balancing risk and reward in incentive-based compensation arrangements because both allow for the passage of time that allows the covered institution to have more information about a covered person's risk-taking activity and its possible outcomes. Both methods allow awards or payments to be made after some or all risk outcomes are realized or better known. However, longer performance periods and deferral of vesting are distinct risk balancing methods.[169]

As noted above, the Agencies took into account the comments received regarding similar deferral requirements in the 2011 Proposed Rule. In response to the proposed deferral requirement in the 2011 Proposed Rule, which did not distinguish between incentive-based compensation awarded under a long-term incentive plan and other incentive-based compensation, several commenters argued that the Agencies should allow incentive-based

[169] The 2011 Proposed Rule expressly recognized this distinction ("The Proposed Rule identifies four methods that currently are often used to make compensation more sensitive to risk. These methods are Risk Adjustment of Awards…Deferral of Payment…Longer Performance Periods…Reduced Sensitivity to Short-Term Performance."). See 76 FR at 21179.

compensation arrangements that use longer performance periods, such as a three-year performance period, to count toward the mandatory deferral requirement. In particular, some commenters argued that institutions that use longer performance periods should be allowed to start the deferral period at the beginning of the performance period. In this way, they argued, a payment made at the end of a three-year performance period has already been deferred for three years for the purposes of the deferral requirement.

As discussed above, deferral allows for time to pass after the conclusion of the performance period. It introduces a period of time in between the end of the performance period and vesting of the incentive-based compensation during which risks may mature without the employee taking additional risks to affect that earlier award.

Currently, institutions commonly use long-term incentive plans without subsequent deferral and thus there is no period following the multi-year performance period that would permit the covered institution to apply forfeiture or other reductions should it become clear that the covered person engaged in inappropriate risk-taking. Without deferral, the incentive-based compensation is awarded and vests at the end of the multi-year performance period.[170] In contrast, during the deferral period, the covered person's incentive-based compensation award is fixed and the vesting could be affected by information about a covered person's risk-taking activities during the performance period that becomes known during the deferral period.

For a long-term incentive plan, the period of time between the beginning of the performance period and when incentive-based compensation is awarded is longer than that of an annual plan. However, the period of time between the end of the performance period and when incentive-based compensation is awarded is the same for both the long-term incentive plan and for the annual plan. Consequently, while a covered institution may have more information about the risk-taking activities of a covered person that occurred near the beginning of the performance period for a long-term incentive plan than for an annual plan, the covered institution would have

[170] An employee may be incentivized to take additional risks near the end of the performance period to attempt to compensate for poor performance early in the period of the long-term incentive compensation plan. For example, as noted above, towards the end of a multi-year performance period, covered persons who have not yet met the target performance measures could be tempted to amplify risk taking or take other actions to meet those targets and receive the maximum long-term incentive plan award with no additional review applied to the risk-taking activities that were taken during the defined performance period to achieve those target performance measures.

no more information about risk-taking activities that occur near the end of the performance period. The incentive-based compensation awarded under the long-term incentive plan would be awarded without the benefit of additional information about risk-taking activities near the end of the performance period.

Therefore, the proposed rule would treat incentive-based compensation awarded under a long-term incentive plan similarly to, but not the same as, qualifying incentive-based compensation for purposes of the deferral requirement. Under the proposed rule, the incentive-based compensation awarded under a long-term incentive plan would be required to be deferred for a shorter amount of time than qualifying incentive-based compensation, although the period of time elapsing between the beginning of the performance period and the actual vesting would be longer. A shorter deferral period would recognize the fact that the longer performance period of a long-term incentive plan allows some time for information to surface about risk-taking activities undertaken at the beginning of the performance period. The longer performance period allows covered institutions to adjust the amount awarded under long-term incentive plans for poor performance during the performance period. Yet, since no additional time would pass between risk-taking activities at the end of the performance period and the award date, the proposed rule would allow a shorter deferral period than would be necessary for qualifying incentive-based compensation.

The percentage of incentive-based compensation awarded that would be required to be deferred would be the same for incentive-based compensation awarded under a long-term incentive plan and for qualifying incentive-based compensation. However, because of the difference in the minimum required deferral period, the minimum deferral amounts for qualifying incentive-based compensation and for incentive-based compensation awarded under a long-term incentive plan would be required to be calculated separately. In other words, any amount of qualifying incentive-based compensation that a covered institution chooses to defer above the minimum required would not decrease the minimum amount of incentive-based compensation awarded under a long-term plan that would be required to be deferred, and vice versa.

For example, a Level 2 covered institution that awards a senior executive officer $50,000 of qualifying incentive-based compensation and $20,000 under a long-term incentive plan would be required to defer at least $25,000 of the qualifying incentive-based compensation and at least $10,000 of the amounts awarded under the long-term incentive plan. The Level 2 covered institution would not be permitted to defer, for example, $35,000 of qualifying incentive-based compensation and no amounts awarded under the long-term incentive plan, even though that would result in the deferral of 50 percent of the senior executive officer's total incentive-based compensation. For a full example of how these requirements would work in the context of a more complete incentive-based compensation arrangement, please see Appendix A of this preamble.

For incentive-based compensation awarded under a long-term incentive plan, section ___.7(a)(2) of the proposed rule would require that minimum deferral periods for senior executive officers and significant risk-takers at a Level 1 covered institution extend to two years after the award date and minimum deferral periods at a Level 2 covered institution extend to one year after the award date. For long-term incentive plans with performance periods of three years,[171] this requirement would delay the vesting of the last portion of this incentive-based compensation until five years after the beginning of the performance period at Level 1 covered institutions and four years after the beginning of the performance period at Level 2 covered institutions. Thus, while the deferral period from the award date is shorter for incentive-based compensation awarded under a long-term incentive plan, the delay in vesting from the beginning of the performance period would generally be the same under the most common qualifying incentive-based compensation and long-term incentive plans.

Under the proposed rule, the incentive-based compensation that would be required by the rule to be deferred would not be permitted to vest faster than on a pro rata annual basis beginning no earlier than the first anniversary of the end of the performance period. This requirement would apply to both deferred qualifying incentive-based compensation and deferred incentive-based compensation awarded under a long-term incentive plan.

The Federal Banking Agencies have also observed that the minimum required deferral amounts and deferral periods that would be required under the proposed rule are generally consistent with industry practice at larger covered institutions that are currently subject to the

[171] Many studies of incentive-based compensation at large institutions have found that long-term incentive plans commonly have performance periods of three years. See Cook Report; Moody's Report.

2010 Federal Banking Agency Guidance, although the Agencies recognize that some institutions would need to revise their individual incentive-based compensation programs and others were not subject to the 2010 Federal Banking Agency Guidance. In part because the 2010 Federal Banking Agency Guidance and compensation regulations imposed by international regulators[172] currently encourage banking institutions to increase the proportion of compensation that is deferred to reflect higher levels of seniority or responsibility, current practice for the largest international banking institutions reflects substantial levels of deferral for such individuals. Many of those individuals would be senior executive officers and significant risk-takers under the proposed rule. Under current practice, deferral typically ranges from 40 percent for less senior significant risk-takers to more than 60 percent for senior executives.[173] The Agencies note that current practice for the largest international banking institutions reflects average deferral periods of at least three years.[174]

The deferral requirements of the proposed rule for senior executive officers and significant risk-takers at the largest covered institutions are also consistent with international standards on compensation. The European Union's 2013 law on remuneration paid by financial institutions requires deferral for large firms, among other requirements.[175] The PRA and the FCA initially adopted the European Union's law and requires covered companies to defer 40 to

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[172] Most members of the FSB, for instance, have issued regulations, or encourage through guidance and supervisory practice, deferral standards that meet the minimums set forth in the FSB's Implementation Standards. See 2015 FSB Compensation Progress Report (concluding "almost all FSB jurisdictions have now fully implemented the P&S for banks."). The FSB standards state that "a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years and these proportions should increase significantly along with the level of seniority and/or responsibility. The deferral period should not be less than three years. See FSB Principles and Implementation Standards.

[173] FSB member jurisdictions provided data for the purposes of the 2015 FSB Compensation Progress Report indicating that while the percentage of variable remuneration deferred varies significantly between institutions and across categories of staff, for the surveyed population of senior executives, the percentage of deferred incentive-based compensation averaged approximately 50 percent. See 2015 FSB Compensation Progress Report.

[174] See Moody's Report.

[175] In June 2013, the European Union adopted CRD IV, which sets out requirements on compensation structures, policies, and practices that applies to all banks and investment firms subject to the CRD. CRD IV provides that at least 50 percent of total variable remuneration should consist of equity-linked interests and at least 40 percent of the variable component must be deferred over a period of three to five years. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 (effective January 1, 2014).

60 percent of “senior manager,” “risk manager,” and “material risk-taker” compensation. The PRA and FCA recently updated their implementing regulations to extend deferral periods to seven years for senior managers and up to five years for certain other persons.[176] The proposed deferral requirements are also generally consistent with the FSB’s Principles for Sound Compensation Practices and their related implementation standards issued in 2009.[177] Having standards that are generally consistent across jurisdictions would be important both to enable institutions subject to multiple regimes to fulfill the requirements of all applicable regimes, and to ensure that covered institutions in the United States would be on a level playing field compared to their non-U.S. peers in the global competition for talent.

7.1 The Agencies invite comment on the proposed requirements in sections ___.7(a)(1) and (a)(2).

7.2 Are minimum required deferral periods and percentages appropriate? If not, why not? Should Level 1 and Level 2 covered institutions be subject to different deferral requirements, as in the proposed rule, or should they be treated more similarly for this purpose and why? Should the minimum required deferral period be extended to, for example, five years or longer in certain cases and why?

7.3 Is a deferral requirement for senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions appropriate to promote the alignment of employees’ incentives with the risk undertaken by such covered persons? If not, why not? For example, comment is invited on whether deferral is generally an appropriate method for achieving incentive-based compensation arrangements that appropriately balance risk and reward for each type of senior executive officer and significant risk-taker at these institutions or whether there are alternative or more effective ways to achieve such balance.

7.4 Commenters are also invited to address the possible impact that the required minimum deferral provisions for senior executive officers and significant risk-takers may have on larger covered institutions and whether any deferral requirements should apply to senior executive officers at Level 3 institutions.

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[176] See UK Remuneration Rules. In the case of a material risk-taker who performs a PRA senior management function, the pro rata vesting requirement applies only from year three onwards (i.e., the required deferral period is seven years, with no vesting to take place until three years after award).

[177] FSB Principles and Implementation Standards.

7.5 A number of commenters to the 2011 Proposed Rule suggested that applying a prescriptive deferral requirement, together with other requirements under that proposal, would make it more difficult for covered institutions to attract and retain key employees in comparison to the ability of organizations not subject to such requirements to recruit and retain the same employees. What implications does the proposed rule have on "level playing fields" between covered institutions and non-covered institutions in setting forth minimum deferral requirements under the rule?

7.6 The Agencies invite comment on whether longer performance periods can provide risk balancing benefits similar to those provided by deferral, such that the shorter deferral periods for incentive-based compensation awarded under long-term incentive plans in the proposed rule would be appropriate.

7.7 Would the proposed distinction between the deferral requirements for qualifying incentive-based compensation and incentive-based compensation awarded under a long-term incentive plan pose practical difficulties for covered institutions or increase compliance burdens? Why or why not?

7.8 Would the requirement in the proposed rule that amounts awarded under long-term incentive plans be deferred result in covered institutions offering fewer long-term incentive plans? If so, why and what other compensation plans will be used in place of long-term incentive plans and what negative or positive consequences might result?

7.9 Are there additional considerations, such as tax or accounting considerations, that may affect the ability of Level 1 or Level 2 covered institutions to comply with the proposed deferral requirement or that the Agencies should consider in connection with this provision in the final rule? Commenters on the 2011 Proposed Rule noted that employees of an investment adviser to a private fund hold partnership interests and that any incentive allocations paid to them are typically taxed at the time of allocation, regardless of whether these allocations have been distributed, and consequently, employees of an investment adviser to a private fund that would have been subject to the deferral requirement in the 2011 Proposed Rule would have been required to pay taxes relating to incentive allocations that they were required to defer. Should the determination of required deferral amounts under the proposed rule be adjusted in the context of investment advisers to private funds and, if so, how? Could the tax liabilities immediately payable on deferred amounts be paid from the compensation that is not deferred?

7.10 The Agencies invite comment on the circumstances under which acceleration of payment should be permitted. Should accelerated vesting be allowed in cases where employees are terminated without cause or cases where there is a change in control and the covered institution ceases to exist and why? Are there other situations for which acceleration should be allowed? If so, how can such situations be limited to those of necessity?

7.11 The Agencies received comment on the 2011 Proposed Rule that stated it was common practice for some private fund adviser personnel to receive payments in order to enable the recipients to make tax payments on unrealized income as they became due. Should this type of practice to satisfy tax liabilities, including tax liabilities payable on unrealized amounts of incentive-based compensation, be permissible under the proposed rule, including, for example, as a permissible acceleration of vesting under the proposed rule? Why or why not? Is this a common industry practice?

§__.7(a)(3) Adjustments of deferred qualifying incentive-based compensation and deferred long-term incentive plan compensation amounts.

Under section ___.7(a)(3) of the proposed rule, during the deferral period, a Level 1 or Level 2 covered institution would not be permitted to increase a senior executive or significant risk-taker's unvested deferred incentive-based compensation.[178] In other words, any deferred incentive-based compensation, whether it was awarded as qualifying incentive-based compensation or under a long-term incentive plan, would be permitted to vest in an amount equal to or less than the amount awarded, but would not be permitted to increase during the deferral period.[179] Deferred incentive-based compensation may be decreased, for example, under a forfeiture and downward adjustment review as would be required under section ___.7(b) of the proposed rule, discussed below. It may also be adjusted downward as a result of performance that falls short of agreed upon performance measure targets

As discussed in section 8(b), under some incentive-based compensation plans, covered persons can be awarded amounts in excess of their target amounts if the covered institution or covered person's performance exceed performance targets. As explained in the discussion on

[178] This requirement is distinct from the prohibition in section 8(b) of the proposed rule, discussed below.
[179] Accelerated vesting would be permitted in limited circumstances under sections ___.7(a)(1)(iii)(B) and ___.7(a)(2)(iii)(B), as described above.

section 8(b), this type of upside leverage in incentive-based compensation plans may encourage covered persons to take inappropriate risks. Therefore, the proposed rule would limit maximum payouts to between 125 and 150 percent of the pre-set target. In a similar vein, the Agencies are concerned that allowing Level 1 and Level 2 covered institutions to provide for additional increases in amounts that are awarded but deferred may encourage senior executive officers and significant risk-takers to take more risk during the deferral period and thus may not balance risk-taking incentives. This concern is especially acute when covered institutions require covered persons to meet more aggressive goals than those established at the beginning of the performance period in order to "re-earn" already awarded, but deferred incentive-based compensation.

Although increases in the amount awarded, as described above, would be prohibited by the proposed rule, increases in the value of deferred incentive-based compensation due solely to a change in share value, a change in interest rates, or the payment of reasonable interest or a reasonable rate of return according to terms set out at the award date would not be considered increases in the amount awarded for purposes of this restriction. Thus, a Level 1 or Level 2 covered institution would be permitted to award incentive-based compensation to a senior executive officer or significant risk-taker in the form of an equity or debt instrument, and, if that instrument increased in market value or included a provision to pay a reasonable rate of interest or other return that was set at the time of the award, the vesting of the full amount of that instrument would not be in violation of the proposed rule.

For an example of how these requirements would work in practice, please see Appendix A of this Supplementary Information section.

7.12 The Agencies invite comment on the requirement in section ___.7(a)(3).

§__.7(a)(4) Composition of deferred qualifying incentive-based compensation and deferred long-term incentive plan compensation for Level 1 and Level 2 covered institutions.

Section ___.7(a)(4) of the proposed rule would require that deferred qualifying incentive-based compensation or deferred incentive-based compensation awarded under a long-term incentive plan of a senior executive officer or significant risk-taker at a Level 1 or Level 2 covered institution meet certain composition requirements.

Cash and equity-like instruments.

Covered institutions award incentive-based compensation in a number of forms, including cash-based awards, equity-like instruments, and in a smaller number of cases, incentive-based compensation in the form of debt or debt-like instruments such as deferred cash. First, the proposed rule would require that, at Level 1 and Level 2 covered institutions[180] that issue equity or are the affiliates of covered institutions that issue equity, deferred incentive-based compensation for senior executive officers and significant risk-takers include substantial portions of both deferred cash and equity-like instruments throughout the deferral period. The Agencies recognize that the form of incentive-based compensation that a senior executive officer or significant risk-taker receives can have an impact on the incentives provided and thus their behavior. In particular, having incentive-based compensation in the form of equity-like instruments can align the interests of the senior executive officers and significant risk-takers with the interests of the covered institution's shareholders. Thus, the proposed rule would require that a senior executive officer's or significant risk-taker's deferred incentive-based compensation include a substantial portion of equity-like instruments.

Similarly, having incentive-based compensation in the form of cash can align the interests of the senior executive officers and significant risk-takers with the interests of other stakeholders in the covered institution.[181] Thus, the proposed rule would require that a senior executive officer's or significant risk-taker's deferred incentive-based compensation include a substantial portion of cash.

The value of equity-like instruments received by a covered person increases or decreases in value based on the value of the equity of the covered institution, which provides an implicit method of adjusting the underlying value of compensation as the share price of the covered

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[180] In the cases of the Board, FDIC and OCC, this requirement would not apply to a Level 1 and Level 2 covered institution that does not issue equity itself and is not an affiliate of an institution that issues equity. Credit unions and certain mutual savings associations, mutual savings banks, and mutual holding companies do not issue equity and do not have a parent that issues equity. For those institutions, imposing this requirement would have little benefit, as no equity-like instruments would be based off of the equity of the covered institution or one of its parents. In the case of FHFA, this requirement would not apply to a Level 1 or Level 2 covered institution that does not issue equity or is not permitted by FHFA to use equity-like instruments as compensation for senior executive officers and significant risk-takers.

[181] Generally, in the case of resolution or bankruptcy, deferred incentive-based compensation in the form of cash would be treated similarly to other unsecured debt.

institution changes as a result of better or worse operational performance. Deferred cash may increase in value over time pursuant to an interest rate, but its value generally does not vary based on the performance of the covered institution. These two forms of incentive-based compensation present a covered person with different incentives for performance, just as a covered institution itself faces different incentives when issuing debt or equity-like instruments.[182]

For purposes of this proposed rule, the Agencies consider incentive-based compensation paid in equity-like instruments to include any form of payment in which the final value of the award or payment is linked to the price of the covered institution's equity, even if such compensation settles in the form of cash. Deferred cash can be structured to share many attributes of a debt instrument. For instance, while equity-like instruments have almost unlimited upside (as the value of the covered institution's shares increase), deferred cash that is structured to resemble a debt instrument can be structured so as to offer limited upside and can be designed with other features that align more closely with the interests of the covered institution's debtholders than its shareholders. [183]

[182] Jensen and Meckling (1976) were the first to point out that the structure of compensation should reflect all of the stakeholders in the firm—both equity and debt holders, an idea further explored by Edmans and Liu (2013). Faulkender et al (2012) argue that a compensation program that relies too heavily on stock-based compensation can lead to excessive risk taking, manipulation, and distract from long-term value creation. Empirical research has found that equity-based pay increases risk at financial firms Balanchandarn et al 2010). See Jensen and Metcking, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," 3 Journal of Financial Economics 305 (July 1, 1976); Edmans and Liu, "Inside Debt," 15 Review of Finance 75 (June 29, 2011); Faulkender, Kadyrzhanova, Prabhala, and Senbet, "Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms," 22 Journal of Applied Corporate Finance 107 (2010); and Balachandran, Kogut, and Harnal, "The Probability of Default, Excess Risk and Executive Compensation: A Study of Financial Service Firms from 1995 to 2008," working paper (June 2010), available at http://www.insead.edu/facultyresearch/areas/accounting/events/documents/excess_risk_bank_revisedjune21bk.pdf.

[183] There has been a recent surge in research on the use of compensation that has a payoff structure similar to debt, or "inside debt." See, e.g., Wei and Yermack, "Investor Reactions to CEOs Inside Debt Incentives," 24 Review of Financial Studies 3813 (2011) (finding that bond prices rise, equity prices fall, and the volatility of both bond and stock prices fall for firms where the CEO has sizable inside debt and arguing the results indicate that firms with higher inside debt have lower risk; Cassell, Huang, Sanchez, and Stuart, "Seeking Safety: The Relation between CEO Inside Debt Holding and the Riskiness of Firm Investment and Financial Policies," 103 Journal of Financial Economics 518 (2012) (finding higher inside debt is associated with lower volatility of future firm stock returns, research and development

Where possible, it is important for the incentive-based compensation of senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions to have some degree of balance between the amounts of deferred cash and equity-like instruments received. With the exception of the limitation of use of options discussed below, the Agencies propose to provide covered institutions with flexibility in meeting the general balancing requirement under section ____.7(a)(4)(i) and thus have not proposed specific percentages of deferred incentive-based compensation that must be paid in each form.

Similar to the rest of section ___.7, the requirement in section ___.7(a)(4)(i) would apply to deferred incentive-based compensation of senior executive officers and significant risk-takers of Level 1 and Level 2 covered institutions. As discussed above, these covered persons are the ones most likely to have a material impact on the financial health and risk-taking of the covered institution. Importantly for this requirement, these covered persons are also the most likely to be able to influence the value of the covered institution's equity and debt.

7.13 The Agencies invite comment on the composition requirement set out in section ___.7(a)(4)(i) of the proposed rule.

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expenditures, and financial leverage, and more diversification and higher asset liquidity and empirical research finding that debt holders recognize the benefits of firms including debt-like components in their compensation structure); Anantharaman, Divya, Fang, and Gong, "Inside Debt and the Design of Corporate Debt Contracts," 60 Management Science 1260 (2013) (finding that higher inside debt is associated with a lower cost of debt and fewer debt covenants); Bennett, Guntay and Unal, "Inside Debt and Bank Default Risk and Performance During the Crisis," FDIC Center for Financial Research Working Paper No. 2012-3 (finding that banks that had higher inside debt before the recent financial crisis had lower default risk and higher performance during the crisis and that banks with higher inside debt had supervisory ratings that indicate that they had stronger capital positions, better management, stronger earnings, and being in a better position to withstand market shocks in the future); Srivastav, Abhishek, Armitage, and Hagendorff, "CEO Inside Debt Holdings and Risk-shifting: Evidence from Bank Payout Policies," 47 Journal of Banking & Finance 41 (2014) (finding that banks with higher inside debt holdings have a more conservative dividend payout policy); Chen, Dou, and Wang, "Executive Inside Debt Holdings and Creditors' Demand for Pricing and Non-Pricing Protections," working paper (2010) (finding that higher inside debt is associated with lower interest rates and less restrictive debt covenants and that in empirical research, specifically on banks, similar patterns emerge). In addition, the Squam Lake Group has done significant work on the use of debt based structures. See, e.g., Squam Lake Group, "Aligning Incentives at Systemically Important Financial Institutions" (2013) available at http://www.squamlakegroup.org/Squam%20Lake%20Bonus%20Bonds%20Memo%20Mar%2019%202013.pdf. In their paper "Enhancing Financial Stability in the Financial Services Industry: Contribution of Deferred Cash Compensation," forthcoming in the Federal Reserve Bank of New York's Economic Policy Review (available at https://www.newyorkfed.org/research/epr/index.html), Hamid Mehran and Joseph Tracy highlight three channels through which deferred cash compensation can help mitigate risk: promoting conservatism, inducing internal monitoring, and creating a liquidity buffer.

7.14 In order to allow Level 1 and Level 2 covered institutions sufficient flexibility in designing their incentive-based compensation arrangements, the Agencies are not proposing a specific definition of “substantial” for the purposes of this section. Should the Agencies more precisely define the term “substantial” (for example, one-third or 40 percent) and if so, should the definition vary among covered institutions and why? Should the term “substantial” be interpreted differently for different types of senior executive officers or significant risk-takers and why? What other considerations should the Agencies factor into level of deferred cash and deferred equity required? Are there particular tax or accounting implications attached to use of particular forms of incentive-based compensation, such as those related to debt or equity?

7.15 The Agencies invite comment on whether the use of certain forms of incentive-based compensation in addition to, or as a replacement for, deferred cash or deferred equity-like instruments would strengthen the alignment between incentive-based compensation and prudent risk-taking.

7.16 The Agencies invite commenters’ views on whether the proposed rule should include a requirement that a certain portion of incentive-based compensation be structured with debt-like attributes. Do debt instruments (as opposed to equity-like instruments or deferred cash) meaningfully influence the behavior of senior executive officers and significant risk-takers? If so, how? How could the specific attributes of deferred cash be structured, if at all, to limit the amount of interest that can be paid? How should such an interest rate be determined, and how should such instruments be priced? Which attributes would most closely align use of a debt-like instrument with the interest of debt holders and promote risk-taking that is not likely to lead to material financial loss?

Options.

Under section ___.7(a)(4)(ii), for senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions that receive incentive-based compensation in the form of options, the total amount of such options that may be used to meet the minimum deferral amount requirements is limited to, no more than 15 percent of the amount of total incentive-based compensation awarded for a given performance period. A Level 1 or Level 2 covered institution would be permitted to award incentive-based compensation to senior executive officers and significant risk-takers in the form of options in excess of this limitation, and could defer such compensation, but the incentive-based compensation in the form of options in excess of the 15 percent limit would not be counted towards meeting the minimum deferral requirements for senior executive officers and significant risk-takers at these covered institutions.

For example, a Level 1 covered institution might award a significant risk-taker $100,000 in incentive-based compensation at the end of a performance period: $80,000 in qualifying incentive-based compensation, of which $25,000 is in options, and $20,000 under a long-term incentive plan, all of which is delivered in cash. The Level 1 covered institution would be required to defer at least $40,000 of the qualifying incentive-based compensation and at least $10,000 of the amount awarded under the long-term incentive plan. Under the draft proposed rule, the amount that could be composed of options and count toward the overall deferral requirement would be limited to 15 percent of the total amount of incentive-based compensation awarded. In this example, the Level 1 covered institution could count $15,000 in options (15 percent of $100,000) toward the requirement to defer $40,000 of qualifying incentive-based compensation. For an example of how these requirements would work in the context of a more complete incentive-based compensation arrangement, please see Appendix A of this preamble.

This requirement would thus limit the total amount of incentive-based compensation in the form of options that could satisfy the minimum deferral amounts in sections ___.7(a)(1)(i) and ___.7(a)(1)(ii). Any incentive-based compensation awarded in the form of options would, however, be required to be included in calculating the total amount of incentive-based compensation awarded in a given performance period for purposes of calculating the minimum deferral amounts at Level 1 and Level 2 covered institutions as laid out in sections ___.7(a)(1)(i) and ___.7(a)(2)(ii).

Options can be a significant and important part of incentive-based compensation arrangements at many covered institutions. The Agencies are concerned, however, that overreliance on options as a form of incentive-based compensation could have negative effects on the financial health of a covered institution due to options' emphasis on upside gains and possible lack of responsiveness to downside risks.[184]

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[184] In theory, since the payoffs from holding stock options are positively related to volatility of stock returns, options create incentives for executives to increase the volatility of share prices by engaging in riskier activities. See, e.g., Guay, W.R., "The Sensitivity of CEO Weather to Equity Risk: An Analysis of the Magnitude and Determinants," 53 Journal of Financial Economics 43 (1999); Cohen, Hall, and

The risk dynamic for senior executive officers and significant risk-takers changes when options are awarded because options offer asymmetric payoffs for stock price performance. Options may generate very high payments to covered persons when the market price of a covered institution's shares rises, representing a leveraged return relative to shareholders. Payment of incentive-based compensation in the form of options may therefore increase the incentives under some market conditions for covered persons to take inappropriate risks in order to increase the covered institution's short-term share price, possibly without giving appropriate weight to long-term risks.

Moreover, unlike restricted stock, options are limited in how much they decrease in value when the covered institution's shares decrease in value.[185] Thus, options may not be an effective tool for causing a covered person to adjust his or her behavior to manage downside risk. For senior executive officers and significant risk-takers, whose activities can materially impact the firm's stock price, incentive-based compensation based on options may therefore create greater incentive to take inappropriate risk or provide inadequate disincentive to manage risk. For these reasons, the Agencies are proposing to limit to 15 percent the amount permitted to be used in meeting the minimum deferral requirements.

In proposing to limit, but not prohibit, the use of options to fulfill the proposed rule's deferral requirements, the Agencies have sought to conservatively apply better practice while

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Viceira, "Do Executive Stock Options Encourage Risk Taking?" working paper (2000) available at http://www.people.hbs.edu/lviceira/cohallvic3.pdf; Rajgopal and Shvelin, "Empirical Evidence on the Relation between Stock Option Compensation and Risk-Taking," 33 Journal of Accounting and Economics 145 (2002); Coles, Daniel, and Naveen, "Managerial Incentives and Risk-Taking," 79 Journal of Financial Economics 431 (2006); Chen, Steiner, and Whyte, "Does Stock Option-Based Executive Compensation Induce Risk-Taking? An Analysis of the Banking Industry," 30 Journal of Banking & Finance 916 (2006); Mehran, Hamid and Rosenberg, "The Effect of Employee Stock Options on Bank Investment Choice, Borrowing and Capital," Federal Reserve Bank of New York Staff Reports No. 305 (2007) available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr305.pdf.

Beyond the typical measures of risk, the academic literature has found a relation between executive stock option holdings and risky behavior. See, e.g., Denis, Hanouna, and Sarin, "Is There a Dark Side to Incentive Compensation?" 12 Journal of Corporate Finance 467 (2006) (finding that there is a significant positive association between the likelihood of securities fraud allegations and the executive stock option incentives); Bergstresser and Phillippon, "CEO Incentives and Earnings Management," 80 Journal of Financial Economics 511 (2006) (finding that the use of discretionary accruals to manipulate reported earnings was more pronounced at firms where CEO's compensation was more closely tied to stock and option holdings).

[185] This would be the case if the current market price for a share is less than or equal to the option's strike price (i.e., the option is not "in the money").

still allowing for some flexibility in the design and operation of incentive-based compensation arrangements. The Agencies note that supervisory experience at large banking organizations and analysis of compensation disclosures, as well as the views of some commenters to the 2011 Proposed Rule, indicate that many institutions have recognized the risks of options as an incentive and have reduced their use of options in recent years.

The proposed rule's 15 percent limit on options is consistent with current industry practice, which is moving away from its historical reliance on options as part of incentive-based compensation. Since the financial crisis that began in 2007, institutions on their own initiative and those working with the Board have decreased the use of options in incentive-based compensation arrangements generally such that for most organizations options constitute no more than 15 percent of an institution's total incentive-based compensation. Restricted stock unit awards have now emerged as the most common form of equity compensation and are more prevalent than stock options at all employee levels.[186] Further, a sample of publicly available disclosures from large covered institutions shows minimal usage of stock options among CEOs and other named executive officers; out of a sample of 14 covered institutions reviewed by the Agencies, only two covered institutions awarded stock options as part of their incentive-based compensation in 2015. Only one of those two covered institutions awarded options in excess of 15 percent of total compensation, and the excess was small. Thus, the proposed rule's limit on options has been set at a level that would, in the Agencies' views, help mitigate concerns about the use of options in incentive-based compensation while still allowing flexibility for covered institutions to use options in a manner that is consistent with the better practices that have developed following the recent financial crisis.[187]

7.17 The Agencies invite comment on the restrictions on the use of options in incentive-based compensation in the proposed rule. Should the percent limit be higher or lower and if so, why? Should options be permitted to be used to meet the deferral requirements of the rule? Why or

[186] Bachelder, Joseph E., "What Has Happened To Stock Options," New York Law Journal (September 19, 2014).

[187] Rajgopal and Shvelin, "Empirical Evidence on the Relation between Stock Option Compensation and Risk-Taking," 33 Journal of Accounting and Economics 145 (2002); Bettis, Bizjak, and Lemmon, "Exercise Behavior, Valuation, and the Incentive Effects of Employee Stock Options," 76 Journal of Financial Economics 445; ISS Compensation FAQs.

why not? Does the use of options by covered institutions create, reduce, or have no effect on the institution's risk of material financial loss?

7.18 Does the proposed 15 percent limit appropriately balance the benefits of using options (such as aligning the recipient's interests with that of shareholders) and drawbacks of using options (such as their emphasis on upside gains)? Why or why not? Is the proposed 15 percent limit the appropriate limit, or should it be higher or lower? If it should be higher or lower, what should the limit be, and why?

7.19 Are there alternative means of addressing the concerns raised by options as a form of incentive-based compensation other than those proposed?

§__.7(b) Forfeiture and Downward Adjustment.

Section ___.7(b) of the proposed rule would require Level 1 and Level 2 covered institutions to place incentive-based compensation of senior executive officers and significant risk-takers at risk of forfeiture and downward adjustment and to subject incentive-based compensation to a forfeiture and downward adjustment review under a defined set of circumstances. As described below, a forfeiture and downward adjustment review would be required to identify senior executive officers or significant risk-takers responsible for the events or circumstances triggering the review. It would also be required to consider certain factors when determining the amount or portion of a senior executive officer's or significant risk-taker's incentive-based compensation that should be forfeited or adjusted downward.

In general, the forfeiture and downward adjustment review requirements in section ___.7(b) would require a Level 1 or Level 2 covered institution to consider reducing some or all of a senior executive officer's or significant risk-taker's incentive-based compensation when the covered institution becomes aware of inappropriate risk-taking or other aspects of behavior that could lead to material financial loss. The amount of incentive-based compensation that would be reduced would depend upon the severity of the event, the impact of the event on the covered institution, and the actions of the senior executive officer or significant risk-taker in the event. The covered institution could accomplish this reduction of incentive-based compensation by reducing the amount of unvested deferred incentive-based compensation (forfeiture), by reducing the amount of incentive-based compensation not yet awarded for a performance period that has begun (downward adjustment), or through a combination of both forfeiture and downward adjustment. The Agencies have found that the possibility of a reduction in incentive-based compensation in the circumstances identified in section ___.7(b)(2) of the rule is needed in order to properly align financial reward with risk-taking by senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions.

The possibility of forfeiture and downward adjustment under the proposed rule would play an important role not only in better aligning incentive-based compensation payouts with long-run risk outcomes at the covered institution but also in reducing incentives for senior executive officers and significant risk-takers to take inappropriate risk that could lead to material financial loss at the covered institution. The proposed rule would also require covered institutions, through policies and procedures,[188] to formalize the governance and review processes surrounding such decision-making, and to document the decisions made.

While forfeiture and downward adjustment reviews would be required components of incentive-based compensation arrangements for senior executive officers and significant risk-takers at Level 1 and Level 2 covered institutions under the proposed rule, and are one way for covered institutions to take into account information about performance that becomes known over time, such reviews would not alone be sufficient to appropriately balance risk and reward, as would be required under section ___.4(c)(1). Incentive-based compensation arrangements for those covered persons would also be required to comply with the specific requirements of sections ___.4(d), ___.7(a), ___.7(c) and ___.8. As discussed above, to achieve balance between risk and reward, covered institutions should examine incentive-based compensation arrangements as a whole, and consider including provisions for risk adjustments before the award is made, and for adjustments resulting from forfeiture and downward adjustment review during the deferral period.

§__.7(b)(1) Compensation at risk.

Under the proposed rule, a Level 1 or Level 2 covered institution would be required to place at risk of forfeiture 100 percent of a senior executive officer's or significant risk-taker's deferred and unvested incentive-based compensation, including unvested deferred amounts awarded under long-term incentive plans. Additionally, a Level 1 or Level 2 covered institution

[188] See sections ___.11(b) and ___.11(c).

would be required to place at risk of downward adjustment all of a senior executive officer's or significant risk-taker's incentive-based compensation that has not yet been awarded, but that could be awarded for a performance period that is underway and not yet completed.

Forfeiture and downward adjustment give covered institutions an appropriate set of tools through which consequences may be imposed on individual risk-takers when inappropriate risk-taking or misconduct, such as the events identified in section ___.7(b)(2), occur or are identified. They also help ensure that a sufficient amount of compensation is at risk. Certain risk management failures and misconduct can take years to manifest, and forfeiture and downward adjustment reviews provide covered institutions an opportunity to adjust the ultimate amount of incentive-based compensation that vests based on information about risk-taking or misconduct that comes to light after the performance period. A senior executive officer or significant risk-taker should not be rewarded for inappropriate risk-taking or misconduct, regardless of when the covered institution learns of it.

Some evidence of inappropriate risk taking, risk management failures and misconduct may not be immediately apparent to the covered institution. To provide a strong disincentive for senior executive officers and significant risk-takers to engage in such conduct, which may lead to material financial loss to the covered institution, the Agencies are proposing to require that all unvested deferred incentive-based compensation and all incentive-based compensation eligible to be awarded for the performance period in which the covered institution becomes aware of the conduct be available for forfeiture and downward adjustment under the forfeiture and downward adjustment review. A covered institution would be required to consider all incentive-based compensation available, in the form of both unvested deferred incentive-based compensation and yet-to-be awarded incentive-based compensation, when considering forfeiture or downward adjustments, even if the incentive-based compensation does not specifically relate to the performance in the period in which the relevant event occurred.

For example, a significant risk-taker of a Level 1 covered institution might engage in misconduct in June 2025, but the Level 1 covered institution might not become aware of the misconduct until September 2028. The Level 1 covered institution would be required to consider downward adjustment of any amounts available under any of the significant risk-taker's incentive-based compensation plans with performance periods that are still in progress as of

September 2028 (for example, an annual plan with a performance period that runs from January 1, 2028, to December 31, 2028, or a long-term incentive plan with a performance period that runs from January 1, 2027, to December 31, 2030). The Level 1 covered institution would also be required to consider forfeiture of any amounts that are deferred, but not yet vested, as of September 2028 (for example, amounts that were awarded for a performance period that ran from January 1, 2026, to December 31, 2026, and that have been deferred and do not vest until December 31, 2030). For an additional example of how these requirements would work in practice, please see Appendix A of this Supplementary Information section.

§__.7(b)(2) Events triggering forfeiture and downward adjustment review.

Section ___.7(b) of the proposed rule would require a Level 1 or Level 2 covered institution to conduct a forfeiture and downward adjustment review based on certain identified adverse outcomes.

Under section __.7(b), events[189] that would be required to trigger a forfeiture and downward adjustment review include: (1) poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered institution's policies and procedures; (2) inappropriate risk-taking, regardless of the impact on financial performance; (3) material risk management or control failures; and (4) non-compliance with statutory, regulatory, or supervisory standards that results in: enforcement or legal action against the covered institution brought by a Federal or state regulator or agency; or a requirement that the covered institution report a restatement of a financial statement to correct a material error. Covered institutions would be permitted to define additional triggers based on conduct or poor performance. Generally, in the Agencies' supervisory experience as earlier described, the triggers are consistent with current practice at the largest financial institutions, although many covered institutions have triggers that are more granular in nature than those proposed and cover a wider

[189] The underlying, or contractual, forfeiture language used by institutions need not be identical to the triggers enumerated in this section, provided the covered institution's triggers capture the full set of outcomes outlined in section 7(b)(2) of the rule. For example, a trigger at a covered institution that read "if an employee improperly or with gross negligence fails to identify, raise, or assess, in a timely manner and as reasonably expected, risks and/or concerns with respect to risks material to the institution or its business activities," would be considered consistent with the minimum parameters set forth in the trigger identified in section 7(b)(2)(ii) of the rule.

set of adverse outcomes. The proposed enumerated adverse outcomes are a set of minimum standards.

As discussed later in this Supplementary Information section, covered institutions would be required to provide for the independent monitoring of all events related to forfeiture and downward adjustment.[190] When such monitoring, or other risk surveillance activity, reveals the occurrence of events triggering forfeiture and downward adjustment reviews, Level 1 and Level 2 covered institutions would be required to conduct those reviews in accordance with section ___.7(b). Covered institutions may choose to coordinate the monitoring for triggering events under section ___.9(c)(2) and the forfeiture and downward adjustment reviews with broader risk surveillance activities. Such coordinated reviews could take place on a schedule identified by the covered institution. Schedules may vary among covered institutions, but they should occur often enough to appropriately monitor risks and events related to forfeiture and downward adjustment. Larger covered institutions with more complex operations are likely to need to conduct more frequent reviews to ensure effective risk management.

Poor financial performance can indicate that inappropriate risk-taking has occurred at a covered institution. The Agencies recognize that not all inappropriate risk-taking does, in fact, lead to poor financial performance, but given the risks that are posed to the covered institutions by poorly designed incentive-based compensation programs and the statutory mandate of section 956, it is appropriate to prohibit incentive-based compensation arrangements that reward such inappropriate risk-taking. Therefore, if evidence of past inappropriate risk-taking becomes known, the proposed rule would require a Level 1 or Level 2 covered institution to perform a forfeiture and downward adjustment review in order to assess whether the relevant senior executive officer's or significant risk-taker's incentive-based compensation should be affected by the inappropriate risk-taking.

Similarly, material risk management or control failures may allow for inappropriate risk-taking that may lead to material financial loss at a covered institution. Because the role of senior executive officers and significant risk-takers, including those in risk management and other control functions whose role is to identify, measure, monitor, and control risk, the material failure by covered persons to properly perform their responsibilities can be especially likely to

[190] See section ___.9(c)(2).

put an institution at risk. Thus, if evidence of past material risk management or control failures becomes known, the proposed rule would require a Level 1 or Level 2 covered institution to perform a forfeiture and downward adjustment review, to assess whether a senior executive officer or significant risk-taker's incentive-based compensation should be affected by the risk management or control failure. Examples of risk management or control failures would include failing to properly document or report a transaction or failing to properly identify and control the risks that are associated with a transaction. In each case, the risk management or control failure, if material, could allow for inappropriate risk-taking at a covered institution that could lead to material financial loss.

Finally, a covered institution's non-compliance with statutory, regulatory, or supervisory standards may also reflect inappropriate risk-taking that may lead to material financial loss at a covered institution. The proposed rule would require a forfeiture and downward adjustment review whenever any such non-compliance (1) results in an enforcement or legal action against the covered institution brought by a Federal or state regulator or agency; or (2) requires the covered institution to restate a financial statement to correct a material error. The Federal Banking Agencies have found that it is appropriate for a covered institution to conduct a forfeiture and downward adjustment review under these circumstances because in many cases a statutory, regulatory, or supervisory standard may have been put in place in order to prevent a covered person from taking an inappropriate risk. In addition, non-compliance with a statute, regulation, or supervisory standard may also give rise to inappropriate compliance risk for a covered institution. A forfeiture and downward adjustment review would allow the institution to assess whether this type of non-compliance should affect a senior executive officer or significant risk-taker's incentive-based compensation.

§__.7(b)(3) Senior executive officers and significant risk-takers affected by forfeiture and downward adjustment.

A forfeiture and downward adjustment review would be required to consider forfeiture and downward adjustment of incentive-based compensation for a senior executive officer and significant risk-taker with direct responsibility or responsibility due to the senior executive officer or significant risk-taker's role or position in the covered institution's organizational structure, for the events that would trigger a forfeiture and downward adjustment review as described in section __.7(b)(2). Covered institutions should consider not only senior executive officers or significant risk-takers who are directly responsible for an event that triggers a forfeiture or downward adjustment review, but also those senior executive officers or significant risk-takers whose roles and responsibilities include areas where failures or poor performance contributed to, or failed to prevent, a triggering event. This requirement would discourage senior executive officers and significant risk-takers who can influence outcomes from failing to report or prevent inappropriate risk. A covered institution conducting a forfeiture and downward adjustment review may also consider forfeiture for other covered persons at its discretion.

§__.7(b)(4) Determining forfeiture and downward adjustment amounts.

The proposed rule sets out factors that Level 1 and Level 2 covered institutions must consider, at a minimum, when making a determination to reduce incentive-based compensation as a result of a forfeiture or downward adjustment review. A Level 1 or Level 2 covered institution would be responsible for determining how much of a reduction in incentive-based compensation is warranted, consistent with the policies and procedures it establishes under §_.11(b), and should be able to support its decisions that such an adjustment was appropriate if requested by its appropriate Federal regulator. In reducing the amount of incentive-based compensation, covered institutions may reduce the dollar amount of deferred cash or cash to be awarded, may lower the amount of equity-like instruments that have been deferred or were eligible to be awarded, or some combination thereof. A reduction in the value of equity-like instruments due to market fluctuations would not be considered a reduction for purposes of this review.

The proposed minimum factors that would be required to be considered when determining the amount of incentive-based compensation to be reduced are: (1) the intent of the senior executive officer or significant risk-taker to operate outside the risk governance framework approved by the covered institution's board of directors or to depart from the covered institution's policies and procedures; (2) the senior executive officer's or significant risk-taker's level of participation in, awareness of, and responsibility for, the events triggering the review; (3) any actions the senior executive officer or significant risk-taker took or could have taken to prevent the events triggering the review; (4) the financial and reputational impact of the events[191] triggering the review as set forth in section __.7(b)(2) on the covered institution, the line or sub-line of business, and individuals involved, as applicable, including the magnitude of any financial loss and the cost of known or potential subsequent fines, settlements, and litigation; (5) the causes of the events triggering the review, including any decision-making by other individuals; and (6) any other relevant information, including past behavior and risk outcomes linked to past behavior attributable to the senior executive officer or significant risk-taker.

The considerations identified constitute a minimum set of parameters that would be utilized for exercising the discretion permissible under the proposed rule while still holding senior executive officers and significant risk-takers accountable for inappropriate risk-taking and other behavior that could encourage inappropriate risk-taking that could lead to risk of material financial loss at covered institutions. For example, a covered institution might identify a pattern of misconduct stemming from activities begun three years before the review that ultimately leads to an enforcement action and reputational damage to the covered institution. A review of facts and circumstances, including consideration of the minimum review parameters set forth in the proposed rule, could reveal that one individual knowingly removed transaction identifiers in order to facilitate a trade or trades with a counterparty on whom regulators had applied Bank Secrecy Act or Anti-Monetary Laundering sanctions. Several of the senior executive officer's or significant risk-taker's peers might have been aware of this pattern of behavior but did not report it to their managers. Under the proposed rule, the individual who knowingly removed the identifiers would, in most cases, be subject to a greater reduction in incentive-based compensation than those who were aware of but not participants in the misconduct. However, those peers that were aware of the misconduct, managers supervising the covered person directly involved in the misconduct, and control staff who should have detected but failed to detect the

[191] Reputational impact or harm related to the actions of covered individuals refers to a potential weakening of confidence in an institution as evidenced by negative reactions from customers, shareholders, bondholders and other creditors, consumer and community groups, the press, or the general public. Reputational impact is a factor currently considered by some institutions in their existing forfeiture policies. See, e.g., Wells Fargo & Company 2016 Proxy Statement, page 47, available at https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2016-proxy-statement.pdf; and Citigroup 2016 Proxy Statement, page 74, available at http://www.citigroup.com/citi/investor/quarterly/2016/ar16cp.pdf?ieNocache=611.

behavior would be considered for a reduction, depending on their role in the organization, and assuming the peers are now senior executive officers or significant risk-takers.

The Agencies do not intend for these proposed factors to be exhaustive and covered institutions should consider additional factors where appropriate. In addition, covered institutions generally should impact incentive-based compensation as a result of forfeiture and downward adjustment reviews to reflect the severity of the event that triggered the review and the level of an individual's involvement. Covered institutions should be able to demonstrate to the appropriate Federal regulator that the impact on incentive-based compensation was appropriate given the particular set of facts and circumstances.

7.20 The Agencies invite comment on the forfeiture and downward adjustment requirements of the proposed rule.

7.21 Should the rule limit the events that require a Level 1 or Level 2 covered institution to consider forfeiture and downward adjustment to adverse outcomes that occurred within a certain time period? If so, why and what would be an appropriate time period? For example, should the events triggering forfeiture and downward adjustment reviews be limited to those events that occurred within the previous seven years?

7.22 Should the rule limit forfeiture and downward adjustment reviews to reducing only the incentive-based compensation that is related to the performance period in which the triggering event(s) occurred? Why or why not? Is it appropriate to subject unvested or unawarded incentive-based compensation to the risk of forfeiture or downward adjustment, respectively, if the incentive-based compensation does not specifically relate to the performance in the period in which the relevant event occurred or manifested? Why or why not?

7.23 Should the rule place all unvested deferred incentive-based compensation, including amounts voluntarily deferred by Level 1 and Level 2 covered institutions or senior executive officers or significant risk-takers, at risk of forfeiture? Should only that unvested deferred incentive-based compensation that is required to be deferred under section ___.7(a) be at risk of forfeiture? Why or why not?

7.24 Are the events triggering a review that are identified in section ___.7(b)(2) comprehensive and appropriate? If not, why not? Should the Agencies add "repeated supervisory actions" as a forfeiture or downward adjustment review trigger and why? Should the Agencies add "final enforcement or legal action" instead of the proposed "enforcement or legal action" and why?

7.25 Is the list of factors that a Level 1 or Level 2 covered institution must consider, at a minimum, in determining the amount of incentive-based compensation to be forfeited or downward adjusted by a covered institution appropriate? If not, why not? Are any of the factors proposed unnecessary? Should additional factors be included?

7.26 Are the proposed parameters for forfeiture and downward adjustment review sufficient to provide an appropriate governance framework for making forfeiture decisions while still permitting adequate discretion for covered institutions to take into account specific facts and circumstances when making determinations related to a wide variety of possible outcomes? Why or why not?

7.27 Should the rule include a presumption of some amount of forfeiture for particularly severe adverse outcomes and why? If so, what should be the amount and what would those outcomes be?

7.28 What protections should covered institutions employ when making forfeiture and downward adjustment determinations?

7.29 In order to determine when forfeiture and downward adjustment should occur, should Level 1 and Level 2 covered institutions be required to establish a formal process that both looks for the occurrence of trigger events and fulfills the requirements of the forfeiture and downward adjustment reviews under the proposed rule? If not, why not? Should covered institutions be required as part of the forfeiture and downward adjustment review process to establish formal review committees including representatives of control functions and a specific timetable for such reviews? Should the answer to this question depend on the size of the institution considered?

§__.7(c) Clawback.

As used in the proposed rule, the term "clawback" means a mechanism by which a covered institution can recover vested incentive-based compensation from a covered person. The proposed rule would require Level 1 and Level 2 covered institutions to include clawback provisions in incentive-based compensation arrangements for senior executive officers and significant risk-takers that, at a minimum, would allow for the recovery of up to 100 percent of vested 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. Under section ___.7(c) of the proposed rule, all vested incentive-based compensation for senior executive officers and significant risk-takers, whether it had been deferred before vesting or paid out immediately upon award, would be required to be subject to clawback for a period of no less than seven years following the date on which such incentive-based compensation vests. Clawback would be exercised under an identified set of circumstances. These circumstances include situations where a senior executive officer or significant risk-taker engaged in: (1) misconduct that resulted in significant financial or reputational harm[192] to the covered institution; (2) fraud; or (3) intentional misrepresentation of information used to determine the senior executive officer's or significant risk-taker's incentive-based compensation.[193] The clawback provisions would apply to all vested incentive-based compensation, whether that incentive-based compensation had been deferred or paid out immediately when awarded. If a Level 1 or Level 2 covered institution discovers that a senior executive officer or significant risk-taker was involved in one of the triggering circumstances during a past performance period, the institution would potentially be able to recover from that senior executive officer or significant risk-taker incentive-based compensation that was awarded for that performance period and has already vested. A covered institution could require clawback irrespective of whether the senior executive officer or significant risk-taker was currently employed by the covered institution.

The proposed set of triggering circumstances would constitute a minimum set of outcomes for which covered institutions would be required to consider recovery of vested incentive-based compensation. Covered institutions would retain flexibility to include other circumstances or outcomes that would trigger additional use of such provisions.

In addition, while the proposed rule would require the inclusion of clawback provisions in incentive-based compensation arrangements, the proposed rule would not require that Level 1 or Level 2 covered institutions exercise the clawback provision, and the proposed rule does not prescribe the process that covered institutions should use to recover vested incentive-based compensation. Facts, circumstances, and all relevant information should determine whether and

[192] As described in the above note 191, reputational impact or harm of an event related to the actions of covered individuals refers to a potential weakening of confidence in an institution as evidenced by negative reactions from customers, shareholders, bondholders and other creditors, consumer and community groups, the press, or the general public.

[193] As with other provisions in this proposed rule, the clawback requirement would not apply to incentive-based compensation plans and arrangements in place at the time the proposed rule is final because those plans and arrangements would be grandfathered.

to what extent it is reasonable for a Level 1 or Level 2 covered institution to seek recovery of any or all vested incentive-based compensation.

The Agencies recognize that clawback provisions may provide another effective tool for Level 1 and Level 2 covered institutions to deter inappropriate risk-taking because it lengthens the time horizons of incentive-based compensation.[194] The Agencies are proposing that vested incentive-based compensation be subject to clawback for up to seven years. The Agencies are proposing seven years as the length of the review period because it is slightly longer than the length of the average business cycle in the United States and is close to the lower end of the range of average credit cycles.[195] Also, the Agencies observe that seven years is consistent with some international standards.[196]

By proposing seven years as the length of the review period, the Agencies intend to encourage institutions to fairly compensate covered persons and incentivize appropriate risk-taking, while also recognizing that recovering amounts that have already been paid is more difficult than reducing compensation that has not yet been paid. The Agencies are concerned that a clawback period that is too short or one that is too long, or even infinite, could result in the covered person ignoring or discounting the effect of the clawback period and accordingly, could be less effective in balancing risk-taking. Additionally, a very long or even infinite clawback period may be difficult to implement.

While the Agencies did not propose a clawback requirement in the 2011 Proposed Rule, mandatory clawback provisions are not a new concept. Commenters to the 2011 Proposed Rule advocated that the Agencies adopt measures to allow shareholders (and others) to recover

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[194] See, e.g., Faulkender, Kadyrzhanova, Prabhala, and Senbet, "Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms," 22 Journal of Applied Corporate Finance 107 (2010) (arguing that clawbacks guard against compensating executives for luck rather than long-term performance); Babenko, Bennett, Bizjak and Coles, "Clawback Provisions," working paper (2015) available at https://wpcarey.asu.edu/sites/default/files/uploads/department-finance/clawbackprovisions.pdf (finding that the use of clawback provisions are associated with lower institution risk); Chen, Greene, and Owers, "The Costs and Benefits of Clawback Provisions in CEO Compensation," 4 Review of Corporate Finance Studies 108 (2015) (finding that the use of clawback provisions are associated with higher reporting quality).

[195] See supra note 154.

[196] See, e.g., PRA, "Policy Statement PS7/14: Clawback" (July 2014), available at http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps714.pdf.

incentive-based compensation already paid to covered persons. As discussed above, clawback provisions are now increasingly common at the largest financial institutions. The largest (and mostly publicly traded) covered institutions are already subject to a number of overlapping clawback regimes as a result of statutory requirements[197] Over the past several years, many financial institutions have further refined such mechanisms.[198] Most often, clawbacks allow banking institutions to recoup incentive-based compensation in cases of financial restatement, misconduct, or poor financial outcomes. A number of covered institutions have gone beyond these minimum parameters to include situations where poor risk management has led to financial or reputational damage to the firm.[199] The Agencies were cognizant of these developments in proposing the clawback provision in section ___.7(c).

The Agencies propose the three triggers referenced above for several reasons. First, a number of the specified triggers reflect better practice at covered institutions today.[200] The factors triggering clawback are based on existing clawback requirements that appear in some covered institutions' incentive-based compensation arrangements. Second, while many of the clawback regulatory regimes currently in place focus only on accounting restatements or material misstatements of financial results, the proposed triggers focus more broadly on risk-related outcomes that are more likely to contribute meaningfully to the balance of incentive-based compensation arrangements. Third, the proposed rule would extend coverage of clawback

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[197] See, e.g., section 304 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7243; section 111 of the Emergency Economic Stabilization Act of 2008, 12 U.S.C. 5221; section 210(s) of the Dodd-Frank Act, 12 U.S.C. 5390(s); section 954 of the Dodd-Frank Act, 15 U.S.C. 78j-4(b).

[198] See, e.g., PricewaterhouseCoopers, "Executive Compensation: Clawbacks, 2014 Proxy Disclosure Study" (January 2015), available at http://www.pwc.com/us/en/hr-management/publications/assets/pwc-executive-compensation-clawbacks-2014.pdf; Compensation Advisory Partners, "2014 Proxy Season: Changing Practices in Executive Compensation: Clawback, Hedging, and Pledging Policies" (December 17, 2014), available at http://www.capartners.com/uploads/news/id204/capartners.com-capflash-issue62.pdf.

[199] See, e.g., JPMorgan Chase & Company 2015 Proxy Statement, page 56, available at http://files.shareholder.com/downloads/ONE/1425504805x0x820065/4c79f471-36d9-47d4-a0b3-7886b0914c92/JPMC-2015-ProxyStatementl.pdf (where vested compensation is subject to clawback if, among other things, "the employee engaged in conduct detrimental to the Firm that causes material financial or reputational harm to the Firm").

[200] See, e.g., notes 198 and 199. See also Dawn Kopecki, "JP Morgan's Drew Forfeits 2 Years' Pay as Managers Ousted," Bloomberg Business (July 13, 2012); Dolia Estevez, "Pay Slash to Citigroup's Top Mexican Executive Called 'Humiliating,'" Forbes (March 13, 2014); Eyk Henning, "Deutsche Bank Cuts Co-CEOs' Compensation," Wall Street Journal (March 20, 2015).

mechanisms to include additional senior executive officers or significant risk-takers whose inappropriate risk-taking may not result in an accounting restatement, but would inflict harm on the covered institution nonetheless.

This provision would go beyond, but not conflict with, clawback provisions in other areas of law.[201] For example, covered institutions that issue securities also may be subject to clawback requirements pursuant to statutes administered by the SEC:

- Section 304 of the Sarbanes-Oxley Act of 2002[202] provides that if an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirements under the securities laws, the CEO and chief financial officer of the issuer shall reimburse the issuer for (i) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC (whichever first occurs) of the financial document embodying such financial reporting requirement and (ii) any profits realized from the sale of securities of the issuer during that 12-month period.
- Section 954 of the Dodd-Frank Act added Section 10D to the Securities Exchange Act of 1934.[203] Specifically, Section 10D(a) of the Securities Exchange Act requires the SEC to adopt rules directing the national securities exchanges[204] and the national securities associations[205] to prohibit the listing of any security of an issuer that is not in compliance with the requirements of Section 10D(b). Section 10D(b) requires the SEC to adopt rules

[201] See, e.g., section 304 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7243; section 111 of the Emergency Economic Stabilization Act of 2008, 12 U.S.C. 5221; section 210(s) of the Dodd-Frank Act, 12 U.S.C. 5390(s); section 954 of the Dodd-Frank Act, 15 U.S.C. 78j-4(b).
[202] 15 U.S.C. 7243.
[203] 15 U.S.C. 78a et seq.
[204] A “national securities exchange” is an exchange registered as such under section 6 of the Exchange Act (15 U.S.C. 78f). There are currently 18 exchanges registered under Section 6(a) of the Exchange Act: BATS Exchange, BATS Y-Exchange, BOX Options Exchange, C2 Options Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, EDGA Exchange, EDGX Exchange, International Securities Exchange (“ISE”), ISE Gemini, Miami International Securities Exchange, NASDAQ OMX BX, NASDAQ OMX PHLX, The NASDAQ Stock Market, National Stock Exchange, New York Stock Exchange (“NYSE”), NYSE Arca and NYSE MKT.
[205] A “national securities association” is an association of brokers and dealers registered as such under Section 15A of the Exchange Act (15 U.S.C. 78o-3). The Financial Industry Regulatory Authority (“FINRA”) is the only association registered with the SEC under section 15A(a) of the Exchange Act, but FINRA does not list securities.

directing the exchanges to establish listing standards to require each issuer to develop and implement a policy providing:

(1) for the disclosure of the issuer's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws; and

(2) that, in the event that the issuer is required to prepare an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement under the securities laws, the issuer will recover from any of the issuer's current or former executive officers who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date the issuer is required to prepare the accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

The SEC has proposed rules to implement the requirements of Exchange Act Section 10D.[206]

7.30 The Agencies invite comment on the clawback requirements of the proposed rule.

7.31 Is a clawback requirement appropriate in achieving the goals of section 956? If not, why not?

7.32 Is the seven-year period appropriate? Why or why not?

7.33 Are there state contract or employment law requirements that would conflict with this proposed requirement? Are there challenges that would be posed by overlapping Federal clawback regimes? Why or why not?

7.34 Do the triggers discussed above effectively achieve the goals of section 956? Should the triggers be based on those contained in section 954 of the Dodd-Frank Act?

7.35 Should the Agencies provide additional guidance on the types of behavior that would constitute misconduct for purposes of section __.7(c)(1)?

7.36 Should the rule include a presumption of some amount of clawback for particularly severe adverse outcomes? Why or why not? If so, what should be the amount and what would those outcomes be?

§ ___.8 Additional Prohibitions for Level 1 and Level 2 Covered Institutions

Section ___.8 of the proposed rule would establish additional prohibitions for Level 1 and Level 2 covered institutions to address practices that, in the view of the Agencies, could

[206] Listing Standards for Recovery of Erroneously Awarded Compensation, Release No. 33-9861 (July 1, 2015), 80 FR 41144 (July 14, 2015).

encourage inappropriate risks that could lead to material financial loss at covered institutions. The Agencies' views are based in part on supervisory experiences in reviewing and supervising incentive-based compensation at some covered institutions, as described earlier in this Supplemental Information section. Under the proposed rule, an incentive-based compensation arrangement at a Level 1 or Level 2 covered institution would be considered to appropriately balance risk and reward, as required by section ___.4(c)(1) of the proposed rule, only if the covered institution complies with the prohibitions of section ___.8.

§ __.8(a) Hedging

Section __.8(a) of the proposed rule would prohibit Level 1 and Level 2 covered institutions from purchasing hedging instruments or similar instruments on behalf of covered persons to hedge or offset any decrease in the value of the covered person's incentive-based compensation. This prohibition would apply to all covered persons at a Level 1 or Level 2 covered institution, not just senior executive officers and significant risk-takers. Personal hedging strategies may undermine the effect of risk-balancing mechanisms such as deferral, downward adjustment and forfeiture, or may otherwise negatively affect the goals of these risk-balancing mechanisms and their overall efficacy in inhibiting inappropriate risk-taking.[207] For example, a financial instrument, such as a derivative security that increases in value as the price of a covered institution's equity decreases would offset the intended balancing effect of awarding incentive-based compensation in the form of equity, the value of which is linked to the performance of the covered institution.

Similarly, a hedging arrangement with a third party, under which the third party would make direct or indirect payments to a covered person that are linked to or commensurate with the amounts by which a covered person's incentive-based compensation is reduced by forfeiture, would protect the covered person against declines in the value of incentive-based compensation. In order for incentive-based compensation to provide the appropriate incentive effects, covered

[207] This prohibition would not limit a covered institutions ability to hedge its own exposure in deferred compensation obligations, which the Board, the OCC, and the FDIC continue to view as prudent practice. (see, e.g., Federal Reserve SR Letter 04-19 (Dec. 7, 2004); OCC Bulletin 2004-56 (Dec. 7, 2004); FDIC FIL-127-2004 (Dec. 7, 2004); OCC Interpretive Letter No. 878 (Dec. 22, 1999).

persons should not be shielded from exposure to the negative financial impact of taking inappropriate risks or other aspects of their performance at the covered institution.

In the 2011 Proposed Rule, the Agencies stated that they were aware that covered persons who received incentive-based compensation in the form of equity might wish to use personal hedging strategies as a way to assure the value of deferred equity compensation.[208] The Agencies expressed concern that such hedging during deferral periods could diminish the alignment between risk and financial rewards that deferral arrangements might otherwise achieve.[209] After considering supervisory experiences in reviewing incentive-based compensation at some covered institutions and the purposes of section 956 and related provisions of the Dodd-Frank Act, the Agencies are proposing a prohibition on covered institutions purchasing hedging and similar instruments on behalf of a covered person as a practical approach to eliminate the possibility that hedging during deferral periods could diminish the alignment between risk and financial rewards that deferral arrangements might otherwise achieve.

8.1. The Agencies invite comment on whether this restriction on Level 1 and Level 2 covered institutions prohibiting the purchase of a hedging instrument or similar instrument on behalf of covered persons is appropriate to implement section 956 of the Dodd-Frank Act.

8.2. Are there additional requirements that should be imposed on covered institutions with respect to hedging of the exposure of covered persons under incentive-based compensation arrangements?

8.3. Should the proposed rule include a prohibition on the purchase of a hedging instrument or similar instrument on behalf of covered persons at Level 3 institutions?

§ __.8(b) Maximum incentive-based compensation opportunity

Section ___.8(b) of the proposed rule would limit the amount by which the actual incentive-based compensation awarded to a senior executive officer or significant risk-taker could exceed the target amounts for performance measure goals established at the beginning of the performance period. It is the understanding of the Agencies that, under current practice,

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[208] See 76 FR at 21183.
[209] The Agencies note that one commenter to the 2011 Proposed Rule supported limits on hedging.

covered institutions generally establish performance measure goals for their covered persons at the beginning of, or early in, a performance period. At that time, under some incentive-based compensation plans, those covered institutions establish target amounts of incentive-based compensation that the covered persons can expect to be awarded if they meet the established performance measure goals. Some covered institutions also set out the additional amounts of incentive-based compensation, in excess of the target amounts, that covered persons can expect to be awarded if they or the covered institution exceed the performance measure goals. Incentive-based compensation plans commonly set out maximum awards of 150 to 200 percent of the pre-set target amounts.[210]

The proposed rule would prohibit a Level 1 or Level 2 covered institution from awarding incentive-based compensation to a senior executive officer in excess of 125 percent of the target amount for that incentive-based compensation. For a significant risk-taker the limit would be 150 percent of the target amount for that incentive-based compensation. This limitation would apply on a plan-by-plan basis, and, therefore, would apply to long-term incentive plans separately from other incentive-based compensation plans.

For example, a Level 1 covered institution might provide an incentive-based compensation plan for its senior executive officers that links the amount awarded to a senior executive officer to the covered institution's four-year average return on assets (ROA). The plan could establish a target award amount of $100,000 and a target four-year average ROA of 75 basis points. That is, if the covered institution's four-year average ROA was 75 basis points, a senior executive officer would receive $100,000. The plan could also provide that senior executive officers would earn nothing (zero percent of target) under the plan if ROA was less than 50 basis points; $60,000 (60 percent of target) if ROA was 65 basis points; and $125,000 (125 percent of target) if ROA was 100 basis points. Under the proposed rule, the plan would not be permitted to provide, for example, $130,000 (130 percent of target) if ROA was 100 basis points or $150,000 (150 percent of target) if ROA was 110 basis points.

[210] See, e.g., Arthur Gallagher & Co., "Study of 2013 Short- and Long-Term Incentive Design Criterion Among Top 200 S&P 500 Companies" (December 5, 2014), available at http://www.ajg.com/media/1420659/study-of-2013-short-and-long-term-incentive-design-criterion-among-top-200.pdf.

The Agencies are proposing these limits, in part, because they are consistent with the current industry practice at large banking organizations. Moreover, high levels of upside leverage (e.g., 200 percent to 300 percent above the target amount) could lead to senior executive officers and significant risk-takers taking inappropriate risks to maximize the opportunity to double or triple their incentive-based compensation. Recognizing the potential for inappropriate risk-taking with such high levels of leverage, the Federal Banking Agencies have worked with large banking organizations to reduce leverage levels to a range of 125 percent to 150 percent. Such a range continues to provide for flexibility in the design and operation of incentive-based compensation arrangements in covered institutions while it addresses the potential for inappropriate risk-taking where leverage opportunities are large or uncapped. For a full example of how these requirements would work in practice, please see Appendix A of this Supplementary Information section.

The proposed rule would set different maximums for senior executive officers and for significant risk-takers because senior executive officers and significant risk-takers have the potential to expose covered institutions to different types and levels of risk, and may be motivated by different types and amounts of incentive-based compensation. The Agencies intend the different limitations to reflect the differences between the risks posed by senior executive officers and significant risk-takers.

The Agencies emphasize that the proposed limits on a covered employee's maximum incentive-based compensation opportunity would not equate to a ceiling on overall incentive-based compensation. Such limits would represent only a constraint on the percentage by which incentive-based compensation could exceed the target amount, and is aimed at prohibiting the use of particular features of incentive-based compensation arrangements which can contribute to inappropriate risk-taking.

8.4. The Agencies invite comment on whether the proposed rule should establish different limitations for senior executive officers and significant risk-takers, or whether the proposed rule should impose the same percentage limitation on senior executive officers and significant risk-takers.

8.5. The Agencies also seek comment on whether setting a limit on the amount that compensation can grow from the time the target is established until an award occurs would achieve the goals of section 956.

8.6. The Agencies invite comment on the appropriateness of the limitation, i.e., 125 percent and 150 percent for senior executive officers and significant risk-takers, respectively. Should the limitations be set higher or lower and, if so, why?

8.7. Should the proposed rule apply this limitation on maximum incentive-based compensation opportunity to Level 3 institutions?

§ __.8(c) Relative performance measures

Under section ___.8(c) of the proposed rule, a Level 1 or Level 2 covered institution would be prohibited from using incentive-based compensation performance measures based solely on industry peer performance comparisons. This prohibition would apply to incentive-based compensation arrangements for all covered persons at a Level 1 or Level 2 covered institution, not just senior executive officers and significant risk-takers.

As discussed above, covered institutions generally establish performance measures for covered persons at the beginning of, or early in, a performance period. For these types of plans, the performance measures (sometimes known as performance metrics) are the basis upon which a covered institution determines the related amounts of incentive-based compensation to be awarded to covered persons. These performance measures can be absolute, meaning they are based on the performance of the covered person or the covered institution without reference to the performance of other covered persons or covered institutions. In contrast, a relative performance measure is a performance measure that compares a covered institution's performance to that of so called "peer institutions" or an industry average. The composition of peer groups is generally decided by the individual covered institution. An example of an absolute performance measure is total shareholder return (TSR). An example of a relative performance measure is the rank of the covered institution's TSR among the TSRs of institutions in a pre-established peer group.

The Agencies have observed that incentive-based compensation arrangements based solely on industry peer performance comparisons (a type of relative performance measure) can cause covered persons to take inappropriate risks that could lead to material financial loss.[211] For example, if a covered institution falls behind its industry peers, it may use performance measures—and set goals for those measures—that lead to inappropriate risk-taking by covered persons in order to perform better than its industry peers. Also, the performance of a covered institution can be strong relative to its peers, but poor on an absolute basis (e.g., every institution in the peer group is performing poorly, but the covered institution is the best of the group). Consequently, if incentive-based compensation arrangements were based only on relative performance measures, they would, in that circumstance, reward covered employees for performance that is poor on an absolute level but still better than that of the covered institution's peer group. Similarly, in cases where only relative performance measures are used and performance is poor, performance-based vesting may still occur when peer performance is also poor. Using a combination of relative and absolute performance measures as part of the performance evaluation process can help maintain balance between financial rewards and potential risks in such situations.

Additionally, covered persons do not know what level of performance is necessary to meet or exceed target peer group rankings, as rankings will become known only at the end of the performance period. As a result, covered employees may be strongly incentivized to achieve exceptional levels of performance by taking inappropriate risks to increase the likelihood that the covered institution will meet or exceed the peer group ranking in order to maximize their incentive-based compensation.

Further, comparing an institution's performance to a peer group can be misleading because the members of the peer group are likely to have different business models, product mixes, operations in different geographical locations, cost structures, or other attributes that make comparisons between institutions inexact.

Relative performance measures, including industry peer performance measures, may be useful when used in combination with absolute performance measures. Thus, under the proposed rule, a covered institution would be permitted to use relative performance measures in combination with absolute performance measures, but not in isolation. For instance, a covered

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[211] Gong, Li, and Shin, "Relative Performance Evaluation and Related Peer Groups in Executive Compensation Contracts," 86 The Accounting Review 1007 (May 2011).

institution would not be in compliance with the proposed rule if the performance of the CEO were assessed solely on the basis of total shareholder return relative to a peer group. However, if the performance of the CEO were assessed on the basis of institution-specific performance measures, such as earnings per share and return on tangible common equity, along with the same relative TSR the covered institution would comply with section ___.8(c) of the proposed rule (assuming the CEO's incentive-based compensation arrangement met the other requirements of the rule, such as an appropriate balance of risk and reward).

8.8. The Agencies invite comment on whether the restricting on the use of relative performance measures for covered persons at Level 1 and Level 2 covered institutions in section ___.8(d) of the proposed rule is appropriate in deterring behavior that could put the covered institution at risk of material financial loss. Should this restriction be limited to a specific group of covered persons and why? What are the relative performance measures being used in industry?

8.9. Should the proposed rule apply this restriction on the use of relative performance measures to Level 3 institutions?

§ __.8(d) Volume-driven incentive-based compensation

Section ___.8(d) of the proposed rule would prohibit Level 1 and Level 2 covered institutions from providing incentive-based compensation to a covered person that is based solely on transaction or revenue volume without regard to transaction quality or the compliance of the covered person with sound risk management. Under the proposed rule, transaction or revenue volume could be used as a factor in incentive-based compensation arrangements, but only in combination with other factors designed to cause covered persons to account for the risks of their activities. This prohibition would apply to incentive-based compensation arrangements for all covered persons at a Level 1 or Level 2 covered institution, not just senior executive officers and significant risk-takers.

Incentive-based compensation arrangements that do not account for the risks covered persons can take to achieve performance measures do not appropriately balance risk and reward, as section ___.4(c)(1) of the proposed rule would require. An arrangement that provides incentive-based compensation to a covered person based solely on transaction or revenue volume, without regard to other factors, would not adequately account for the risks to which the transaction in question could expose the covered institution. For instance, an incentive-based compensation arrangement that rewarded mortgage originators based solely on the volume of loans approved, without any subsequent adjustment for the quality of the loans originated (such as adjustments for early payment default or problems with representations and warranties) would not adequately balance risk and financial rewards.

An incentive-based compensation arrangement with performance measures based solely on transaction or revenue volume could incentivize covered persons to generate as many transactions or as much revenue as possible without appropriate attention to resulting risks. Such arrangements were noted in MLRs and similar reports where compensation had been cited as a contributing factor to a financial institution's failure during the recent financial crisis.[212] In addition, many studies about the causes of the recent financial crisis discuss how volume-driven incentive-based compensation lead to inappropriate risk-taking and caused material financial loss to financial institutions.[213]

8.10. The Agencies invite comment on whether there are circumstances under which consideration of transaction or revenue volume as a sole performance measure goal, without consideration of risk, can be appropriate in incentive-based compensation arrangements for Level 1 or Level 2 covered institutions.

8.11. Should the proposed rule apply this restriction on the use of volume-driven incentive-based compensation arrangements to Level 3 institutions?

§ ___.9 Risk Management and Controls Requirements for Level 1 and Level 2 Covered Institutions

Prior to the financial crisis that began in 2007, institutions rarely involved risk management in either the design or monitoring of incentive-based compensation arrangements.

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[212] In accordance with section 38(k) of the FDIA, 12 U.S.C. 1831o(k), MLRs are conducted by the Inspectors General of the appropriate Federal banking agency following the failure of insured depository institutions.
See, e.g., Office of Inspector General for the Department of Treasury, "Material Loss Review of Indymac Bank, FSB," OIG-09-032 (February 26, 2009), available at http://www.treasury.gov/about/organizational-structure/ig/Documents/oig09032.pdf; Offices of Inspector General for the Federal Deposit Insurance Corporation and the Department of Treasury, "Evaluation of Federal Regulatory Oversight of Washington Mutual Bank," EVAL-10-002 (April 9, 2010), available at https://www.fdicig.gov/reports10/10-002EV.pdf.

[213] See, e.g., Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report" (January 2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

Federal Banking Agency reviews of compensation practices have shown that one important development in the intervening years has been the increasing integration of control functions in compensation design and decision-making. For instance, control functions are increasingly relied on to ensure that risk is properly considered in incentive-based compensation programs. At the largest covered institutions, the role of the board of directors in oversight of compensation programs (including the oversight of supporting risk management processes) has also expanded.

Section ___.9 of the proposed rule would establish additional risk management and controls requirements at Level 1 and Level 2 covered institutions. Without effective risk management and controls, larger covered institutions could establish incentive-based compensation arrangements that, in the view of the Agencies,[214] could encourage inappropriate risks that could lead to material financial loss at covered institutions. Under the proposed rule, an incentive-based compensation arrangement at a Level 1 or Level 2 covered institution would be considered to be compatible with effective risk management and controls, as required by section ___.4(c)(2) of the proposed rule, only if the covered institution also complies with the requirements of section ___.9. In proposing section __.9, the Agencies are also cognizant of comments received on the 2011 Proposed Rule.[215] In order to facilitate consistent adoption of the practices that contribute to incentive-based compensation arrangements that appropriately balance risk and reward, the Agencies are proposing that the practices set forth in section ___.9 be required for all Level 1 and Level 2 covered institutions.

Section ___.9(a) of the proposed rule would establish minimum requirements for a risk management framework at a Level 1 or Level 2 covered institution by requiring that such

[214] This view is based in part on supervisory experiences in reviewing and supervising incentive-based compensation at some covered institutions.

[215] The 2011 Proposed Rule would have required incentive-based compensation arrangements to be compatible with effective risk management and controls. A number of commenters offered views on the proposed requirements, and some raised concerns. Some commenters emphasized the importance of sound risk management practices in the area of incentive-based compensation. However, a number of commenters also questioned whether the determination of an “appropriate” role for risk management personnel should be left to the discretion of individual institutions. In light of these comments, the proposed rule is designed to strike a reasonable balance between requiring an appropriate role for risk management and allowing institutions the ability to tailor their risk management practices to their business model. The proposed rule does not include prescriptive standards. Instead, it would allow Level 1 and Level 2 covered institutions to retain flexibility to determine the specific role that risk management and control functions should play in incentive-based compensation processes, while still allowing for appropriate oversight of incentive-based compensation arrangements.

framework: (1) be independent of any lines of business; (2) include an independent compliance program that provides for internal controls, testing, monitoring, and training with written policies and procedures consistent with section ___.11 of the proposed rule; and (3) be commensurate with the size and complexity of the covered institution's operations.

Generally, section ___.9(a) would require that Level 1 and Level 2 covered institutions have a systematic approach to designing and implementing their incentive-based compensation arrangements and incentive-based compensation programs supported by independent risk management frameworks with written policies and procedures, and developed systems. These frameworks would include processes and systems for identifying and reporting deficiencies; establishing managerial and employee responsibility; and ensuring the independence of control functions. To be effective, an independent risk management framework should have sufficient stature, authority, resources and access to the board of directors.

Level 1 and Level 2 covered institutions would be required to develop, as part of their broader risk management framework, an independent compliance program for incentive-based compensation. The Federal Banking Agencies have found that an independent compliance program leads to more robust oversight of incentive-based compensation programs, helps to avoid undue influence by lines of business, and facilitates supervision. Agencies would expect such a compliance program to have formal policies and procedures to support compliance with the proposed rule and to help to ensure that risk is effectively taken into account in both design and decision-making processes related to incentive-based compensation. The requirements for such policies and procedures are set forth in section ___.11 of the proposed rule.

The requirements of the proposed rule would encourage Level 1 and Level 2 covered institutions to develop well-targeted internal controls that work within the covered institution's broader risk management framework to support balanced risk-taking. Independent control functions should regularly monitor and test the covered institution's incentive-based compensation program and its arrangements to validate their effectiveness. Training would generally include communication to employees of the covered institution's compliance risk management standards and policies and procedures, and communication to managers on expectations regarding risk adjustment and documentation.

The Agencies note that independent compliance programs consistent with these proposed requirements are already in place at a significant number of larger covered institutions, in part due to supervisory efforts such as the Board's ongoing horizontal review of incentive-based compensation,[216] Enhanced Prudential Standards from section 165 of the Dodd-Frank Act,[217] and the OCC's Heightened Standards.[218] For example, control function employees monitor compliance with policies and procedures and help to ensure robust documentation of compensation decisions, including those relating to forfeiture and risk-adjustment processes. Institutions have also improved communication to managers and employees about how risk adjustment should work and have developed processes to review the application of related guidance in order to ensure better consideration of risk in compensation decisions. The Agencies are proposing to require similar compliance programs at covered institutions not subject to the supervisory efforts described above, as well as to reinforce the practices of covered institutions that already have such compliance programs in place.

Section ___.9(b) of the proposed rule would require Level 1 and Level 2 covered institutions to provide individuals engaged in control functions with the authority to influence the risk-taking of the business areas they monitor and to ensure covered persons engaged in control functions are compensated in accordance with the achievement of performance objectives linked to their control functions and independent of the performance of the business areas they oversee. These protections are intended to mitigate potential conflicts of interest that might undermine the role covered persons engaged in control functions play in supporting incentive-based compensation arrangements that appropriately balance risk and reward.

Under section___.9(c) of the proposed rule, Level 1 and Level 2 covered institutions would be required to provide for independent monitoring of: (1) incentive-based compensation plans to identify whether those plans appropriately balance risk and reward; (2) events relating to forfeiture and downward adjustment reviews and decisions related thereto; and (3) compliance of the incentive-based compensation program with the covered institution's policies and procedures.

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[216] See 2011 FRB White Paper.
[217] See 12 CFR Part 252.
[218] See 12 CFR Part 30, Appendix D.

To be considered independent under the proposed rule, the group or person at the covered institution responsible for monitoring the areas described above generally should have a reporting line to senior management or the board that is separate from the covered persons whom the group or person is responsible for monitoring. Some covered institutions may use internal audit to perform the independent monitoring that would be required under this section.[219] The type of independent monitoring conducted to fulfill the requirements of section ___.9(c) generally should be appropriate to the size and complexity of the covered institution and its use of incentive-based compensation. For example, a Level 1 covered institution might be expected to use a different scope and type of data and analysis to monitor its incentive-based compensation program than a Level 2 covered institution. Likewise, a covered institution that offers incentive-based compensation to only a few employees may require a less formal monitoring process than a covered institution that offers many types of incentive-based compensation to many of its employees.

Section ___.9(c)(1) of the proposed rule would require covered institutions to periodically review all incentive-based compensation plans to assess whether those plans provide incentives that appropriately balance risk and reward. Monitoring the incentives embedded in plans, rather than the individual arrangements that rely on those plans, provides an opportunity to identify incentives for imprudent risk-taking. It also reduces burden on covered institutions in a reasonable way in light of the proposed rule’s additional protections against excessive risk-taking which operate at the level of incentive-based compensation arrangements. Supervisory experience indicates that many covered institutions already periodically perform such a review, and the Agencies consider it a better practice. Level 1 and Level 2 covered institutions should have procedures for collecting information about the effects of their incentive-based compensation arrangements on employee risk-taking, and have systems and processes for using this information to adjust incentive-based compensation arrangements in order to eliminate or reduce unintended incentives for inappropriate risk-taking.

Under Section ___.9(c)(2), covered institutions would be required to provide for the independent monitoring of all events related to forfeiture and downward adjustment. With

[219] At OCC-supervised institutions, the independent monitoring required under section ___.9(c) would be carried out by internal audit.

regard to forfeiture and downward adjustment decisions, covered institutions would be expected to regularly monitor the events that could trigger a forfeiture and downward adjustment review. Many covered institutions also regularly conduct independent monitoring and testing activities, or broad-based risk reviews, that could reveal instances of inappropriate risk-taking. The policies and procedures established under section __.11(b) would be expected to specify that covered institutions would evaluate whether inappropriate risk-taking identified in the course of any independent monitoring and testing activities triggered a forfeiture and downward adjustment review. The frequency of reviews may vary depending on the size and complexity of, and the level of risks at, the covered institution, but they should occur often enough to reasonably monitor risks and events related to the forfeiture and downward adjustment triggers.[220] When these reviews uncover events that trigger forfeiture and downward adjustment reviews, Level 1 and Level 2 covered institutions would be required to complete such a review, consistent with the requirements of section ___.7(b). They would also be required to monitor adherence to policies and procedures that support effective balancing of risk and rewards. Many covered institutions currently perform forfeiture reviews in the context of broader and more regular risk reviews to ensure that the forfeiture review process appropriately captures all risk-taking activity. The Agencies view this approach as better practice, as decisions about appropriate adjustment of compensation in such circumstances are only one desired outcome. For instance, identification of risk events generally should lead not only to consideration of compensation adjustments, but also to analysis of whether there are weaknesses in broader controls or risk management oversight that need to be addressed. In their supervisory experience, the Federal Banking Agencies have found that tying forfeiture reviews to broader risk reviews is a better practice.

Section ___.9(c)(3) of the proposed rule would require covered institutions to provide for independent compliance monitoring of the institution's incentive-based compensation program with policies and procedures. To be considered independent under the proposed rule, the group or person at the covered institution monitoring compliance should have a separate reporting line to senior management or to the board of directors from the business line or group being monitored, but may be conducted by groups within the covered institution. For example, internal

[220] See section ___.7(b)(2).

audit could review whether award disbursement and vesting policies were adhered to and whether documentation of such decisions was sufficient to support independent review. Such independence will help ensure that the monitoring is unbiased and identifies appropriate issues.

The Agencies have taken the position that Level 1 and Level 2 covered institutions should regularly review whether the design and implementation of their incentive-based compensation arrangements deliver appropriate risk-taking incentives. Independent monitoring should enable covered institutions to correct deficiencies and make necessary improvements in a timely fashion based on the results of those reviews.[221]

9.1 Some Level 1 and Level 2 covered institutions are subject to separate risk management and controls requirements under other statutory or regulatory regimes. For example, OCC-supervised Level 1 and Level 2 covered institution are subject to the OCC's Heightened Standards. Is it clear to commenters how the risk management and controls requirements under the proposed rule would interact, if at all, with requirements under other statutory or regulatory regimes?

§ ___.10 Governance Requirements for Level 1 and Level 2 Covered Institutions

Section ___.10 of the proposed rule contains specific governance requirements that would apply to Level 1 and Level 2 covered institutions. Under the proposed rule, an incentive-based compensation arrangement at a Level 1 or Level 2 covered institution would be considered to be supported by effective governance, as required by section ___.4(c)(3) of the proposed rule, only if the covered institution also complies with the requirements of section ___.10.

As discussed earlier in this Supplementary Information section, the supervisory experience of the Federal Banking Agencies at large consolidated financial institutions is that effective oversight by a covered institution's board of directors, including review and approval by the board of the overall goals and purposes of the covered institution's incentive-based

[221] The 2010 Federal Banking Agency Guidance mentions several practices that can contribute to the effectiveness of such activity, including internal reviews and audits of compliance with policies and procedures, and monitoring of results relative to expectations. For instance, internal audit should assess the effectiveness of the compliance risk management program by performing regular independent reviews and evaluating whether internal controls, policies, and processes that limit incentive-based compensation risk are effective and appropriate for the covered institution's activities and associated risks.

compensation program, is essential to the attainment of incentive-based compensation arrangements that do not encourage inappropriate risks that could lead to material financial loss to the covered institution.

Accordingly, section ___.10(a) of the proposed rule would require that a Level 1 or Level 2 covered institution establish a compensation committee, composed solely of directors who are not senior executive officers, to assist the board in carrying out its responsibilities related to incentive-based compensation.[222] Having an independent compensation committee is consistent with the emphasis the Agencies place on the need for incentive-based compensation arrangements to be compatible with effective risk management and controls and supported by effective governance. In response to the 2011 Proposed Rule, some commenters expressed a view that an independent compensation committee composed solely of non-management directors would have helped to avoid potential conflicts of interest and more appropriate consideration of management proposals, particularly proposed awards and payouts for senior executive officers.

Section ___.10(b) of the proposed rule would require that compensation committees at Level 1 and Level 2 covered institutions obtain input and assessments from various parties. For example, the compensation committees would be required to obtain input on the effectiveness of risk measures and adjustments used to balance risk and reward in incentive-based compensation arrangements from the risk and audit committees of the covered institution's board of directors, or groups performing similar functions, and from the covered institution's risk management function. The proposed requirements would help protect covered institutions against inappropriate risk-taking that could lead to material financial loss by leveraging the expertise and experience of these parties.

[222] As described above, under the Board's and FDIC's proposed rules, for a foreign banking organization, "board of directors" would mean the relevant oversight body for the institution's U.S. branch, agency, or operations, consistent with the foreign banking organization's overall corporate and management structure. The Board and FDIC will work with foreign banking organizations to determine the appropriate persons to carry out the required functions of a compensation committee under the proposed rule. Likewise, under the OCC's proposed rule, for a Federal branch or agency of a foreign bank, "board of directors" would mean the relevant oversight body for the Federal branch or agency, consistent with its overall corporate and management structure. The OCC would work closely with Federal branches and agencies to determine the person or committee to undertake the responsibilities assigned to the oversight body.

In their review of the incentive-based compensation practices of many of the largest covered institutions, the Federal Banking Agencies have noted that the compensation, risk, and audit committees of the boards of directors collaborate and seek advice from risk management and other control functions before making decisions. Many of these covered institutions have members of the compensation committee that are also members of the risk and audit committees. Some covered institutions rely on regular meetings between the compensation and risk committees, while others rely on more ad hoc communications. Human resources, risk management, finance, and audit committees work with compensation committees to ensure that compensation systems attain multiple objectives, including appropriate risk-taking.[223]

Section __.10(b)(2) of the proposed rule would require the compensation committees to obtain from management, on an annual or more frequent basis, a written assessment of the covered institution's incentive-based compensation program and related compliance and control processes. The report should assess the extent to which the program and processes provide risk-taking incentives that are consistent with the covered institution's risk profile. Management would be required to develop the assessment with input from the covered institutions' risk and audit committees, or groups performing similar functions, and from individuals in risk management and audit functions. In addition to the written assessment submitted by management, section __.10(b)(3) of the proposed rule would require the compensation committee to obtain another written assessment on the same matter, submitted on an annual or more frequent basis, by the internal audit or risk management function of the covered institution. This written assessment would be developed independently of the covered institution's management.

The Agencies are proposing that the independent compensation committee of the board of directors to be the recipient of such input and written assessments.

Developing incentive-based compensation arrangements that provide balanced risk-taking incentives and monitoring arrangements to ensure they achieve balance requires an understanding of the full spectrum of risks (including compliance risks) and potential risk

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[223] See generally 2011 FRB White Paper; FSB, "FSB 2015 Workshop on Compensation Practices" (April 14, 2015), available at http://www.fsb.org/wp-content/uploads/Summary-of-the-April-2015-FSB-workshop-on-compensation-practices.pdf.

outcomes associated with the activities of covered persons. For this reason, risk-management and other control functions generally should each have an appropriate role in the covered institution's processes, not only for designing incentive-based compensation arrangements, but also for assessing their effectiveness in providing risk-taking incentives that are consistent with the risk profile of the institution. The proposed rule sets forth two separate effectiveness assessments: (1) an assessment under the auspices of management, but reliant on risk management and audit functions, as well as the audit and risk committees of the board, and (2) an assessment conducted by the internal audit or risk management function of the covered institution, independent of management.

In support of the first requirement, a covered institution's management has a full understanding of both the entirety of the covered institution's activities and a detailed understanding of its incentive-based compensation program, including both the performance that the covered institution intends to reward and the risks to which covered persons can expose the covered institution. An understanding of the full compensation program (including the effectiveness of risk measures across various lines of business, the measurement of actual risk outcomes, and the analysis of risk-taking and risk outcomes relative to incentive-based compensation payments) requires a large degree of technical expertise. It also requires an understanding of the wider strategic and risk management frameworks in place at the covered institution (including the various objectives that compensation programs seek to balance, such as recruiting and retention goals and prudent risk management). While the board of directors at a covered institution is ultimately responsible for the balance of incentive-based compensation arrangements, and for an incentive-based compensation program that incentivizes behaviors consistent with the long-term health of the organization, the board should generally hold senior management accountable for effectively executing the covered institution's incentive-based compensation program, and for modifying it when weaknesses are identified.

In addition, some Level 1 and Level 2 covered institutions use automated systems to monitor the effectiveness of incentive-based compensation arrangements in balancing risk-taking incentives, especially systems that support capture of relevant data in databases that support monitoring and analysis. Management plays a role in all of these activities and is well-positioned to oversee an analysis that considers such a wide variety of inputs. In order to ensure that considerations of risk-taking are included in such an exercise, an active role for independent control functions is critical in such a review as well as input from the risk and audit committees of the board of directors, or groups performing similar functions. Periodic presentations by the chief risk officer or other risk management staff to the board of directors can help complement the annual effectiveness review.

In addition, the proposed rule includes a requirement that internal audit or risk management submit a written assessment of the effectiveness of a Level 1 or Level 2 covered institution's incentive-based compensation program and related control processes in providing risk-taking incentives that are consistent with the risk profile of the covered institution. Regular internal reviews and audits of compliance with policies and procedures are important to helping implement the incentive-based compensation system as intended by those employees involved in incentive-based compensation decision-making. Internal audit and risk management are well-positioned to provide an independent perspective on a covered institution's incentive-based compensation program and related control processes. The Federal Banking Agencies have observed that compensation committees benefit from an independent analysis of the effectiveness of their covered institutions' incentive-based compensation programs.[224]

The proposed requirement takes into consideration comments received on the policies and procedures standards embodied in the 2011 Proposed Rule that would have required the covered financial institution's board of directors, or a committee thereof, to receive data and analysis from management and other sources sufficient to allow the board, or committee thereof, to assess whether the overall design and performance of the institution's incentive-based compensation arrangements were consistent with section 956. Many commenters on the 2011 Proposed Rule expressed concern that the proposed requirements in the 2011 Proposed Rule would have inappropriately expanded the traditional "oversight" role of the board and would have required the board to exercise judgment in areas that traditionally have been—and, in the view of some commenters, are best left to—the expertise and prerogative of management. Commenters suggested that the proposed requirement instead place responsibility on management to conduct a formal assessment of the effectiveness of the covered institution's incentive-based compensation program and related compliance and control processes. The

[224] For example, the 2010 Federal Banking Agency Guidance notes that a banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

Agencies agree that management should be responsible for conducting such an assessment and section ___.10(b)(2) of the proposed rule would thus place this responsibility on management, while requiring input from risk and audit committees, or groups performing similar functions, and from the covered institutions' risk management and audit functions. Under the proposed rule, the board's primary focus would be oversight of incentive-based compensation program and arrangements, while management would be expected to implement a program consistent with the vision of the board.

10.1. The Agencies invite comment on this provision generally and whether the written assessments required under sections___.10(b)(2) and___.10(b)(3) of the proposed rule should be provided to the compensation committee on an annual basis or at more or less frequent intervals?

10.2. Are both reports required under §__.10(b)(2) and (3) necessary to aid the compensation committee in carrying out its responsibilities under the proposed rule? Would one or the other be more helpful? Why or why not?

§ ___.11 Policies and Procedures Requirements for Level 1 and Level 2 Covered Institutions

Section ___.11 of the proposed rule would require Level 1 and Level 2 covered institutions to develop and implement certain minimum policies and procedures relating to their incentive-based compensation programs. Requiring covered institutions to develop and follow policies and procedures related to incentive-based compensation would help both covered institutions and regulators identify the incentive-based compensation risks to which covered institutions are exposed, and how these risks are managed so as not to incentivize inappropriate risk-taking by covered persons that could lead to material financial loss to the covered institution. The Agencies are not proposing to require specific policies and procedures of Level 3 covered institutions because these institutions are generally less complex and the impact to the financial system by risks taken at these covered institutions is not as significant as risks taken by covered persons at the larger, more complex covered institutions. In addition, by not requiring additional policies and procedures, Agencies intend to reduce burden on smaller covered institutions. In contrast, the larger Level 1 and Level 2 covered institutions generally will have more complex organizations that tend to conduct a wide range of business activities and therefore will need robust policies and procedures as part of their compliance programs.[225] Therefore, under section ___.11 of the proposed rule, Level 3 covered institutions would not be subject to any specific requirements in this area, while Level 1 and Level 2 covered institutions would be required to develop and implement specific policies and procedures for their incentive-based compensation programs.

Section ___.11 of the proposed rule would identify certain areas that the policies and procedures of Level 1 and Level 2 covered institutions would, at a minimum, have to address. The list is not exhaustive. Instead, it is meant to indicate the policies and procedures that would, at a minimum, be necessary to carry out the requirements in other sections of the proposed rule.

The development and implementation of the policies and procedures under section ___.11 of the proposed rule would help to ensure and monitor compliance with the requirements set forth in section 956 and the other requirements in the proposed rule because the policies and procedures would set clear expectations for covered persons and allow the Agencies to better understand how a covered institution's incentive-based compensation program operates. Section ___.11(a) of the proposed rule would contain the general requirement that the policies and procedures be consistent with the prohibitions and requirements under the proposed rule. Other parts of section ___.11 of the proposed rule would help to ensure and monitor compliance with specific portions of the proposed rule.

Under section ___.11(b) of the proposed rule, a Level 1 or Level 2 covered institution would have to develop and implement policies and procedures that specify the substantive and procedural criteria for the application of forfeiture and clawback, including the process for determining the amount of incentive-based compensation to be clawed back. These policies and procedures would provide covered persons with notice of the circumstances that would lead to forfeiture and clawback at their covered institutions, including any circumstances identified by the covered institution in addition to those required under the proposed rule. They would also help ensure consistent application of forfeiture and clawback by establishing a common set of expectations.

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[225] See Federal Reserve SR Letter 08-08, "Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles" (October 16, 2008).

Policies and procedures should make clear the triggers that will result in consideration of forfeiture, downward adjustment, and clawback; should indicate what individuals or committees are responsible for identifying, escalating and resolving these issues in such cases; should ensure that control functions contribute relevant information and participate in any decisions; and should set out a clear process for determining responsibility for the events triggering the forfeiture and downward adjustment review including provisions requiring appropriate input from covered employees under consideration for forfeiture or clawback.

The proposed rule also would require that Level 1 and Level 2 covered institutions' policies and procedures require the maintenance of documentation of final forfeiture, downward adjustment, and clawback decisions under section __.11(c) of the proposed rule. Documentation would allow control functions and the Agencies to evaluate compliance with the requirements of section __.7 of the proposed rule. The Agencies are proposing this requirement because they have found that it is critical that forfeiture and downward adjustment reviews at covered institutions be supported by effective governance to ensure consistency, fairness and robustness of all related decision-making.

Section ___.11(d) of the proposed rule would include a requirement for policies and procedures of Level 1 and Level 2 covered institutions that would specify the substantive and procedural criteria for acceleration of payments of deferred incentive-based compensation to a covered person consistent with sections __.7(a)(1)(iii)(B) and __.7(a)(2)(iii)(B) of the proposed rule. Under section __.7 of the proposed rule, acceleration of vesting of incentive-based compensation that is required to be deferred under such section would only be permitted in the case of death or disability. A Level 1 or Level 2 covered institution would have to have policies and procedures that describe how disability would be evaluated for purposes of determining whether to accelerate payments of deferred incentive-based compensation.

Section __.11(e) would require Level 1 and Level 2 covered institutions to have policies and procedures that identify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions, including when discretion is authorized. A Level 1 or Level 2 covered institution's policies and procedures would also have to describe how discretion is expected to be exercised in order to appropriately balance risk and reward and how the incentive-based compensation arrangements will be monitored under sections __.11(f) and (h) of the proposed rule, respectively.

Related to the requirements regarding disclosure under sections __.4(f) and __.5 of the proposed rule, under section __.11(g), a Level 1 or Level 2 covered institution would need to have policies and procedures that require the covered institution to maintain documentation of the establishment, implementation, modification, and monitoring of incentive-based compensation arrangements sufficient to support the covered institution's decisions. Section __.11(i) would require the policies and procedures to specify the substantive and procedural requirements of the independent compliance program, consistent with section __.9(a)(2). And section __.11(j) would require policies and procedures that address the appropriate roles for risk management, risk oversight, and other control function personnel in the covered institution's processes for (1) designing incentive-based compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback, and vesting, and (2) assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.

The Agencies anticipate that some Level 1 and Level 2 covered institutions that have international operations might choose to adopt enterprise-wide incentive-based compensation policies and procedures. The Agencies recognize that such policies and procedures, when utilized by various subsidiary institutions, may need to be further modified to reflect local regulation and the requirements of home country regulators in the case of international institutions and tailored to a certain extent by line of business, legal entity, or business model.

11.1. The Agencies invite general comment on the proposed policies and procedures requirements for Level 1 and Level 2 covered institutions under section ___.11 of the proposed rule.

§ ___.12 Indirect Actions

Section ___.12 of the proposed rule would prohibit a covered institution from doing indirectly what it cannot do directly under the proposed rule. Section ___.12 would apply all of the proposed rule's requirements and prohibitions to actions taken by covered institutions indirectly or through or by any other person. Section ___.12 is substantially the same as section ___.7 of the 2011 Proposed Rule. The Agencies did not receive any comments on section ___.7 of the 2011 Proposed Rule.

By subjecting such indirect actions by covered institutions to all of the proposed rule's requirements and prohibitions, section ___.12 would implement the directive in section 956(b) to adopt rules that prohibit any type of incentive-based payment arrangement, or any feature of any such arrangement, that the Agencies determine encourages inappropriate risks by covered institutions (1) by providing excessive compensation, fees, or benefits or (2) that could lead to material financial loss. The Agencies are concerned that a covered institution may take indirect actions in order to avoid application of the proposed rule's requirements and prohibitions. For example, a covered institution could attempt to make substantial numbers of its covered persons independent contractors for the purpose of avoiding application of the proposed rule's requirements and prohibitions. A covered institution could also attempt to make substantial numbers of its covered persons employees of another entity for the purpose of avoiding application of the proposed rule's requirements and prohibitions. If left unchecked, such indirect actions could encourage inappropriate risk-taking by providing covered persons with excessive compensation or could lead to material financial loss at a covered institution.

The Agencies, however, do not intend to disrupt indirect actions, including independent contractor or employment relationships, not undertaken for the purpose of avoiding application of the proposed rule's requirements and prohibitions. Thus, the Agencies would apply the proposed rule regardless of how covered institutions classify their actions, while also recognizing that covered institutions may legitimately engage in activities that are outside the scope of section 956 and the proposed rule.[226]

NCUA's proposed rule also would clarify that covered credit unions may not use CUSOs to avoid the requirements of the proposed rule, such as by using CUSOs to maintain non-compliant incentive-based compensation arrangements on behalf of senior executive officers or significant risk-takers of Federally insured credit unions.

12.1. Commenters are invited to address all aspects of section ___.12, including any examples of other indirect actions that the Agencies should consider.

§ ___.13 Enforcement.

[226] The Agencies note, however, that section 956 of the Dodd-Frank Act does not, and the proposed rule would not, limit the authority of the Agencies under other provisions of applicable law and regulations.

By its terms, section 956 applies to any depository institution and any depository institution holding company (as those terms are defined in section 3 of the FDIA), any broker-dealer registered under section 15 of the Securities Exchange Act, any credit union, any investment adviser (as that term is defined in the Investment Advisers Act of 1940), the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. Section 956 also applies to any other financial institution that the appropriate Federal regulators jointly by rule determine should be treated as a covered financial institution for purposes of section 956.

Section 956(d) also specifically sets forth the enforcement mechanism for rules adopted under that section. The statute provides that section 956 and the implementing rules shall be enforced under section 505 of the Gramm-Leach-Bliley Act and that a violation of section 956 or the regulations under section 956 will be treated as a violation of subtitle A of Title V of the Gramm-Leach-Bliley Act.

Section 505 of the Gramm-Leach-Bliley Act provides for enforcement:

(1) under section 1818 of title 12, by the appropriate Federal banking agency, as defined in section 1813(q) of title 12,[227] in the case of—

(A) national banks, Federal branches and Federal agencies of foreign banks, and any subsidiaries of such entities (except brokers, dealers, persons providing insurance, investment companies, and investment advisers);

(B) member banks of the Federal Reserve System (other than national banks), branches and agencies of foreign banks (other than Federal branches, Federal agencies, and insured State branches of foreign banks), commercial lending companies owned or controlled by foreign banks, organizations operating under section 25 or 25A of the Federal Reserve Act [12 U.S.C. 601 et seq., 611 et seq.], and bank holding companies and their nonbank subsidiaries or affiliates (except brokers, dealers, persons providing insurance, investment companies, and investment advisers);

[227] For purposes of section 1813(q), the appropriate Federal banking agency for institutions listed in paragraphs (A) and (D) is the OCC; for institutions listed in paragraphs (B), the Board; and for institutions listed in paragraph (C), the FDIC. 12 U.S.C. 1813(q).

(C) banks insured by the FDIC (other than members of the Federal Reserve System), insured State branches of foreign banks, and any subsidiaries of such entities (except brokers, dealers, persons providing insurance, investment companies, and investment advisers); and

(D) savings associations the deposits of which are insured by the FDIC, and any subsidiaries of such savings associations (except brokers, dealers, persons providing insurance, investment companies, and investment advisers).

(2) under the Federal Credit Union Act [12 U.S.C. 1751 et seq.], by the Board of the NCUA with respect to any federally insured credit union, and any subsidiaries of such an entity;

(3) under the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.], by the SEC with respect to any broker or dealer;

(4) under the Investment Company Act of 1940 [15 U.S.C. 80a–1 et seq.], by the SEC with respect to investment companies;

(5) under the Investment Advisers Act of 1940 [15 U.S.C. 80b–1 et seq.], by the SEC with respect to investment advisers registered with the Commission under such Act;

(6) under State insurance law, in the case of any person engaged in providing insurance, by the applicable State insurance authority of the State in which the person is domiciled, subject to section 6701 of this title;

(7) under the Federal Trade Commission Act [15 U.S.C. 41 et seq.], by the Federal Trade Commission for any other financial institution or other person that is not subject to the jurisdiction of any agency or authority under paragraphs (1) through (6) of this subsection; and

(8) under subtitle E of the Consumer Financial Protection Act of 2010 [12 U.S.C. 5561 et seq.], by the Bureau of Consumer Financial Protection, in the case of any financial institution and other covered person or service provider that is subject to the jurisdiction of the Bureau.

The proposed rule includes these enforcement provisions as provided in section 956.

FHFA's enforcement authority for the proposed rule derives from its authorizing statute, the Safety and Soundness Act. FHFA is not one of the "Federal functional regulators" listed in section 505 of the Gramm-Leach-Bliley Act. Additionally, the applicability of Title V of the Gramm-Leach-Bliley Act to Fannie Mae and Freddie Mac is limited by their conditional exclusion from that Title's definition of "financial institution." But there is no evidence that Congress intended to exclude FHFA, or Fannie Mae and Freddie Mac, from enforcement of the proposed rule. To the contrary, Congress specifically included Fannie Mae and Freddie Mac as covered financial institutions and FHFA as an "appropriate federal regulator" in section 956, and FHFA requires no additional enforcement authority. The Safety and Soundness Act provides FHFA with enforcement authority for all laws and regulations that apply to its regulated entities.

13.1. The Agencies invite comment on all aspects of section ___.13.

§ ___.14 NCUA and FHFA Covered Institutions in Conservatorship, Receivership, or Liquidation.

The NCUA's and FHFA's proposed rules each include a section __.14 that would address those instances when a covered institution is placed in conservatorship, receivership, or liquidation, including limited-life regulated entities, under their respective authorizing statutes, the Federal Credit Union Act or the Safety and Soundness Act.[228] If a covered institution is placed in conservatorship, receivership, or liquidation, the conservator, receiver, or liquidating agent, respectively, and not the covered institution's board or management, has ultimate authority over all compensation arrangements, including any incentive-based compensation for covered persons. When determining or approving any incentive-based compensation plans for covered persons at such a covered institution, the conservator, receiver, or liquidating agent will implement the purposes of the Dodd-Frank Act by prohibiting excessive incentive-based compensation and incentive-based compensation that encourages inappropriate risk-taking.

Institutions placed in conservatorship, receivership, or liquidation may be subject to different needs and circumstances with respect to attracting and retaining talent than other types of covered institutions. In order to attract and retain qualified individuals at a covered institution in conservatorship, for example, the conservator may determine that while a significant portion

[228] The FDIC's proposed rule would not apply to institutions for which the FDIC is appointed receiver under the FDIA or Title II of the Dodd-Frank Act, as appropriate, as those statutes govern such cases.

of a covered person's incentive-based compensation should be deferred, due to the uncertain future of the covered institution in conservatorship, the deferral period would be shorter than that set forth in the deferral provisions of the proposed rule. In another example, where a conservator assumes the roles and responsibilities of the covered institution's board and its committees, the conservator may determine that it is not necessary for the board of the covered institution, if any remains in conservatorship, to approve a material adjustment to a senior executive officer's incentive-based compensation arrangement as described by the governance section of the proposed rule.

Certain provisions of the proposed rule, such as the deferral and governance provisions, may not be appropriate for institutions in conservatorship, receivership, or liquidation, and the incentive-based compensation structure that best meets their needs while implementing the purposes of the Dodd-Frank Act is appropriately left to the conservator, receiver, or liquidating agent, respectively. Under the applicable section __.14 of the proposed rule, if a covered institution is placed in conservatorship, receivership, or liquidation under the Safety and Soundness Act, for FHFA's proposed rule, or the Federal Credit Union Act, for the NCUA's proposed rule, the respective conservator, receiver, or liquidating agent would have the responsibility to fulfill the requirements and purposes of 12 U.S.C. 5641. The conservator, receiver, or liquidating agent also has the discretion to determine transition terms should the covered institution cease to be in conservatorship, receivership, or liquidation.

14.1. Commenters are invited to address all aspects of section ___.14 of the proposed rule.

SEC Amendment to Exchange Act Rule 17a-4.

The SEC is proposing an amendment to Exchange Act Rule 17a-4(e) (17 CFR 240.17a-4(e)) to require that broker-dealers maintain the records required by § ___.4(f), and for Level 1 and Level 2 broker-dealers, §§ ___.5 and ___.11, in accordance with the recordkeeping requirements of Exchange Act Rule 17a-4. Exchange Rule 17a-4 establishes the general formatting and storage requirements for records that broker-dealers are required to keep. For the sake of consistency with other broker-dealer records, the SEC believes that broker-dealers should also keep the records required by § ___.4(f), and for Level 1 and Level 2 broker-dealers, §§ ___.5 and ___.11, in accordance with these requirements.

New paragraph (e)(10) of Exchange Act Rule 17a-4 would require Level 1, Level 2, and Level 3 broker-dealers to maintain and preserve in an easily accessible place the records required by § ___.4(f), and for Level 1 and Level 2 broker-dealers, the records required by §§ ___.5 and ___.11. Paragraph (f) of Exchange Act Rule 17a-4 provides that the records a broker-dealer is required to maintain and preserve under Exchange Act Rule 17a-3 (17 CFR 240.17a-3) and Exchange Act Rule 17a-4 may be immediately produced or reproduced on micrographic media or by means of electronic storage media. Paragraph (j) of Exchange Act Rule 17a-4 requires a broker-dealer, which would include a broker-dealer that is a Level 1, Level 2, or Level 3 covered institution pursuant to the proposed rules, to furnish promptly to a representative of the SEC legible, true, complete, and current copies of those records of the broker-dealer that are required to be preserved under Exchange Act Rule 17a-4, or any other records of the broker-dealer subject to examination under section 17(b) of the Securities Exchange Act of 1934 that are requested by the representative.[229]

SEC Amendment to Investment Advisers Act Rule 204-2.

The SEC is proposing an amendment to rule 204-2 under the Investment Advisers Act (17 CFR 275.204-2) to require that investment advisers registered or required to be registered under section 203 of the Investment Advisers Act (15 U.S.C. 80b-3) maintain the records required by § __.4(f) and, for those investment advisers that are Level 1 or Level 2 covered institutions, §§ __.5 and __.11, in accordance with the recordkeeping requirements of rule 204-2. New paragraph (a)(19) of rule 204-2 would require investment advisers subject to rule 204-2 that are Level 1, Level 2, or Level 3 covered institutions to make and keep true, accurate, and current the records required by, and for the period specified in, § __.4(f) and, for those investment

[229] For a discussion generally of Exchange Act Rule 17a-4, see Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Release No. 34-71958 (Apr. 17, 2014), 79 FR 25194 (May 2, 2014).

advisers that are Level 1 or Level 2 covered institutions, the records required by, and for the periods specified in, §§ __.5 and __.11.

Rule 204-2 establishes the general recordkeeping requirements for investment advisers registered or required to be registered under section 203 of the Investment Advisers Act. For the sake of consistency with other investment adviser records, the SEC is proposing that this rule require such investment advisers that are covered institutions to keep the records required by § __.4(f) and those that are Level 1 or Level 2 covered institutions to keep the records required by §§ __.5 and __.11 in accordance with the requirements of rule 204-2.

III. Appendix to the Supplementary Information: Example Incentive-Based Compensation Arrangement and Forfeiture and Downward Adjustment Review

For an incentive-based compensation arrangement to meet the requirements of the proposed rule, particularly the requirement that such an arrangement appropriately balance risk and reward, covered institutions would need to look holistically at the entire incentive-based arrangement. Below, for purposes of illustration only, the Agencies outline an example of a hypothetical incentive-based compensation arrangement that would meet the requirements of the proposed rule and an example of how a forfeiture and downward adjustment review might be conducted. These illustrations do not cover every aspect of the proposed rule. They are provided as an aid to understanding the proposed rule and would not carry the force and effect of law or regulation, if issued as a companion to a final rule. Reviewing these illustrations does not substitute for a review of the proposed rule.

This example assumes that the final rule was published as proposed and all incentive-based compensation programs and arrangements were required to comply on or before January 1, 2020.

Ms. Ledger: Senior Executive Officer at Level 2 Covered Institution

Ms. Ledger is the chief financial officer at a bank holding company, henceforth "ABC," which has $200 billion in average total consolidated assets. Under the definitions of the proposed rule Ms. Ledger would be a senior executive officer and ABC would be a Level 2 covered institution.[230]

Ms. Ledger is provided incentive-based compensation under three separate incentive-based compensation plans. The first plan, the "Annual Executive Plan," is applicable to all senior executive officers at ABC, and requires assessment over the course of one calendar year. The second plan, the "Annual Firm-Wide Plan," is applicable to all employees at ABC, and is also based on a one-year performance period that coincides with the calendar year. The third plan, "Ms. Ledger's LTIP," is applicable only to Ms. Ledger, and requires assessment of performance over a three-year performance period that begins on January 1 of year 1 and ends on December 31 of year 3. These three plans together comprise Ms. Ledger's incentive-based compensation arrangement.

The proposed rule would impose certain requirements on Ms. Ledger's incentive-based compensation arrangement. Section ___.4(a)(1) of the proposed rule would require that Ms. Ledger's entire incentive-based compensation arrangement, and each feature of that arrangement, not provide excessive compensation. ABC would be required to consider the six factors listed in section ___.4(b) of the proposed rule, as well as any other factors that ABC finds relevant, in evaluating whether Ms. Ledger's incentive-based compensation arrangement provides excessive compensation before approving Ms. Ledger's incentive-based compensation arrangement.

Balance.

Under section ___.4(c)(1) of the proposed rule, the entire arrangement would be required to appropriately balance risk and reward. ABC would be expected to consider the risks that Ms. Ledger's activities pose to the institution, and the performance that Ms. Ledger's incentive-based compensation arrangement rewards. ABC might consider both the type and target level of any

[230] See the definitions of "senior executive officer" and "Level 2 covered institution" in section __.2 of the proposed rule.

associated performance measures; how all performance measures would work together under the three plans; the form of incentive-based compensation; the recourse ABC has to reduce incentive-based compensation once awarded (through forfeiture)[231] including under the conditions outlined in section __.7 of the proposed rule; the ability ABC has to use clawback of incentive-based compensation once vested, including under the conditions outlined in section __.7 of the proposed rule; and any overlapping performance periods of the various incentive-based compensation plans, which apply to Ms. Ledger.

Under section ___.4(d) of the proposed rule, Ms. Ledger's incentive-based compensation arrangement would be required to include both financial and non-financial measures of performance. These measures would need to include considerations of risk-taking that are relevant to Ms. Ledger's role within ABC and to the type of business in which Ms. Ledger is engaged. They also would need to be appropriately weighted to reflect risk-taking. The arrangement would be required to allow non-financial measures of performance to override financial measures of performance when appropriate in determining Ms. Ledger's incentive-based compensation. Any amounts to be awarded under Ms. Ledger's arrangement would be subject to adjustment to reflect ABC's actual losses, inappropriate risks Ms. Ledger took or was accountable for others taking, compliance deficiencies Ms. Ledger was accountable for, or other measures or aspects of Ms. Ledger's and ABC's financial and non-financial performance. For example, the Annual Firm-Wide Plan might use a forward-looking internal profit measure that takes into account stressed conditions as a proxy for liquidity risk that Ms. Ledger's activities pose to ABC and thus mitigates against incentives to take imprudent liquidity risk. It might also include limits on liquidity risk, the repeated breach of which would result in non-compliance with a key non-financial performance objective.

In practice, each incentive-based compensation plan will include various measures of performance, and under the proposed rule, each plan would be required to include both financial and non-financial measures. The Annual Firm-Wide Plan may be largely based on the change in value of ABC's equity over the performance year, but that cannot be the only basis for incentive-

[231] This requirement for balance under section ___.4(c)(1) would not, however require forfeiture, or any specific forfeiture measure, for any particular covered person. As discussed below, sections ___.7 and ___.8 contain specific requirements applicable to senior executive officers at Level 1 and Level 2 covered institutions.

based compensation awarded under that plan. Non-financial measures of Ms. Ledger's risk-taking activity would have to be taken into account in determining the incentive-based compensation awarded under that plan, and those non-financial measures would need to be appropriately weighted so that they could override financial measures. Even if ABC's equity performed very well over the performance year, if Ms. Ledger was found to have violated risk performance measures, Ms. Ledger should not be awarded the full target of incentive-based compensation from the plan.

Because Ms. Ledger is a senior executive officer at a Level 2 covered institution, Ms. Ledger's incentive-based compensation arrangement would not be considered to appropriately balance risk and reward unless it was structured to be consistent with the requirements set forth in sections ___.7 and ___.8 of the proposed rule. The incentive-based compensation awarded to Ms. Ledger would not be permitted to be based solely on relative performance measures[232] or be based solely on transaction revenue or volume.[233] The Annual Executive Plan may include a measure of ABC's TSR relative to its peer group, but that plan would comply with the proposed rule only if other absolute measures of ABC's or Ms. Ledger's performance were also included (e.g., achievement of a three-year average return on risk adjusted capital). Similarly, a plan that applied to significant risk-takers who were engaged in trading might include transaction volume as one of the financial performance measures, but that plan would comply with the proposed rule only if it also included other factors, such as measurement of transaction quality or the significant risk-taker's compliance with the institution's risk-management policies.

Award of incentive-based compensation for performance periods ending December 31, 2024.

Ms. Ledger's incentive-based compensation is awarded on January 31, 2025. The Annual Executive Plan and the Annual Firm-Wide Plan are awarded on this date for the performance period starting on January 1, 2024 and ending on December 31, 2024. Ms. Ledger's LTIP will be awarded on this date for the performance period starting on January 1, 2022 and ending on December 31, 2024. This example assumes ABC's share price on December 31, 2024 (the end of the performance period) is $50.

[232] See section ___.8(c) of the proposed rule.
[233] See section ___.8(d) of the proposed rule.

Ms. Ledger's target incentive-based compensation award amount under the Annual Executive plan is $60,000 and 1,000 shares of ABC.[234] Under the Annual Firm-Wide Plan, Ms. Ledger's target incentive-based compensation award amount is $30,000. Finally, under Ms. Ledger's LTIP, her target incentive-based compensation award amount is $40,000 and 2,000 shares of ABC.

To be consistent with the proposed rule, the maximum incentive-based compensation amounts that ABC would be allowed to award to Ms. Ledger are 125 percent of the target amount, which would amount to: $75,000 and 1,250 shares under the Annual Executive Plan; $37,500 under the Annual Firm-Wide Plan; and $50,000 and 2,500 shares under Ms. Ledger's LTIP.

If Ms. Ledger were implicated in a forfeiture and downward adjustment review during the performance period, ABC would be expected to consider whether and by what amount to reduce the amounts awarded to Ms. Ledger. As part of that review, ABC would be expected to consider all of the amounts that could be awarded to Ms. Ledger under the Annual Executive Plan, Annual Firm-Wide Plan, and Ms. Ledger's LTIP for downward adjustment before any incentive-based compensation were awarded to Ms. Ledger.[235]

Regardless of whether a downward forfeiture and downward adjustment review occurred, ABC would be expected to evaluate Ms. Ledger's performance, including Ms. Ledger's risk-taking activities, at or near the end of the performance period (December 31, 2024). ABC would be required to use non-financial measures of performance, and particularly measures of risk-taking, to determine Ms. Ledger's incentive-based compensation award, possibly decreasing the amount Ms. Ledger would be awarded if only financial measures were taken into account.[236]

Based on performance and taking into account Ms. Ledger's risk-taking behavior, ABC decides to award Ms. Ledger: $30,000 and 1,000 shares under the Annual Executive Plan; $35,000 under the Annual Firm-Wide Plan; and $40,000 and 2,000 shares under Ms. Ledger's LTIP. Valuing the ABC equity at the time of award, the total value of Ms. Ledger's award under

[234] That is, if Ms. Ledger meets all of the performance measure targets set out under that plan, she will be awarded both $60,000 in cash and 1,000 shares of ABC stock.
[235] See section __.7(b) of the proposed rule.
[236] See section __.4(d)(2) of the proposed rule.

the Annual Executive Plan is $80,000, under the Annual Firm-Wide Plan is $35,000, and under Ms. Ledger's LTIP is $140,000.

	Target Award				Maximum Award				Actual Award			
Incentive-Based *Compensation*	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Total Value ($)*	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Total Value ($)*	*Cash[1] ($)*	*Equity [2] (#)*	*Value of Equity ($)*	*Total Value ($)*
Annual Executive Plan	$60,000	1,000	$50,000	$110,000	$75,000	1,250	$62,500	$137,500	$30,000	1,000	$50,000	$80,000
Annual Firm-Wide Plan	$30,000	-	-	$30,000	$37,500	-	-	$37,500	$35,000	-	-	$35,000
Ms. Ledger's LTIP	$40,000	2,000	$100,000	$140,000	$50,000	2,500	$125,000	$175,000	$40,000	2,000	$100,000	$140,000
Total Incentive-Based Compensation	$130,000	3,000	$150,000	$280,000	$162,500	3,750	$87,500	$350,000	$105,000	3,000	$150,000	$255,000

[1] The amount of actual cash award ABC chose to award.

[2] The amount of actual equity award ABC chose to award.

To calculate the minimum required deferred amounts, ABC would have to aggregate the amounts awarded under both the Annual Executive Plan ($80,000) and the Annual Firm-Wide Plan ($35,000), because each has the same performance period, which is less than three years, to determine the total amount of qualifying incentive-based compensation awarded ($115,000).[237] At least 50 percent of that qualifying incentive-based compensation would be required to be deferred for at least three years.[238] Thus, ABC would be required to defer cash and equity with an aggregate value of at least $57,500 from qualifying incentive-based compensation. ABC would have the flexibility to defer the amounts awarded in cash or in equity, as long as the total deferred incentive-based compensation was composed of both substantial amounts of deferred cash and substantial amounts of deferred equity.[239] ABC would also have the flexibility to defer amounts awarded from either the Annual Executive Plan or the Annual Firm-Wide Plan.

In this example, ABC chooses to defer $27,500 of cash and 650 shares from Ms. Ledger's award from the Annual Executive Plan, which has a total value of $60,000 at the time of the award, for three years and none of the award under the Annual Firm-Wide Plan.[240]

[237] See section __.7(a)(1) of the proposed rule.
[238] See sections __.7(a)(1)(i)(C) and __.7(a)(1)(ii)(B) of the proposed rule.
[239] See section __.7(a)(4)(i) of the proposed rule.
[240] Ms. Ledger's entire award under the Annual Firm-Wide Plan, $35,000, and remaining award under the Annual Executive Plan, $2,500 and 350 shares, could vest immediately.

Incentive-Based Compensation	**Total Award**				**Minimum Required Deferred**			**Actual Deferred**			
	Cash ($)	*Equity (#)*	*Value of Equity ($)*	*Total Value ($)*	*Total Value ($)*	*Deferral Rate (%)*	*Total Value ($)*	*Cash[2] ($)*	*Equity[3] (#)*	*Value of Equity ($)*	*Total Value ($)*
Annual Executive Plan	$30,000	1,000	$50,000	$80,000	-	-	-	$27,500	650	$32,500	$60,000
Annual Firm-Wide Plan	$35,000	-	-	$35,000	-	-	-	-	-	-	-
Qualified Incentive-Based Compensation	$65,000	1,000	$50,000	$115,000	$115,000	50%	$57,500	$27,500	650	$32,500	$60,000
Ms. Ledger's LTIP	$40,000	2,000	$100,000	$140,000	$140,000	50%	$70,000	$35,000	700	$35,000	$70,000
Total Incentive-Based Compensation	$105,000	3,000	$150,000	$255,000	$255,000	50%	$127,500	$62,500	1,350	$67,500	$130,000

1 The aggregate amount from both the Annual Executive Plan and Annual Firm-Wide Plan.

2 The amount of actual cash award ABC chose to defer.

3 The amount of actual equity award ABC chose to defer.

Vesting schedule.

ABC would have the flexibility to determine the schedule by which this deferred incentive-based compensation would be eligible for vesting, as long as the cumulative total of the deferred incentive-based compensation that has been made eligible for vesting by any given year is not greater than the cumulative total that would have been eligible for vesting had the covered institution made equal amounts eligible for vesting each year.[241] With deferred qualifying incentive-based compensation valued at $60,000 and three-year vesting, no more than $20,000 would be allowed to be eligible to vest on December 31, 2025, and no more than $40,000 would be eligible to vest on or before December 31, 2026. At least $20,000 would need to be eligible to vest on December 31, 2027, to be consistent with the proposed rule. In this example, ABC decides to make none of the deferred award from the Annual Executive Plan eligible for vesting on December 31, 2025; to make $13,750 and 325 shares (total value of cash and equity $30,000) eligible for vesting on December 31, 2026; and to make $13,750 and 325 shares (total value of cash and equity $30,000) eligible for vesting on December 31, 2027.

Ms. Ledger's LTIP has a performance period of three years, so Ms. Ledger's LTIP would meet the definition of a "long-term incentive-plan" under the proposed rule.[242] At least 50

[241] See section __.7(a)(1)(iii) of the proposed rule.
[242] See the definition of "long-term incentive plan" in section __.2 of the proposed rule.

percent of Ms. Ledger's LTIP amount ($140,000) would be required to be deferred for at least one year.[243] Thus, ABC would be required to defer cash and equity with an aggregate value of at least $70,000 from Ms. Ledger's LTIP, which would be eligible for vesting on December 31, 2025. ABC would have flexibility to defer the amounts awarded in cash or in equity, as long as the total deferred incentive-based compensation were composed of both substantial amounts of deferred cash and substantial amounts of deferred equity.[244] If ABC chooses to defer amounts awarded from Ms. Ledger's LTIP for longer than one year, ABC would have flexibility to determine the schedule on which it would be eligible for vesting, as long as the cumulative total of the deferred incentive-based compensation that has been made eligible for vesting by any given year is not greater than the cumulative total that would have been eligible for vesting had the covered institution made equal amounts eligible for vesting in one year.[245]

In this example, ABC chooses to defer $35,000 of cash and 700 shares of the award from Ms. Ledger's LTIP, which has a total value of $70,000 at the time of the award, for one year.[246] The non-deferred amount ($35,000 and 700 shares) could vest at the time of the award on January 31, 2025.

In summary, Ms. Ledger would receive $42,500 and 1,650 shares (a total value of $125,000) immediately after December 31, 2024.[247] A total of $35,000 and 700 shares (total value $70,000) would be eligible to vest on December 31, 2025. A total of $13,750 and 325 shares (total value $30,000) would be eligible to vest on December 31, 2026. Finally, a total of $13,750 and 325 shares (total value $30,000) would again be eligible to vest on December 31, 2027.

	Immediate Amounts Payable				**Total Amounts Deferred**			
Incentive-Based Compensation	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Total Value ($)*	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Total Value ($)*
Annual Executive Plan	$2,500	350	$17,500	$20,000	$27,500	650	$32,500	$60,000

[243] See sections __.7(a)(2)(i)(C) and __.7(a)(2)(ii)(B) of the proposed rule.
[244] See section __.7(a)(4)(i) of the proposed rule.
[245] See section __.7(a)(2)(iii) of the proposed rule.
[246] Ms. Ledger's remaining award under Ms. Ledger's LTIP would vest immediately.
[247] This amount would represent $2,500 and 350 shares awarded under the Annual Executive Plan, $35,000 awarded under the Annual Firm-Wide Plan and $5,000 and 1,300 shares awarded under Ms. Ledger's LTIP.

Annual Firm-Wide Plan	$35,000	-	-	$35,000	-	-	-	-
Ms. Ledger's LTIP	$5,000	1,300	$65,000	$70,000	$35,000	700	$35,000	$70,000
Total Incentive-Based Compensation	$42,500	1,650	$82,500	$125,000	$62,500	1,350	$67,500	$130,000

	Vesting Schedule											
	12/31/2025				**12/31/2026**				**12/31/2027**			
Incentive-Based Compensation	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Total Value ($)*	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Total Value ($)*	*Cash ($)*	*Equit y (#)*	*Value of Equity ($)*	*Total Value ($)*
Annual Executive Plan	-	-	-	-	$13,750	325	$16,250	$30,000	$13,750	325	$16,250	$30,000
Ms. Ledger's LTIP	$35,000	700	$35,000	$70,000	-	-	-	-	-	-	-	-
Amount Eligible for Vesting	-	-	-	$70,000	-	-	-	$30,000	-	-	-	$30,000
Remaining Unvested Amount	-	-	-	$60,000	-	-	-	$30,000	-	-	-	$0

Use of options in deferred incentive-based compensation.

If, under the total award amount outlined above, ABC chooses to award Ms. Ledger incentive-based compensation partially in the form of options, and chooses to defer the vesting of those options, no more than $38,250 worth of those options (the equivalent of 15 percent of the aggregate incentive-based compensation awarded to Ms. Ledger) would be eligible to be treated as deferred incentive-based compensation.[248] As an example, ABC may award Ms. Ledger options that have a value at the end of the performance period of $10 and deferred vesting. ABC may choose to award Ms. Ledger incentive-based compensation with a total value of $255,000 in the following forms: $30,000 in cash, 640 shares of equity (valued at $32,000), and 1,800 options (valued at $18,000) under the Annual Executive Plan; $35,000 cash under the Annual Firm-Wide Plan; and $40,000 cash, 1,600 shares of equity (valued at $80,000), and 2,000 options (valued at $20,000) under Ms. Ledger's LTIP. Of that award, ABC may defer: $27,500 in cash, 290 shares (valued at $14,500), and 1,800 options (valued at $18,000) under the Annual Executive Plan (total value of deferred $60,000); none of the award from the Annual Firm-Wide

[248] See section __.7(a)(4)(ii)

Plan; and $35,000 in cash, 300 shares (valued at $15,000) and 2,000 options (valued at $20,000) under Ms. Ledger's LTIP (total value of deferred $70,000). The total value of options being counted as deferred incentive-based compensation would be $38,000, which would be 14.9 percent of the total incentive-based compensation awarded ($255,000). Assuming the vesting schedule is consistent with the proposed rule, Ms. Ledger's incentive-based compensation arrangement would be consistent with the proposed rule, because: (1) the value of Ms. Ledger's deferred incentive-based compensation under the Annual Executive Plan (which comprises all of Ms. Ledger's deferred qualifying incentive-based compensation) is more than 50 percent of the value of Ms. Ledger's total qualifying incentive-based compensation award ($115,000) and (2) the value of Ms. Ledger's deferred incentive-based compensation under Ms. Ledger's LTIP is 50 percent the value of Ms. Ledger's incentive-based compensation awarded under a long-term incentive plan ($140,000).

Alternative Scenario 1:
Deferred Options Consistent with the Proposed Rule

	Total Award Amounts					
Incentive-Based Compensation	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Options (#)*	*Value of Options ($)*	*Total Value ($)*
Annual Executive Plan	$30,000	640	$32,000	1,800	$18,000	$80,000
Annual Firm-Wide Plan	$35,000	-	-	-	-	$35,000
Ms. Ledger's LTIP	$40,000	1,600	$80,000	2,000	$20,000	$140,000
Total	$105,000	2,240	$112,000	3,800	$38,000	$255,000

	Amounts Immediately Payable					
Incentive-Based Compensation	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Options (#)*	*Value of Options ($)*	*Total Value ($)*
Annual Executive Plan	$2,500	350	$17,500	-	-	$20,000
Annual Firm-Wide Plan	$35,000	-	-	-	-	$35,000
Ms. Ledger's LTIP	$5,000	1,300	$65,000	-	-	$70,000
Total	$42,500	1,650	$82,500	-	-	$125,000

	Total Deferred Amounts					
Incentive-Based Compensation	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Options (#)*	*Value of Options ($)*	*Total Value ($)*
Annual Executive Plan	$27,500	290	$14,500	1,800	$18,000	$60,000
Annual Firm-Wide Plan	-	-	-	-	-	-
Ms. Ledger's LTIP	$35,000	300	$15,000	2,000	$20,000	$70,000
Total	$62,500	590	$29,500	3,800	$38,000	$130,000

Aggregate Incentive-Based Compensation Awarded	$255,000
Option Value at 15% Threshold Maximum	$38,250
Minimum Qualifying Incentive-Based Compensation - Deferral at 50%	$57,500
Minimum Incentive-Based Compensation Required under a Long-Term Incentive Plan - Deferral at 50%	$70,000

In contrast, if ABC chooses to award Ms. Ledger more options than in the example above, Ms. Ledger's incentive-based compensation arrangement may no longer be consistent with the proposed rule. As a second alternative scenario, ABC may choose to award Ms. Ledger incentive-based compensation with a total value of $255,000 in the following forms: $30,000 in cash, 500 shares of equity (valued at $25,000), and 2,500 options (valued at $25,000) under the Annual Executive Plan; $35,000 cash under the Annual Firm-Wide Plan; and $40,000 cash, 1,600 shares of equity (valued at $80,000), and 2,000 options (valued at $20,000) under Ms. Ledger's LTIP. Of that award, if ABC defers the following amounts, the arrangement would not be consistent with the proposed rule: $27,500 in cash, 150 shares (valued at $7,500), and 2,500 options (valued at $25,000) under the Annual Executive Plan (total value of deferred $60,000); none of the award from the Annual Firm-Wide Plan; and $35,000 in cash, 300 shares (valued at $15,000) and 2,000 options (valued at $20,000) under Ms. Ledger's LTIP (total value of deferred $70,000). The total value of options would be $45,000, which would be 17.6 percent of the total incentive-based compensation awarded ($255,000). Thus, 675 of those options, or $6,750 worth, would not qualify to meet the minimum deferral requirements of the proposed rule. Combining qualifying incentive-based compensation and incentive-based compensation awarded under a long-term incentive plan, Ms. Ledger's total minimum required deferral amount would be

$127,500, and yet incentive-based compensation worth only $123,250 would be eligible to meet the minimum deferral requirements. ABC could alter the proportions of incentive-based compensation awarded and deferred in order to comply with the proposed rule.

Alternative Scenario 2:
Deferred Options Inconsistent with the Proposed Rule

	Total Award Amounts					
Incentive-Based Compensation	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Options (#)*	*Value of Options ($)*	*Total Value ($)*
Annual Executive Plan	$30,000	500	$25,000	2,500	$25,000	$80,000
Annual Firm-Wide Plan	$35,000	-	-	-	-	$35,000
Ms. Ledger's LTIP	$40,000	1,600	$80,000	2,000	$20,000	$140,000
Total	$105,000	2,100	$105,000	4,500	$45,000	$255,000

	Amounts Immediately Payable					
Incentive-Based Compensation	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Options (#)*	*Value of Options ($)*	*Total Value ($)*
Annual Executive Plan	$2,500	350	$17,500	-	-	$20,000
Annual Firm-Wide Plan	$35,000	-	-	-	-	$35,000
Ms. Ledger's LTIP	$5,000	1,300	$65,000	-	-	$70,000
Total	$42,500	1,650	$82,500	-	-	$125,000

	Total Deferred Amounts					
Incentive-Based Compensation	*Cash ($)*	*Equity (#)*	*Value of Equity ($)*	*Options (#)*	*Value of Options ($)*	*Total Value ($)*
Annual Executive Plan	$27,500	150	$7,500	2,500	$25,000	$60,000
Annual Firm-Wide Plan	-	-	-	-	-	-
Ms. Ledger's LTIP	$35,000	300	$15,000	2,000	$20,000	$70,000
Total	$62,500	450	$22,500	4,500	$45,000	$130,000

Aggregate Incentive-Based Compensation Awarded	$255,000
Option Value at 15% Threshold Maximum	$38,250
Non-Qualifying Options	$6,750 or 675 options
Incentive-Based Compensation Eligible to Meet the Minimum Deferral Requirements	$123,250

Other requirements specific to Ms. Ledger's incentive-based compensation arrangement.

Under the proposed rule, ABC would not be allowed to accelerate the vesting of Ms. Ledger's deferred incentive-based compensation, except in the case of Ms. Ledger's death or disability, as determined by ABC pursuant to sections ___.7(a)(1)(iii)(B) and ___.7(a)(2)(iii)(B).

Before vesting, ABC may determine to reduce the amount of deferred incentive-based compensation that Ms. Ledger receives pursuant to a forfeiture and downward adjustment review.[249] If Ms. Ledger, or an employee Ms. Ledger managed, had been responsible for an event triggering the proposed rule's requirements for forfeiture and downward adjustment review, ABC would be expected to consider all of the unvested deferred amounts from the Annual Executive Plan and Ms. Ledger's LTIP for forfeiture before any incentive-based compensation vested even if the event occurred outside of the relevant performance period for the awards discussed in the example (i.e., January 1, 2022 to December 31, 2024).[250] ABC may also rely on other performance adjustments during the deferral period to appropriately balance Ms. Ledger's incentive-based compensation arrangement. In this case ABC would take into account information about Ms. Ledger's and ABC's performance that becomes better known during the deferral period to potentially reduce the amount of deferred incentive-based compensation that vests. ABC would not be allowed to increase the amount of deferred incentive-based compensation that vests. In the case of the deferred equity awarded to Ms. Ledger, the number of shares or options awarded to Ms. Ledger and eligible for vesting on each anniversary of the end of the performance period is the maximum number of shares or options that may vest on that date. An increase in the total value of those shares or options would not be

[249] See "Mr. Ticker: Forfeiture and downward adjustment review" discussion below for more details about the requirements for a forfeiture and downward adjustment review.
[250] See section __.7(b) of the proposed rule.

considered an increase in the amount of deferred incentive-based compensation for the purposes of the proposed rule.[251]

ABC would be required to include clawback provisions in Ms. Ledger's incentive-based compensation arrangement that, at a minimum, allowed for clawback for seven years following the date on which Ms. Ledger's incentive-based compensation vested.[252] These provisions would permit ABC to recover up to 100 percent of any vested incentive-based compensation if ABC determined that Ms. Ledger engaged in certain misconduct, fraud or intentional misrepresentation of information, as described in section ___.7(c) of the proposed rule. Thus, if in the year 2030, ABC determined that Ms. Ledger engaged in fraud in the year 2024, the entirety of the $42,500 and 1,650 shares of equity that vested immediately after 2024, and as well as any part of her deferred incentive-based compensation ($62,500 and 1,350 shares of equity) that actually had vested by 2030, could be subject to clawback by ABC. Facts and circumstances would determine whether the ABC would actually seek to claw back amounts, as well as the specific amount ABC would seek to recover from Ms. Ledger's already-vested incentive-based compensation.

Finally, in order for Ms. Ledger's incentive-based compensation arrangement to appropriately balance risk and reward, ABC would not be permitted to purchase a hedging instrument or similar instrument on Ms. Ledger's behalf that would offset any decrease in the value of Ms. Ledger's deferred incentive-based compensation.[253]

Risk management and controls and governance.

Sections ___.4(c)(2) and ___.4(c)(3) of the proposed rule would require that Ms. Ledger's incentive-based compensation arrangement be compatible with effective risk management and controls and be supported by effective governance.

For Ms. Ledger's arrangement to be compatible with effective risk management and controls, ABC's risk management framework and controls would be required to comply with the specific provisions of section ___.9 of the proposed rule. ABC would have to maintain a risk management framework for its incentive-based compensation program that is independent of any

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[251] See section __.7(a)(3) of the proposed rule.
[252] See section __.7(c) of the proposed rule.
[253] See section __.8(a) of the proposed rule.

lines of business, includes an independent compliance program, and is commensurate with the size and complexity of ABC's operations.[254] ABC would have to provide individuals engaged in control functions with the authority to influence the risk-taking of the business areas they monitor and ensure that covered persons engaged in control functions are compensated in accordance with the achievement of performance objectives linked to their job functions, independent of the performance of those business areas.[255] In addition, ABC would have to provide for independent monitoring of events related to forfeiture and downward adjustment reviews and decisions of forfeiture and downward adjustment reviews.[256]

For Ms. Ledger's arrangement to be consistent with the effective governance requirement in the proposed rule, the board of directors of ABC would be required to establish a compensation committee composed solely of directors who are not senior executive officers. The board of directors, or a committee thereof, would be required to approve Ms. Ledger's incentive-based compensation arrangements, including the amounts of all awards and payouts under those arrangements.[257] In this example, the board of directors or a committee thereof (such as the compensation committee) would be required to approve the total award of $105,000 and 3,000 shares in 2024. Each time deferred amounts are scheduled to vest (in this example, in December 31, 2025, December 31, 2026, and December 31, 2027), the board of directors or a committee thereof would also be required to approve the amounts that vest.[258] Additionally, the compensation committee would be required to receive input from the risk and audit committees of the ABC's board of directors on the effectiveness of risk measures and adjustments used to balance risk and reward in incentive-based compensation arrangements.[259] Finally, the compensation committee would be required to obtain at least annually two written assessments, one prepared by ABC's management with input from the risk and audit committees of the board of directors and a separate assessment written from ABC's risk management or internal audit function developed independently of ABC's senior management. Both assessments would focus

[254] See section ___.9(a) of the proposed rule.
[255] See section ___.9(b) of the proposed rule.
[256] See section ___.9(c) of the proposed rule.
[257] See section __.4(e) of the proposed rule.
[258] See sections __.4(e)(2) and __.4(e)(3) of the proposed rule.
[259] See section __.10(b)(1) of the proposed rule.

on the effectiveness of ABC's incentive-based compensation program and related compliance and control processes in providing appropriate risk-taking incentives.[260]

Recordkeeping.

In order to comply with the recordkeeping requirements in the proposed rule, ABC would be required to document Ms. Ledger's incentive-based compensation arrangement.[261] ABC would be required to maintain copies of the Annual Executive Plan, the Annual Firm-Wide Plan, and Ms. Ledger's LTIP, along with all plans that are part of ABC's incentive-based compensation program. ABC also would be required to include Ms. Ledger on the list of senior executive officers and significant risk-takers, including the legal entity for which she works, her job function, her line of business, and her position in the organizational hierarchy.[262] Finally, ABC would be required to document Ms. Ledger's entire incentive-based compensation arrangement, including information on percentage deferred and form of payment and any forfeiture and downward adjustment or clawback reviews and decisions that pertain to her.[263]

Mr. Ticker: Forfeiture and Downward Adjustment Review.

Under section __.7(b) of the proposed rule, ABC would be required to put certain portions of a senior executive officer's or significant risk-taker's incentive-based compensation at risk of forfeiture and downward adjustment upon certain triggering events.[264] In this example, Mr. Ticker is a significant risk-taker who is the senior manager of a trader and a trading desk that engaged in inappropriate risk-taking in calendar year 2021, which was discovered on March 1, 2024.[265] The activity of the trader, and several other members of the same trading desk, resulted in an enforcement proceeding against ABC and the imposition of a significant fine.

Mr. Ticker is provided incentive-based compensation under two separate incentive-based compensation plans. The first plan, the "Annual Firm-Wide Plan," is applicable to all employees at ABC, and is based on a one-year performance period that coincides with the calendar year. The second plan, "Mr. Ticker's LTIP," is applicable to all traders at Mr. Ticker's level, and

[260] See sections __.10(b)(2) and ___.10(b)(3) of the proposed rule.
[261] See sections __.4(f) and __.5(a) of the proposed rule.
[262] See section __.5(a) of the proposed rule.
[263] See section __.5(a) of the proposed rule.
[264] See section __.7(b) of the proposed rule.
[265] If Mr. Ticker's inappropriate risk-taking during 2021 were instead discovered in another year, ABC could subject all deferred amounts not yet vested in that year to forfeiture.

requires assessment of performance over a three-year performance period that begins on January 1, 2022 (year 1) and ends on December 31, 2024 (year 3). These two plans together comprise Mr. Ticker's incentive-based compensation arrangement.

The proposed rule would require ABC to conduct a forfeiture and downward adjustment review both because the trades resulted from inappropriate risk-taking and because they failed to comply with a statutory, regulatory, or supervisory standard in a manner that resulted in an enforcement or legal action against ABC.[266] In addition, the possibility exists that a material risk management and control failure as described in section __.7(b)(2)(iii) of the proposed rule has occurred, which would widen the group of covered employees whose incentive-based compensation would be considered for possible forfeiture and downward adjustment. Under the proposed rule, covered institutions would be required to consider forfeiture and downward adjustment for a covered person with direct responsibility for the adverse outcome (in this case, the trader, if designated as a significant risk-taker), as well as responsibility due to the covered person's role or position in the covered institution's organizational structure (in this case, Mr. Ticker for his possible lack of oversight of the trader when such activities were conducted).[267]

In this example, ABC determines that as the senior manager of the trader, Mr. Ticker is responsible for inappropriate oversight of the trader and that Mr. Ticker facilitated the inappropriate risk-taking the trader engaged in. Under the proposed rule, ABC would have to consider all of Mr. Ticker's unvested deferred incentive-based compensation, including unvested deferred amounts awarded under Mr. Ticker's LTIP, when determining the appropriate impact on Mr. Ticker's incentive-based compensation.[268] In addition, all of Mr. Ticker's incentive-based compensation amounts not yet awarded for the current performance period, including amounts to be awarded under Mr. Ticker's LTIP, would have to be considered for possible downward adjustment.[269] The amount by which Mr. Ticker's incentive-based compensation would be reduced could be part or all of the relevant tranches which have not yet vested or have not yet been awarded. For example, if Mr. Ticker's lack of oversight were determined to be only a contributing factor that led to the adverse outcome (e.g., Mr. Ticker identified and elevated the

[266] See sections __.7(b)(2)(ii) and __.7(b)(2)(iv)(A) of the proposed rule.
[267] See section __.7(b)(3) of the proposed rule.
[268] See section __.7(b)(1)(i) of the proposed rule.
[269] See section __.7(b)(1)(ii) of the proposed rule.

breach of related risk limits but made no effort to follow up in order to ensure that such activity immediately ceased), ABC might be comfortable reducing only a portion of the incentive-based compensation to be awarded under Mr. Ticker's LTIP in 2024.

To determine the amount or portion of Mr. Ticker's incentive-based compensation that should be forfeited or adjusted downward under the proposed rule, ABC would be required to consider, at a minimum, the six factors listed in section __.7(b)(4) of the proposed rule.[270] The cumulative impact of these factors, when appropriately weighed in the final decision-making process, might lead to lesser or greater impact on Mr. Ticker's incentive-based compensation. For instance, if it were found that Mr. Ticker had repeatedly failed to manage traders or others who report to him, ABC might decide that a reduction of 100 percent of Mr. Ticker's incentive-based compensation at risk would be appropriate.[271] On the other hand, if it were determined that Mr. Ticker took immediate and meaningful actions to prevent the adverse outcome from occurring and immediately escalated and addressed the inappropriate behavior, the impact on Mr. Ticker's incentive-based compensation could be less than 100 percent, or nothing.

It is possible that some or all of Mr. Ticker's incentive-based compensation may be forfeited before it vests, which could result in amounts vesting faster than pro rata. In this case, ABC decides to defer $30,000 of Mr. Ticker's incentive-based compensation for three years so that $10,000 is eligible for vesting in 2022, $10,000 is eligible for vesting in 2023, and $10,000 is eligible for vesting in 2024. This schedule would meet the proposed rule's pro rata vesting requirement. No adverse information about Mr. Ticker's performance comes to light in 2022 or 2023 and so $10,000 vests in each of those years. However, Mr. Ticker's inappropriate risk-taking during 2021 is discovered in 2024, causing ABC to forfeit the remaining $10,000. Therefore, the amounts that vest in this case are $10,000 in 2022, $10,000 in 2023, and $0 in 2024. While the vesting is faster than pro rata due to the forfeiture, the incentive-based compensation arrangement would still be consistent with the proposed rule since the original vesting schedule would have been in compliance.

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[270] See section __.7(b)(4) of the proposed rule.
[271] See sections __.7(b)(4)(ii) and (iii) of the proposed rule.

ABC would be required to document the rationale for its decision and to keep timely and accurate records that detail the individuals considered for compensation adjustments, the factors weighed in reaching a final decision and how those factors were considered during the decision-making process.[272]

IV. REQUEST FOR COMMENTS

The Agencies are interested in receiving comments on all aspects of the proposed rule.

V. REGULATORY ANALYSIS

A. Regulatory Flexibility Act

OCC: Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b) ("RFA"), the initial regulatory flexibility analysis otherwise required under section 603 of the RFA is not required if the agency certifies that the proposed rule will not, if promulgated, have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include banks and Federal branches and agencies with assets less than or equal to $550 million) and publishes its certification and a short, explanatory statement in the **Federal Register** along with its proposed rule.

As discussed in the **SUPPLEMENTARY INFORMATION** section above, section 956 of the Dodd-Frank Act does not apply to institutions with assets of less than $1 billion. As a result, the proposed rule will not, if promulgated, apply to any OCC-supervised small entities. For this reason, the proposed rule will not, if promulgated, have a significant economic impact on a substantial number of OCC-supervised small entities. Therefore, the OCC certifies that the proposed rule will not, if promulgated, have a significant economic impact on a substantial number of small entities.

[272] See section __.5(a)(3) of the proposed rule.

Board: The Board has considered the potential impact of the proposed rule on small banking organizations in accordance with the RFA (5 U.S.C. 603(b)). As discussed in the "Supplementary Information" above, section 956 of the Dodd-Frank Act (codified at 12 U.S.C. 5641) requires that the Agencies prohibit any incentive-based payment arrangement, or any feature of any such arrangement, at a covered financial institution that the Agencies determine encourages inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. In addition, under the Dodd-Frank Act a covered financial institution also must disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements. The Board and the other Agencies have issued the proposed rule in response to these requirements of the Dodd-Frank Act.

The proposed rule would apply to "covered institutions" as defined in the proposed rule. Covered institutions as so defined include specifically listed types of institutions, as well as other institutions added by the Agencies acting jointly by rule. In every case, however, covered institutions must have at least $1 billion in total consolidated assets pursuant to section 956(f). Thus the proposed rule is not expected to apply to any small banking organizations (defined as banking organizations with $550 million or less in total assets). See 13 CFR 121.201.

The proposed rule would implement section 956(a) of the Dodd-Frank act by requiring a covered institution to create annually and maintain for a period of at least seven years records that document the structure of all its incentive-based compensation arrangements and demonstrate compliance with the proposed rule. A covered institution must disclose the records to the Board upon request. At a minimum, the records must include copies of all incentive-based compensation plans, a record of who is subject to each plan, and a description of how the incentive-based compensation program is compatible with effective risk management and controls.

Covered institutions with at least $50 billion in consolidated assets, and their subsidiaries with at least $1 billion in total consolidated assets, would be subject to additional, more specific requirements, including that such covered institutions create annually and maintain for a period of at least seven years records that document: (1) the covered institution's senior executive officers and significant risk-takers, listed by legal entity, job function, organizational hierarchy, and line of business; (2) the incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on percentage of incentive-based compensation deferred and form of award; (3) any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and (4) any material changes to the covered institution's incentive-based compensation arrangements and policies. These larger covered institutions must provide these records in such form and with such frequency as requested by the Board, and they must be maintained in a manner that allows for an independent audit of incentive-based compensation arrangements, policies, and procedures.

As described above, the volume and detail of information required to be created and maintained by a covered institution is tiered; covered institutions with less than $50 billion in total consolidated assets are subject to less rigorous and detailed informational requirements than larger covered institutions. As such, the Board expects that the volume and detail of information created and maintained by a covered institution with greater than $50 billion in consolidated assets, that may use incentive-based arrangements to a significant degree, would be substantially greater than that created and maintained by a smaller institution.

The proposed rule would implement section 956(b) of the Dodd-Frank Act by prohibiting a covered institution from having incentive-based compensation arrangements that may encourage inappropriate risks (i) by providing excessive compensation or (ii) that could lead to material financial loss. The proposed rule would establish standards for determining whether an incentive-based compensation arrangement violates these prohibitions. These standards would include deferral, forfeiture, downward adjustment, clawback, and other requirements for certain covered persons at covered institutions with total consolidated assets of more than $50 billion, and their subsidiaries with at least $1 billion in assets, as well as specific prohibitions on incentive-based compensation arrangements at these institutions. Consistent with section 956(c), the standards adopted under section 956 are comparable to the compensation-related safety and soundness standards applicable to insured depository institutions under section 39 of the FDIA. The proposed rule also would supplement existing guidance adopted by the Board and the other Federal Banking Agencies regarding incentive-based compensation (i.e., the 2010 Federal Banking Agency Guidance, as defined in the "Supplementary Information" above).

The proposed rule also would require all covered institutions to have incentive-based compensation arrangements that are compatible with effective risk management and controls and supported by effective governance. In addition, the board of directors, or a committee thereof, of a covered institution to conduct oversight of the covered institution's incentive-based compensation program and to approve incentive-based compensation arrangements and material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers. For covered institutions with greater than $50 billion in total consolidated assets, and their subsidiaries with at least $1 billion in total consolidated assets, the proposed rule includes additional specific requirements for risk management and controls, governance and policies and procedures. Thus, like the deferral, forfeiture, downward adjustment, clawback and other requirements referred to above, risk management, governance, and policies and procedures requirements are tiered based on the size of the covered institution, with smaller institutions only subject to general risk management, controls, and governance requirements and larger institutions subject to more detailed requirements, including policies and procedures requirements. Therefore, the requirements of the proposed rule in these areas would be expected to be less extensive for covered institutions with less than $50 billion in total consolidated assets than for larger covered institutions.

As noted above, because the proposed rule applies to institutions that have at least $1 billion in total consolidated assets, if adopted in final form it is not expected to apply to any small banking organizations for purposes of the RFA. In light of the foregoing, the Board does not believe that the proposed rule, if adopted in final form, would have a significant economic impact on a substantial number of small entities supervised by the Board. The Board specifically seeks comment on whether the proposed rule would impose undue burdens on, or have unintended consequences for, small institutions and whether there are ways such potential burdens or consequences could be addressed in a manner consistent with section 956 of the Dodd-Frank Act.

FDIC: In accordance with the RFA, 5 U.S.C. 601-612 ("RFA"), an agency must provide an initial regulatory flexibility analysis with a proposed rule or to certify that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include banking entities with total assets of $550 million or less).

As described in the Scope and Initial Applicability section of the SUPPLEMENTARY INFORMATION above, the proposed rule would establish general requirements applicable to the incentive-based compensation arrangements of all institutions defined as covered institutions under the proposed rule (i.e., covered institutions with average total consolidated assets of $1 billion or more that offers incentive-based compensation to covered persons). As of December 31, 2015, a total of 348 FDIC-supervised institutions had total assets of $1 billion or more and would be subject to the proposed rule.

As of December 31, 2015, there were 3,947 FDIC-supervised depository institutions. Of those depository institutions, 3,262 had total assets of $550 million or less. All FDIC-supervised depository institutions that fall under the $550 million asset threshold, by definition, would not be subject to the proposed rule, regardless of their incentive-based compensation practices.

Therefore, the FDIC certifies that the notice of proposed rulemaking would not have a significant economic impact on a substantial number of small FDIC-supervised institutions.

FHFA: FHFA believes that the proposed rule will not have a significant economic impact on a substantial number of small entities, since none of FHFA's regulated entities come within the meaning of small entities as defined in the RFA (see 5 U.S.C. 601(6)), and the proposed rule will not substantially affect any business that its regulated entities might conduct with such small entities.

NCUA: The RFA requires NCUA to prepare an analysis to describe any significant economic impact a regulation may have on a substantial number of small entities.[273] For purposes of this analysis, NCUA considers small credit unions to be those having under $100 million in assets.[274] Section 956 of the Dodd Frank Act and the NCUA's proposed rule apply only to credit unions with $1 billion or more in assets. Accordingly, NCUA certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities since the credit unions subject to NCUA's proposed rule are not small entities for RFA purposes.

[273] 5 U.S.C. 603(a).
[274] 80 FR 57512 (September 24, 2015).

SEC: Pursuant to 5 U.S.C. 605(b), the SEC hereby certifies that the proposed rules would not, if adopted, have a significant economic impact on a substantial number of small entities. The SEC notes that the proposed rules would not apply to broker-dealers or investment advisers with less than $1 billion in total consolidated assets. Therefore, the SEC believes that all broker-dealers and investment advisers that are likely to be covered institutions under the proposed rules would not be small entities.

The SEC encourages written comments regarding this certification. The SEC solicits comment as to whether the proposed rules could have an effect on small entities that has not been considered. The SEC requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

B. Paperwork Reduction Act

Certain provisions of the proposed rule contain "collection of information" requirements within the meaning of the Paperwork Reduction Act (PRA) of 1995.[275] In accordance with the requirements of the PRA, the Agencies may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this joint notice of proposed rulemaking have been submitted by the OCC, FDIC, NCUA, and SEC to OMB for review and approval under section 3506 of the PRA and section 1320.11 of OMB's implementing regulations (5 CFR 1320). The Board reviewed the proposed rule under the authority delegated to the Board by OMB. FHFA has found that, with respect to any regulated entity as defined in section 1303(20) of the Safety and Soundness Act (12 U.S.C. 4502(20)), the proposed rule does not contain any collection of information that requires the approval of the OMB under the PRA. The recordkeeping requirements are found in sections __.4(f), __.5, and __.11.

Comments are invited on:

(a) Whether the collections of information are necessary for the proper performance of the Agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used;

[275] 44 U.S.C. 3501–3521.

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Comments on aspects of this notice that may affect reporting, recordkeeping, or disclosure requirements and burden estimates should be sent to the addresses listed in the ADDRESSES section. A copy of the comments may also be submitted to the OMB desk officer for the Agencies by mail to U.S. Office of Management and Budget, 725 17th Street NW, #10235, Washington, DC 20503, by facsimile to (202) 395-5806, or by e-mail to oira_submission@omb.eop.gov, Attention, Commission and Federal Banking Agency Desk Officer.

Proposed Information Collection

Title of Information Collection: Recordkeeping Requirements Associated with Incentive-Based Compensation Arrangements.

Frequency of Response: Annual.

Affected Public: Businesses or other for-profit.

Respondents:

OCC: National banks, Federal savings associations, and Federal branches or agencies of a foreign bank with average total consolidated assets greater than or equal to $1 billion and their subsidiaries.

Board: State member banks, bank holding companies, savings and loan holding companies, Edge and Agreement corporations, state-licensed uninsured branches or agencies of a foreign bank, and foreign banking organization with average total consolidated assets greater than or equal to $1 billion and their subsidiaries.

FDIC: State nonmember banks, state savings associations, and State insured branches of a foreign bank, and certain subsidiaries thereof, with average total consolidated assets greater than or equal to $1 billion and their subsidiaries.

NCUA: Credit unions with average total consolidated assets greater than or equal to $1 billion.

SEC: Brokers or dealers registered under section 15 of the Securities Exchange Act of 1934 and investment advisers as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940, in each case, with average total consolidated assets greater than or equal to $1 billion.

Abstract: Section 956(e) of the Dodd- Frank Act requires that the Agencies prohibit incentive-based payment arrangements at a covered financial institution that encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. Under the Dodd-Frank Act, a covered financial institution also must disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements sufficient to determine whether the structure provides “excessive compensation, fees, or benefits” or “could lead to material financial loss” to the institution. The Dodd-Frank Act does not require a covered financial institution to disclose compensation of individuals as part of this requirement.

Section __.4(f) would require all covered institutions to create annually and maintain for a period of at least seven years records that document the structure of all its incentive-based compensation arrangements and demonstrate compliance with this part. A covered institution must disclose the records to the Agency upon request. At a minimum, the records must include copies of all incentive-based compensation plans, a record of who is subject to each plan, and a description of how the incentive-based compensation program is compatible with effective risk management and controls.

Section __.5 would require a Level 1 or Level 2 covered institution to create annually and maintain for a period of at least seven years records that document: (1) the covered institution’s senior executive officers and significant risk-takers, listed by legal entity, job function, organizational hierarchy, and line of business; (2) the incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on percentage of incentive-based compensation deferred and form of award; (3) any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and (4) any material changes to the covered institution's incentive-based compensation arrangements and policies. A Level 1 or Level 2 covered institution must create and maintain records in a manner that allows for an independent audit of incentive-based compensation arrangements, policies, and procedures, including, those required under §_.11. A Level 1 or Level 2 covered institution must provide the records described above to the Agency in such form and with such frequency as requested by Agency.

Section __.11 would require a Level 1 or Level 2 covered institution to develop and implement policies and procedures for its incentive-based compensation program that, at a minimum (1) are consistent with the prohibitions and requirements of this part; (2) specify the substantive and procedural criteria for the application of forfeiture and clawback, including the process for determining the amount of incentive-based compensation to be clawed back; (3) require that the covered institution maintain documentation of final forfeiture, downward adjustment, and clawback decisions; (4) specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person, consistent with section ___.7(a)(1)(iii)(B) and section ___.7(a)(2)(iii)(B)); (5) identify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions, including when discretion is authorized; (6) describe how discretion is expected to be exercised to appropriately balance risk and reward; (7) require that the covered institution maintain documentation of the establishment, implementation, modification, and monitoring of incentive-based compensation arrangements, sufficient to support the covered institution's decisions; (8) describe how incentive-based compensation arrangements will be monitored; (9) specify the substantive and procedural requirements of the independent compliance program consistent with section 9(a)(2); and (10) ensure appropriate roles for risk management, risk oversight, and other control function personnel in the covered institution's processes for designing incentive-based compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback, and vesting; and assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.

Collection of Information is Mandatory

The collection of information will be mandatory for any covered institution subject to the proposed rules.

Confidentiality

The information collected pursuant to the collection of information will be kept confidential, subject to the provisions of applicable law.

Estimated Paperwork Burden

In determining the method for estimating the paperwork burden the Board, OCC and FDIC made the assumption that covered institution subsidiaries of a covered institution subject to the Board's, OCC's or FDIC's proposed rule, respectively, would act in concert with one another to take advantage of efficiencies that may exist. The Board, OCC and FDIC invite comment on whether it is reasonable to assume that covered institutions that are affiliated entities would act jointly or whether they would act independently to implement programs tailored to each entity.

Estimated average hours per response:

Recordkeeping Burden

§__.4(f) - 20 hours (Initial setup 40 hours).

§§__.5 and __.11 (Level 1 and Level 2) - 20 hours (Initial setup 40 hours).

OCC

Number of respondents: 229 (Level 1 – 18, Level 2 – 17, and Level 3 – 194).

Total estimated annual burden: 15,840 hours (10,560 hours for initial setup and 5,280 hours for ongoing compliance).

Board

Number of respondents: 829 (Level 1 – 15, Level 2 – 51, and Level 3 – 763).

Total estimated annual burden: 53,700 hours (35,800 hours for initial setup and 17,900 hours for ongoing compliance).

FDIC

Number of respondents: 353 (Level 1 – 0, Level 2 – 13, and Level 3 – 340).

Total estimated annual burden: 21,960 hours (14,640 hours for initial setup and 7,320 hours for ongoing compliance).

NCUA

Number of respondents: 258 (Level 1 – 0, Level 2 – 1, and Level 3 – 257).

Total estimated annual burden: 15,540 hours (10,360 hours for initial setup and 5,180 hours for ongoing compliance).

SEC

Number of respondents: 806 (Level 1 – 58, Level 2 – 36, and Level 3 – 712).

Total estimated annual burden: 54,000 hours (36,000 hours for initial setup and 18,000 hours for ongoing compliance)

Amendments to Exchange Act Rule 17a-4 and Investment Advisers Act Rule 204-2: The proposed amendments to Exchange Act Rule 17a-4 and Investment Advisers Act Rule 204-2 contain "collection of information requirements" within the meaning of the PRA. The SEC has submitted the collections of information to OMB for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB has assigned control number 3235-0279 to Exchange Act Rule 17a-4 and control number 3235-0278 to Investment Advisers Act Rule 204-2. The titles of these collections of information are "Rule 17a-4; Records to be Preserved by Certain Exchange Members, Brokers and Dealers" and "Rule 204-2 under the Investment Advisers Act of 1940." The collections of information required by the proposed amendments to Exchange Act Rule 17a-4 and Investment Advisers Act Rule 204-2 will be necessary for any broker-dealer or investment adviser (registered or required to be registered under section 203 of the Investment Advisers Act (15 U.S.C. 80b-3)) ("covered investment advisers"), as applicable, that is a covered institution subject to the proposed rules.

A. Summary of Collection of Information

The SEC is proposing amendments to Exchange Act Rule 17a-4(e) (17 CFR 240.17a-4(e)) and Investment Advisers Act Rule 204-2 (17 CFR 275.204-2) to require that broker-dealers and covered investment advisers that are covered institutions maintain the records required by § ___.4(f), and for broker-dealers or covered investment advisers that are Level 1 or Level 2 covered institutions, §§ ___.5 and ___.11, in accordance with the recordkeeping requirements of Exchange Act Rule 17a-4 or Investment Advisers Act Rule 204-2, as applicable.

B. Proposed Use of Information

The collections of information are necessary for, and will be used by, the SEC to determine compliance with the proposed rules and section 956 of the Dodd-Frank Act. Exchange Act Rule 17a-4 requires a broker-dealer to preserve records if the broker-dealer makes or receives the type of record and establishes the general formatting and storage requirements for records that broker-dealers are required to keep. Investment Advisers Act Rule 204-2 establishes general recordkeeping requirements for covered investment advisers. For the sake of consistency with other broker-dealer or covered investment adviser records, the SEC believes that broker-dealers and covered investment advisers that are covered institutions should also keep the records required by § ___.4(f), and for broker-dealers or covered investment advisers that are Level 1 or Level 2 covered institutions, §§ ___.5 and ___.11, in accordance with these requirements.

C. Respondents

The collections of information will apply to any broker-dealer or covered investment advisers that is a covered institution under the proposed rules. The SEC estimates that 131 broker-dealers and approximately 669 investment advisers will be covered institutions under the proposed rules. The SEC further estimates that of those 131 broker-dealers, 49 will be Level 1 or Level 2 covered institutions, and 82 will be Level 3 covered institutions and that of those 669 investment advisers, approximately 18 will be Level 1 covered institutions, approximately 21 will be Level 2 covered institutions, and approximately 630 will be Level 3 covered institutions.[276]

D. Total Annual Reporting and Recordkeeping Burden

The collection of information would add three types of records to be maintained and preserved by broker-dealers and covered investment advisers: the records required by § ___.4(f), and for broker-dealers or covered investment advisers that are Level 1 or Level 2 covered institutions, the records required by § ___.5 and the policies and procedures required by § ___.11.

1. Exchange Act Rule 17a-4

[276] For a discussion of how the SEC arrived at these estimates, see the SEC Economic Analysis at Section V.I.

In recent proposed amendments to Exchange Act Rule 17a-4, the SEC estimated that proposed amendments adding three types of records to be preserved by broker-dealers pursuant to Exchange Act Rule 17a-4(b) would impose an initial burden of 39 hours per broker-dealer and an ongoing annual burden of 18 hours and $360 per broker-dealer.[277] The SEC believes that those estimates provide a reasonable estimate for the burden imposed by the collection of information because the collection of information would add three types of records to be preserved by broker-dealers pursuant to Exchange Act Rule 17a-4(e). The records required to be preserved under Exchange Act Rule 17a-4(e) are subject to the similar formatting and storage requirements as the records required to be preserved under Exchange Act Rule 17a-4(b). For example, paragraph (f) of Exchange Act Rule 17a-4 provides that the records a broker-dealer is required to maintain and preserve under Exchange Act Rule 17a-4, including those under paragraph (b) and (e), may be immediately produced or reproduced on micrographic media or by means of electronic storage media. Similarly, paragraph (j) of Exchange Act Rule 17a-4 requires a broker-dealer to furnish promptly to a representative of the SEC legible, true, complete, and current copies of those records of the broker-dealer that are required to be preserved under Exchange Act Rule 17a-4, including those under paragraph (b) and (e).

The SEC notes, however, that paragraph (b) of Exchange Act Rule 17a-4 includes a three-year minimum retention period while paragraph (e) does not include any retention period. Thus, to the extent that a portion of the SEC's previously estimated burdens with respect to the amendments to Exchange Act Rule 17a-4(b) represent the burden of complying with the minimum retention period, using those same burden estimates with respect to the collection of information may represent a slight overestimate because the collection of information does not include a minimum retention period. The SEC believes, however, that the previously estimated burdens with respect to the amendments to Exchange Act Rule 17a-4(b) represent a reasonable estimate of the burdens of the collection of information given the other similarities between

[277] Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Release No. 34-71958 (Apr. 17, 2014), 79 FR 25194, 25267 (May 2, 2014). The burden hours estimated by the SEC for amending Exchange Act Rule 17a-4(b) include burdens attributable to ensuring adequate physical space and computer hardware and software storage for the records and promptly producing them when requested. These burdens may include, as necessary, acquiring additional physical space, computer hardware, and software storage and establishing and maintaining additional systems for computer software and hardware storage.

Exchange Act Rule 17a-4(b) and Exchange Act Rule 17a-4(e) discussed above. Moreover, the burden to create, and the retention period for, the records required by § ___.4(f), and for Level 1 and Level 2 broker-dealers, the records required by § ___.5 and the policies and procedures required by § ___.11, is accounted for in the PRA estimates for the proposed rules. Consequently, the burdens imposed by the collection of information are to ensure adequate physical space and computer hardware and software storage for the records and promptly produce them when requested.[278]

Therefore, the SEC estimates that each of the three types of records required to be preserved pursuant to the collection of information will each impose an initial burden of 13 hours[279] per respondent and an ongoing annual burden of 6 hours[280] and $120[281] per respondent. This is the result of dividing the SEC's previously estimated burdens with respect to the amendments to Exchange Act Rule 17a-4(b) by three to produce a per-record burden estimate.

The SEC estimates that requiring broker-dealers to maintain the records required by § ___.4(f) in accordance with Exchange Act Rule 17a-4 will impose an initial burden of 13 hours per respondent and a total ongoing annual burden of 6 hours and $120 per respondent. The total burden for all respondents will be 1,703 hours initially (13 hours x 131 Level 1, Level 2, and Level 3 broker-dealers) and 786 hours annually (6 hours x 131 Level 1, Level 2, and Level 3 broker-dealers) with an annual cost of $15,720 ($120 x 131 Level 1, Level 2, and Level 3 broker-dealers).

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278 As discussed above, paragraph (j) of Exchange Act Rule 17a-4 requires a broker-dealer to furnish promptly to a representative of the SEC legible, true, complete, and current copies of those records of the broker-dealer that are required to be preserved under Exchange Act Rule 17a-4. Thus, the SEC estimates that this promptness requirement will be part of the incremental burden of the collection of information.

279 13 hours is the result of dividing the SEC's previously estimated burdens with respect to the amendments to Exchange Act Rule 17a-4(b) (39 hours) by three to produce a per-record burden estimate. 39 hours / 3 types of records = 13 hours per record. These internal hours likely will be performed by a senior database administrator.

280 6 hours is the result of dividing the SEC's previously estimated burdens with respect to the amendments to Exchange Act Rule 17a-4(b) (18 hours) by three to produce a per-record burden estimate. 18 hours / 3 types of records = 6 hours per record. These internal hours likely will be performed by a compliance clerk.

281 $120 is the result of dividing the SEC's previously estimated cost with respect to the amendments to Exchange Act Rule 17a-4(b) ($360) by three to produce a per-record cost estimate. $360 hours / 3 types of records = $120 per record.

The SEC estimates that requiring Level 1 and Level 2 broker-dealers to maintain the records required by § ___.5 in accordance with Exchange Act Rule 17a-4 will impose an initial burden of 13 hours per respondent and a total ongoing annual burden of 6 hours and $120 per respondent. The total burden for all Level 1 and Level 2 broker-dealers will be 637 hours initially (13 hours x 49 Level 1 and Level 2 broker-dealers) and 294 hours annually (6 hours x 49 Level 1 and Level 2 broker-dealers) with an annual cost of $5,880 ($120 x 49 Level 1 and Level 2 broker-dealers).

The SEC estimates that requiring Level 1 and Level 2 broker-dealers to maintain the policies and procedures required by § ___.11 in accordance with Exchange Act Rule 17a-4 will impose an initial burden of 13 hours per respondent and a total ongoing annual burden of 6 hours and $120 per respondent. The total burden for all Level 1 and Level 2 broker-dealers will be 637 hours initially (13 hours x 49 Level 1 and Level 2 broker-dealers) and 294 hours annually (6 hours x 49 Level 1 and Level 2 broker-dealers) with an annual cost of $5,880 ($120 x 49 Level 1 and Level 2 broker-dealers).

In the Supporting Statement accompanying the most recent extension of Exchange Act Rule 17a-4's collection of information, the SEC estimated that each registered broker-dealer spends 254 hours annually to ensure it is in compliance with Rule 17a-4 and produce records promptly when required, and $5,000 each year on physical space and computer hardware and software to store the requisite documents and information.[282] Thus, for Level 3 broker-dealers, as a result of the collection of information, the total annual burden to ensure compliance with Rule 17a-4 and produce records promptly when required will be 260 hours[283] and $5,120[284] per Level 3 broker-dealer, or 21,320 hours and $419,840 per all 82 Level 3 broker-dealers. For Level 1 and Level 2 broker-dealers, as a result of the collection of information, the total annual burden to ensure compliance with Rule 17a-4 and produce records promptly when required will

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282 See Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 17a-4, Collection of Information for Exchange Act Rule 17a-4 (OMB Control No. 3235-0279), Office of information and Regulatory Affairs, Office of Management and Budget, available at http://www.reginfo.gov/public/do PRAMain.

283 254 hours + 6 hour annual burden of maintaining the records required by § ___.4(f) in accordance with Exchange Act Rule 17a-4.

284 $5,000 + $ 120 annual cost of maintaining the records required by § ___.4(f) in accordance with Exchange Act Rule 17a-4.

be 272 hours[285] and $5,360[286] per Level 1 and Level 2 broker-dealer, or 13,328 hours and $262,640 per all 49 Level 1 and Level 2 broker-dealers.

Summary of Collection of Information Burdens Per Record Type

Nature of Information Collection Burden	**Initial Hourly Burden Estimate Per Respondent (All Respondents)**	**Annual Hourly Burden Estimate Per Respondent (All Respondents)**	**Annual Cost Estimate Per Respondent (All Respondents)**
§ ___.4(f) Recordkeeping for Level 1, Level 2, and Level 3 Broker-Dealers	13 (1,703)	6 (786)	$120 ($15,720)
§ ___.5 Recordkeeping for Level 1 and Level 2 Broker-Dealers	13 (637)	6 (294)	$120 ($5,880)
§ ___.11 Policies and Procedures for Level 1 and Level 2 Broker-Dealers	13 (637)	6 (294)	$120 ($5,880)
Totals	39 (2,977)	18 (1,374)	$360 ($27,480)

285 254 hours + 6 hour annual burden of maintaining the records required by § ___.4(f) in accordance with Exchange Act Rule 17a-4 + 6 hour annual burden of maintaining the records required by § ___.5 in accordance with Exchange Act Rule 17a-4 + 6 hour annual burden of maintaining the policies and procedures required by § ___.11 in accordance with Exchange Act Rule 17a-4.

286 $5,000 + $120 annual cost of maintaining the records required by § ___.4(f) in accordance with Exchange Act Rule 17a-4 + $120 annual cost of maintaining the records required by § ___.5 in accordance with Exchange Act Rule 17a-4 + $120 annual cost of maintaining the policies and procedures required by § ___.11 in accordance with Exchange Act Rule 17a-4.

Summary of Collection of Information Burdens Per Respondent Type

Nature of Information Collection Burden	**Initial Hourly Burden Estimate Per Respondent (All Respondents)**	**Annual Hourly Burden Estimate Per Respondent (All Respondents)**	**Annual Cost Estimate Per Respondent (All Respondents)**
Level 1 and Level 2 Broker-Dealers (49 total)	39 (1,911)	18 (882)	$360 ($17,640)
Level 3 Broker-Dealers (82 total)	13 (1,066)	6 (492)	$120 ($9,840)

Summary of Collection of Information Burdens Per Respondent Type Including Estimate of Annual Compliance with Rule 17a-4

Nature of Information Collection Burden	**Annual Hourly Burden Estimate Per Respondent (All Respondents)**	**Annual Cost Estimate Per Respondent (All Respondents)**
Level 1 and Level 2 Broker-Dealers (49 total)	272 (13,328)	$5,360 ($262,640)

Nature of Information Collection Burden	**Annual Hourly Burden Estimate Per Respondent (All Respondents)**	**Annual Cost Estimate Per Respondent (All Respondents)**
Level 3 Broker-Dealers (82 total)	260 (21,320)	$5,120 ($419,840)

As discussed above, the SEC estimates an increase of $120 for Level 3 broker-dealers and $360 for Level 1 and Level 2 broker-dealers to the $5,000 spent each year by a broker-dealer on physical space and computer hardware and software to store the requisite documents and information as a result of the collection of information. The SEC estimates that respondents will not otherwise seek outside assistance in completing the collection of information or experience any other external costs in connection with the collection of information.

2. Investment Advisers Act Rule 204-2

The currently-approved total annual burden estimate for rule 204-2 is 1,986,152 hours. This burden estimate was based on estimates that 10,946 advisers were subject to the rule, and each of these advisers spends an average of 181.45 hours preparing and preserving records in accordance with the rule. Based on updated data as of January 4, 2016, there are 11,956 registered investment advisers.[287] This increase in the number of registered investment advisers increases the total burden hours of current rule 204-2 from 1,986,152 to 2,169,417, an increase of 183,265 hours.[288]

The proposed amendment to rule 204-2 would require covered investment advisers that are Level 1, Level 2, or Level 3 covered institutions to make and keep true, accurate, and current the records required by, and for the period specified in, § __.4(f) and, for those covered

287 Based on data from the Commission's Investment Adviser Registration Depository ("IARD") as of January 4, 2016.

288 This estimate is based on the following calculations: (11,956 – 10,946) x 181.45 = 183,265; 183,265 + 1,986,152 = 2,169,417.

investment advisers that are Level 1 or Level 2 covered institutions, the records required by, and for the periods specified in, §§ __.5 and __.11.

Based on SEC staff experience, the SEC estimates that the proposed amendment to rule 204-2 would increase each registered investment adviser's average annual collection burden under rule 204-2 by 2 hours[289] for each of the three types of records required to be preserved pursuant to the collection of information.[290] Therefore, for a covered investment adviser that is a Level 1 covered institution, the increase in its average annual collection burden would be from 181.45 hours to 187.45 hours,[291] and would thus increase the annual aggregate burden for rule 204-2 by 108 hours,[292] from 2,169,417 hours to 2,169,525 hours.[293] As monetized, the estimated burden for each such investment adviser's average annual burden under rule 204-2 would increase by approximately $450,[294] which would increase the estimated monetized aggregate annual burden for rule 204-2 by $8,100, from $162,706,275 to $162,714,375.[295] For a covered investment adviser that is a Level 2 covered institution, the increase in its average annual collection burden would be from 181.45 hours to 185.45 hours,[296] and would thus increase the

289 The burden hours estimated by the SEC for amending Investment Advisers Act Rule 204-2 assumes that the covered investment adviser already has systems in place to comply with the general requirements of Investment Advisers Rule 204-2. Accordingly, the 2 burden hours estimated by the SEC for each type of record required to be preserved pursuant to these proposed rules is attributable solely to the burden associated with maintaining such record.

290 The records required by § ___.4(f), and for covered investment advisers that are Level 1 or Level 2 covered institutions, the records required by § ___.5 and the policies and procedures required by § ___.11.

291 This estimate is based on the following calculation: 181.45 existing hours + 6 new hours = 187.45 hours.

292 This estimate is based on the following calculation: 18 (Level 1 covered institution) advisers x 6 hours = 108 hours.

293 This estimate is based on the following calculation: 2,169,417 hours + 108 hours = 2,169,525 hours.

294 This estimate is based on the following calculation: 6 hours x $75 (hourly rate for an administrative assistant) = $450. The hourly wage used is from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and inflation and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

295 This estimate is based on the following calculations: 2,169,417 hours x $75 = $162,706,275. 2,169,525 hours x $75 = $162,714,375. $162,714,375 – $162,706,275 = $8,100.

296 This estimate is based on the following calculation: 181.45 existing hours + 4 new hours = 185.45 hours.

annual aggregate burden for rule 204-2 by 84 hours,[297] from 2,169,525 hours[298] to 2,169,609 hours.[299] As monetized, the estimated burden for each such investment adviser's average annual burden under rule 204-2 would increase by approximately $300,[300] which would increase the estimated monetized aggregate annual burden for rule 204-2 by $6,300, from $162,714,375[301] to $162,720,675.[302] For a covered investment adviser that is a Level 3 covered institution, the increase in its average annual collection burden would be from 181.45 hours to 183.45 hours,[303] and would thus increase the annual aggregate burden for rule 204-2 by 1,260 hours,[304] from 2,169,609 hours[305] to 2,170,869 hours.[306] As monetized, the estimated burden for each such investment adviser's average annual burden under rule 204-2 would increase by approximately $150,[307] which would increase the estimated monetized aggregate annual burden for rule 204-2 by $94,500, from $162,720,675[308] to $162,815,175.[309] The SEC estimates that the proposed

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297 This estimate is based on the following calculation: 21 (Level 2 covered institution) advisers x 4 hours = 84 hours.

298 This estimate includes the increase in the annual aggregate burden for covered investment advisers that are Level 1 covered institutions.

299 This estimate is based on the following calculation: 2,169,525 hours + 84 hours = 2,169,609 hours.

300 This estimate is based on the following calculation: 4 hours x $75 (hourly rate for an administrative assistant) = $300. The hourly wage used is from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and inflation and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

301 This estimate includes the monetized increase in the annual aggregate burden for covered investment advisers that are Level 1 covered institutions.

302 This estimate is based on the following calculations: 2,169,525 hours x $75 = $162,714,375. 2,169,609 hours x $75 = $162,720,675. $162,720,675 – $162,714,375 = $6,300.

303 This estimate is based on the following calculation: 181.45 existing hours + 2 new hours = 183.45 hours.

304 This estimate is based on the following calculation: 630 (Level 3 covered institution) advisers x 2 hours = 1,260 hours.

305 This estimate includes the increase in the annual aggregate burden for covered investment advisers that are Level 1 or Level 2 covered institutions.

306 This estimate is based on the following calculation: 2,169,609 hours + 1,260 hours = 2,170,869 hours.

307 This estimate is based on the following calculation: 2 hours x $75 (hourly rate for an administrative assistant) = $150. The hourly wage used is from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and inflation and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

308 This estimate includes the monetized increase in the annual aggregate burden for covered investment advisers that are Level 1 or Level 2 covered institutions.

309 This estimate is based on the following calculations: 2,169,609 hours x $75 = $162,720,675. 2,170,869 hours x $75 = $162,815,175. $162,815,175 – $162,706,275 = $94,500.

amendment does not result in any additional external costs associated with this collection of information for rule 204-2.

E. Collection of Information is Mandatory

The collections of information will be mandatory for any broker-dealer or covered investment adviser that is a covered institution subject to the proposed rules.

F. Confidentiality

The information collected pursuant to the collections of information will be kept confidential, subject to the provisions of applicable law.

G. Retention Period of Recordkeeping Requirements

The collections of information will not impose any retention period with respect to recordkeeping requirements. The retention period for the records required by § ___.4(f) and the records required by § ___.5 is accounted for in the PRA estimates for the proposed rules.

H. Request for Comment

Pursuant to 44 U.S.C. 3505(c)(2)(B), the SEC solicits comment to:

1. Evaluate whether the proposed collections are necessary for the proper performance of its functions, including whether the information shall have practical utility;

2. Evaluate the accuracy of its estimate of the burden of the proposed collections of information;

3. Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and

4. Evaluate whether there are ways to minimize the burden of collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090, with reference to File No. [ ]. Requests for materials submitted to OMB by the SEC with regard to this collection of information should be in writing, with reference to File No. [ ], and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington, DC 20549. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this proposal, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

C. The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families

NCUA and the FDIC have determined that this proposed rulemaking would not affect family well-being within the meaning of Section 654 of the Treasury and General Government Appropriations Act of 1999.[310]

D. Riegle Community Development and Regulatory Improvement Act of 1994

The Riegle Community Development and Regulatory Improvement Act of 1994 ("RCDRIA") requires that each Federal Banking Agency, in determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, consider, consistent with principles of safety and soundness and the public interest, any administrative burdens that such regulations would place on depository institutions, including small depository institutions, and customers of depository institutions, as well as the benefits of such regulations. In addition, new regulations that impose additional reporting, disclosures, or other new requirements on insured depository institutions generally must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form.

The Federal Banking Agencies note that comment on these matters has been solicited in the discussions of section __.1 and __.3 in Part II of the Supplementary Information, as well as other sections of the preamble, and that the requirements of RCDRIA will be considered as part of the overall rulemaking process. In addition, the Federal Banking Agencies also invite any other comments that further will inform the Federal Banking Agencies' consideration of RCDRIA.

E . Solicitation of Comments on Use of Plain Language

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[310] Public Law 105-277, 112 Stat. 2681 (1998).

Section 722 of the Gramm-Leach-Bliley Act[311] requires the Federal Banking Agencies to use plain language in all proposed and final rules published after January 1, 2000. The Federal Banking Agencies invite comments on how to make these proposed rules easier to understand. For example:

• Have the agencies organized the material to suit your needs? If not, how could this material be better organized?

• Are the requirements in the proposed rules clearly stated? If not, how could the proposed rules be more clearly stated?

• Do the proposed rules contain language or jargon that is not clear? If so, which language requires clarification?

• Would a different format (grouping and order of sections, use of headings, paragraphing) make the proposed rules easier to understand? If so, what changes to the format would make the proposed rules easier to understand?

• What else could the Agencies do to make the regulation easier to understand?

F. OCC Unfunded Mandates Reform Act of 1995 Determination

The OCC has analyzed the proposed rule under the factors set forth in section 202 of the Unfunded Mandates Reform Act of 1995 ("UMRA") (2 U.S.C. 1532). Under this analysis, the OCC considered whether the proposed rule includes Federal mandates that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year (adjusted annually for inflation). For the following reasons, the OCC finds that the proposed rule does not trigger the $100 million UMRA threshold. First, the mandates in the proposed rule do not apply to State, local, and tribal governments. Second, the overall estimate of the maximum one-year cost of the proposed rule to the private sector is approximately $50 million. For this reason, and for the other reasons cited

[311] Pub. L. 106-102, section 722, 113 Stat. 1338 1471 (1999).

above, the OCC has determined that this proposed rule will not result in expenditures by State, local, and tribal governments, or the private sector, of $100 million or more in any one year. Accordingly, this proposed rule is not subject to section 202 of the UMRA.

G. Differences Between the Federal Home Loan Banks and the Enterprises

Section 1313(f) of the Safety and Soundness Act requires the Director of FHFA, when promulgating regulations relating to the Federal Home Loan Banks, to consider the differences between the Federal Home Loan Banks and the Enterprises (Fannie Mae and Freddie Mac) as they relate to: The Federal Home Loan Banks' cooperative ownership structure; the mission of providing liquidity to members; the affordable housing and community development mission; their capital structure; and their joint and several liability on consolidated obligations. (12 U.S.C. 4513(f)). The Director also may consider any other differences that are deemed appropriate. In preparing this proposed rule, the Director considered the differences between the Federal Home Loan Banks and the Enterprises as they relate to the above factors, and determined that the rule is appropriate. FHFA requests comments regarding whether differences related to those factors should result in any revisions to the proposed rule.

H. NCUA Executive Order 13132 Determination

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency,[312] voluntarily complies with the Executive Order. As required by statute, the proposed rule, if adopted, will apply to federally insured, state-chartered credit unions. These institutions are already subject to numerous provisions of NCUA's rules, based on the agency's role as the insurer of member share accounts and the significant interest NCUA has in the safety and soundness of their operations. Because the statute specifies that this rule must apply to state-chartered credit unions, NCUA has determined that the proposed rule does not constitute a policy that has federalism implications for purposes of the Executive Order.

[312] 44 U.S.C. 3502(5).

National Credit Union Administration

12 CFR Chapter VII

Authority and Issuance

For the reasons stated in the preamble, the National Credit Union Administration proposes to amend chapter VII of title 12 of the Code of Federal Regulations as follows:

PART 741—REQUIREMENTS FOR INSURANCE

1. The authority citation for part 741 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766, 1781-1790, and 1790d; 31 U.S.C. 3717.

2. Add a new § 741.226 to read as follows:

§741.226 Incentive-based compensation arrangements.

Any credit union which is insured pursuant to Title II of the Act must adhere to the requirements stated in part 751 of this chapter.

1. Add a new part 751 to subchapter A to read as follows.

PART 751 INCENTIVE-BASED COMPENSATION ARRANGEMENTS

Sec.

751.1 Authority, scope and initial applicability.

751.2 Definitions

751.3 Applicability

751.4 Requirements and prohibitions applicable to all credit unions subject to this part

751.5 Additional disclosure and recordkeeping requirements for Level 1 and Level 2 credit unions

751.6 Reservation of authority for Level 3 credit unions.

751.7 Deferral, forfeiture and downward adjustment, and clawback requirements for Level 1 and Level 2 credit unions

751.8 Additional prohibitions for Level 1 and Level 2 credit unions

Authority: 12 U.S.C. 1751 et seq. and 5641.

§ 751.1 Authority, scope and initial applicability.

(a) Authority. This part is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641) and the Federal Credit Union Act (12 U.S.C. 1751 et seq.)

(b) Scope. This part applies to any federally insured credit union, or any credit union eligible to make application to become an insured credit union under 12 U.S.C. 1781, with average total consolidated assets greater than or equal to $1 billion that offers incentive-based compensation to covered persons.

(c) Initial applicability.

(1) Compliance date. A credit union must meet the requirements of this part no later than [Date of the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register]. Whether a credit union is a Level 1, Level 2, or Level 3 credit union at that time will be determined based on average total consolidated assets as of [Date of the beginning of the first calendar quarter that begins after a final rule is published in the Federal Register].

(2) Grandfathered plans. A credit union is not required to comply with the requirements of this part with respect to any incentive-based compensation plan with a performance period that begins before [Compliance Date as described in paragraph (c)(1) of this section].

(d) Preservation of authority. Nothing in this part in any way limits the authority of NCUA under other provisions of applicable law and regulations.

§ 751.2 Definitions

For purposes of this part only, the following definitions apply unless otherwise specified:

(a) [Reserved]

(b) Average total consolidated assets means the average of a credit union's total consolidated assets, as reported on the credit union's regulatory reports, for the four most recent consecutive quarters. If a credit union has not filed a regulatory report for each of the four most recent consecutive quarters, the credit union's average total consolidated assets means the average of its total consolidated assets, as reported on its regulatory reports, for the most recent quarter or consecutive quarters, as applicable. Average total consolidated assets are measured on the as-of date of the most recent regulatory report used in the calculation of the average.

(c) To award incentive-based compensation means to make a final determination, conveyed to a covered person, of the amount of incentive-based compensation payable to the covered person for performance over a performance period.

(d) Board of directors means the governing body of a credit union that oversees the activities of the credit union.

(e) Clawback means a mechanism by which a credit union can recover vested incentive-based compensation from a covered person.

(f) Compensation, fees, or benefits means all direct and indirect payments, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to a credit union.

(g) [Reserved]

(h) Control function means a compliance, risk management, internal audit, legal, human resources, accounting, financial reporting, or finance role responsible for identifying, measuring, monitoring, or controlling risk-taking.

(i) [Reserved]

(j) Covered person means any executive officer, employee, or director who receives incentive-based compensation at a credit union.

(k) Deferral means the delay of vesting of incentive-based compensation beyond the date on which the incentive-based compensation is awarded.

(l) Deferral period means the period of time between the date a performance period ends and the last date on which the incentive-based compensation awarded for such performance period vests.

(m) [Reserved]

(n) Director of a credit union means a member of the board of directors.

(o) 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, including amounts payable under long-term incentive plans, in accordance with a forfeiture and downward adjustment review under § 751.7(b).

(p) [Reserved]

(q) Forfeiture means a reduction of the amount of deferred incentive-based compensation awarded to a covered person that has not vested.

(r) Incentive-based compensation means any variable compensation, fees, or benefits that serve as an incentive or reward for performance.

(s) Incentive-based compensation arrangement means an agreement between a credit union and a covered person, under which the credit union provides incentive-based compensation to the covered person, including incentive-based compensation delivered through one or more incentive-based compensation plans.

(t) Incentive-based compensation plan means a document setting forth terms and conditions governing the opportunity for and the payment of incentive-based compensation payments to one or more covered persons.

(u) Incentive-based compensation program means a credit union's framework for incentive-based compensation that governs incentive-based compensation practices and establishes related controls.

(v) Level 1 credit union means a credit union with average total consolidated assets greater than or equal to $250 billion.

(w) Level 2 credit union means a credit union with average total consolidated assets greater than or equal to $50 billion that is not a Level 1 credit union.

(x) Level 3 credit union means a credit union with average total consolidated assets greater than or equal to $1 billion that is not a Level 1 credit union or Level 2 credit union.

(y) Long-term incentive plan means a plan to provide incentive-based compensation that is based on a performance period of at least three years.

(z) [Reserved]

(aa) Performance period means the period during which the performance of a covered person is assessed for purposes of determining incentive-based compensation.

(bb) [Reserved]

(cc) Qualifying incentive-based compensation means the amount of incentive-based compensation awarded to a covered person for a particular performance period, excluding amounts awarded to the covered person for that particular performance period under a long-term incentive plan.

(dd) [Reserved]

(ee) Regulatory report means NCUA form 5300 or 5310 call report.

(ff) [Reserved]

(gg) Senior executive officer means 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 credit union for any period of time in the relevant performance period: 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.

(hh) Significant risk-taker means:

(1) Any covered person at a Level 1 or Level 2 credit union, other than a senior executive officer, who received annual base salary and incentive-based compensation for the last calendar year that ended at least 180 days before the beginning of the performance period of which at least one-third is incentive-based compensation and is—

(i) A covered person of a Level 1 credit union who received annual base salary and incentive-based compensation for the last calendar year that ended at least 180 days before the beginning of the performance period that placed the covered person among the highest 5 percent in annual base salary and incentive-based compensation among all covered persons (excluding senior executive officers) of the Level 1 credit union;

(ii) A covered person of a Level 2 credit union who received annual base salary and incentive-based compensation for the last calendar year that ended at least 180 days before the beginning of the performance period that placed the covered person among the highest 2 percent in annual base salary and incentive-based compensation among all covered persons (excluding senior executive officers) of the Level 2 credit union; or

(iii) A covered person of a credit union who may commit or expose 0.5 percent or more of the net worth or total capital of the credit union; and

(2) Any covered person at a Level 1 or Level 2 credit union, other than a senior executive officer, who is designated as a "significant risk-taker" by NCUA because of that person's ability to expose a credit union to risks that could lead to material financial loss in relation to the credit union's size, capital, or overall risk tolerance, in accordance with procedures established by NCUA, or by the credit union.

(3) [Reserved]

(4) If NCUA determines, in accordance with procedures established by NCUA, that a Level 1 credit union's activities, complexity of operations, risk profile, and compensation practices are similar to those of a Level 2 credit union, the Level 1

credit union may apply paragraph (1)(i) of this definition to covered persons of the Level 1 credit union by substituting “2 percent” for “5 percent”.

(ii) [Reserved]

(jj) Vesting of incentive-based compensation means the transfer of ownership of the incentive-based compensation to the covered person to whom the incentive-based compensation was awarded, such that the covered person’s right to the incentive-based compensation is no longer contingent on the occurrence of any event.

§751. 3 Applicability

(a) When average total consolidated assets increase.

(1) In general. A credit union shall become a Level 1, Level 2, or Level 3 credit union when its average total consolidated assets increase to an amount that equals or exceeds $250 billion, $50 billion, or $1 billion, respectively.

(2) Compliance date. A credit union that becomes a Level 1, Level 2, or Level 3 credit union pursuant to paragraph (a)(1) of this section shall comply with the requirements of this part for a Level 1, Level 2, or Level 3 credit union, respectively, not later than the first day of the first calendar quarter that begins at least 540 days after the date on which the credit union becomes a Level 1, Level 2, or Level 3 credit union, respectively. Until that day, the Level 1, Level 2, or Level 3 credit union will remain subject to the requirements of this part, if any, that applied to the credit union on the day before the date on which it became a Level 1, Level 2, or Level 3 credit union.

(3) Grandfathered plans. A credit union that becomes a Level 1, Level 2, or Level 3 credit union under paragraph (a)(1) of this section is not required to comply with requirements of this part applicable to a Level 1, Level 2, or Level 3 credit union, respectively, with respect to any incentive-based compensation plan with a performance period that begins before the date described in paragraph (a)(2) of this section.

(b) When total consolidated assets decrease. A Level 1, Level 2, or Level 3 credit union will remain subject to the requirements applicable to such credit union under this part unless and until the total consolidated assets of the credit union, as reported on the credit union’s regulatory reports, fall below $250 billion, $50 billion, or $1 billion, respectively, for each of four consecutive quarters. The calculation will be effective on the as-of date of the fourth consecutive regulatory report.

§751. 4 Requirements and prohibitions applicable to all credit unions subject to this part

(a) In general. A credit union must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the credit union:

(1) By providing a covered person with excessive compensation, fees, or benefits; or

(2) That could lead to material financial loss to the credit union.

(b) Excessive compensation. Compensation, fees, and benefits are considered excessive for purposes of paragraph (a)(1) of this section 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, but not limited to:

(1) The combined value of all compensation, fees, or benefits provided to the covered person;

(2) The compensation history of the covered person and other individuals with comparable expertise at the credit union;

(3) The financial condition of the credit union;

(4) Compensation practices at comparable credit unions, based upon such factors as asset size, geographic location, and the complexity of the credit union's operations and assets;

(5) For post-employment benefits, the projected total cost and benefit to the credit union; and

(6) 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 credit union.

(c) Material financial loss. An incentive-based compensation arrangement at a credit union encourages inappropriate risks that could lead to material financial loss to the credit union, unless the arrangement:

(1) Appropriately balances risk and reward;

(2) Is compatible with effective risk management and controls; and

(3) Is supported by effective governance.

(d) Performance measures. An incentive-based compensation arrangement will not be considered to appropriately balance risk and reward for purposes of paragraph (c)(1) of this section unless:

(1) The arrangement includes financial and non-financial measures of performance, including considerations of risk-taking, that are relevant to a covered person's role within a credit union and to the type of business in which the covered person is engaged and that are appropriately weighted to reflect risk-taking;

(2) The arrangement is designed to allow non-financial measures of performance to override financial measures of performance when appropriate in determining incentive-based compensation; and

(3) Any amounts to be awarded under the arrangement are subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.

(e) Board of directors. A credit union's board of directors, or a committee thereof, must:

(1) Conduct oversight of the credit union's incentive-based compensation program;

(2) Approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and

(3) Approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.

(f) Disclosure and recordkeeping requirements. A credit union must create annually and maintain for a period of at least seven years records that document the structure of all its incentive-based compensation arrangements and demonstrate compliance with this part. A credit union must disclose the records to NCUA upon request. At a minimum, the records must include copies of all incentive-based compensation plans, a record of who is subject to each plan, and a description of how the incentive-based compensation program is compatible with effective risk management and controls.

(g) Rule of construction. A credit union is not required to report the actual amount of compensation, fees, or benefits of individual covered persons as part of the disclosure and recordkeeping requirements under this part.

§ 751.5 Additional disclosure and recordkeeping requirements for Level 1 and Level 2 credit unions

(a) A Level 1 or Level 2 credit union must create annually and maintain for a period of at least seven years records that document:

(1) The credit union's senior executive officers and significant risk-takers, listed by legal entity, job function, organizational hierarchy, and line of business;

(2) The incentive-based compensation arrangements for senior executive officers and significant risk-takers, including information on percentage of incentive-based compensation deferred and form of award;

(3) Any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and significant risk-takers; and

(4) Any material changes to the credit union's incentive-based compensation arrangements and policies.

(b) A Level 1 or Level 2 credit union must create and maintain records in a manner that allows for an independent audit of incentive-based compensation arrangements, policies, and procedures, including, those required under § 751.11.

(c) A Level 1 or Level 2 credit union must provide the records described in paragraph (a) of this section to NCUA in such form and with such frequency as requested by NCUA.

§ 751.6 Reservation of authority for Level 3 credit unions.

(a) In general. NCUA may require a Level 3 credit union with average total consolidated assets greater than or equal to $10 billion and less than $50 billion to comply with some or all of the provisions of §§ 751.5 and 751.7 through 751.11 if NCUA determines that the Level 3 credit union's complexity of operations or compensation practices are consistent with those of a Level 1 or Level 2 credit union.

(b) Factors considered. Any exercise of authority under this section will be in writing by the NCUA Board in accordance with procedures established by the NCUA Board and will consider the activities, complexity of operations, risk profile, and compensation practices of the Level 3 credit union, in addition to any other relevant factors.

§ 751.7 Deferral, forfeiture and downward adjustment, and clawback requirements for Level 1 and Level 2 credit unions

An incentive-based compensation arrangement at a Level 1 or Level 2 credit union will not be considered to appropriately balance risk and reward, for purposes of § 751.4(c)(1), unless the following requirements are met.

(a) Deferral.

(1) Qualifying incentive-based compensation must be deferred as follows:

(i) Minimum required deferral amount.

(A) A Level 1 credit union must defer at least 60 percent of a senior executive officer's qualifying incentive-based compensation awarded for each performance period.

(B) A Level 1 credit union must defer at least 50 percent of a significant risk-taker's qualifying incentive-based compensation awarded for each performance period.

(C) A Level 2 credit union must defer at least 50 percent of a senior executive officer's qualifying incentive-based compensation awarded for each performance period.

(D) A Level 2 credit union must defer at least 40 percent of a significant risk-taker's qualifying incentive-based compensation awarded for each performance period.

(ii) Minimum required deferral period.

(A) For a senior executive officer or significant risk-taker of a Level 1 credit union, the deferral period for deferred qualifying incentive-based compensation must be at least 4 years.

(B) For a senior executive officer or significant risk-taker of a Level 2 credit union, the deferral period for deferred qualifying incentive-based compensation must be at least 3 years.

(iii) Vesting of amounts during deferral period.

(A) Pro rata vesting. During a deferral period, deferred qualifying incentive-based compensation may not vest faster than on a pro rata annual basis beginning no earlier than the first anniversary of the end of the performance period for which the amounts were awarded.

(B) Acceleration of vesting. A Level 1 or Level 2 credit union must not accelerate the vesting of a covered person's deferred qualifying incentive-based compensation that is required to be deferred under this part, except in the case of:

(1) death or disability of such covered person; or

(2) The payment of income taxes that become due on deferred amounts before the covered person is vested in the deferred amount. For purposes of this paragraph, any accelerated vesting must be deducted from the scheduled deferred amounts proportionally to the deferral schedule.

(2) Incentive-based compensation awarded under a long-term incentive plan must be deferred as follows:

(i) Minimum required deferral amount.

(A) A Level 1 credit union must defer at least 60 percent of a senior executive officer's incentive-based compensation awarded under a long-term incentive plan for each performance period.

(B) A Level 1 credit union must defer at least 50 percent of a significant risk-taker's incentive-based compensation awarded under a long-term incentive plan for each performance period.

(C) A Level 2 credit union must defer at least 50 percent of a senior executive officer's incentive-based compensation awarded under a long-term incentive plan for each performance period.

(D) A Level 2 credit union must defer at least 40 percent of a significant risk-taker's incentive-based compensation awarded under a long-term incentive plan for each performance period.

(ii) Minimum required deferral period.

(A) For a senior executive officer or significant risk-taker of a Level 1 credit union, the deferral period for deferred long-term incentive plan amounts must be at least 2 years.

(B) For a senior executive officer or significant risk-taker of a Level 2 credit union, the deferral period for deferred long-term incentive plan amounts must be at least 1 year.

(iii) Vesting of amounts during deferral period.

(A) Pro rata vesting. During a deferral period, deferred long-term incentive plan amounts may not vest faster than on a pro rata annual basis beginning no earlier than the first anniversary of the end of the performance period for which the amounts were awarded.

(B) Acceleration of vesting. A Level 1 or Level 2 credit union must not accelerate the vesting of a covered person's deferred long-term incentive plan amounts that is required to be deferred under this part, except in the case of:

(1) death or disability of such covered person; or

(2) The payment of income taxes that become due on deferred amounts before the covered person is vested in the deferred amount. For purposes of this

paragraph, any accelerated vesting must be deducted from the scheduled deferred amounts proportionally to the deferral schedule.

(3) Adjustments of deferred qualifying incentive-based compensation and deferred long-term incentive plan compensation amounts. A Level 1 or Level 2 credit union may not increase deferred qualifying incentive-based compensation or deferred long-term incentive plan amounts for a senior executive officer or significant risk-taker during the deferral period. For purposes of this paragraph, an increase in value attributable solely to a change in share value, a change in interest rates, or the payment of interest according to terms set out at the time of the award is not considered an increase in incentive-based compensation amounts.

(4) [Reserved]

(b) Forfeiture and downward adjustment.

(1) Compensation at risk.

(i) A Level 1 or Level 2 credit union must place at risk of forfeiture all unvested deferred incentive-based compensation of any senior executive officer or significant risk-taker, including unvested deferred amounts awarded under long-term incentive plans.

(ii) A Level 1 or Level 2 credit union must place at risk of downward adjustment all of a senior executive officer's or significant risk-taker's incentive-based compensation amounts not yet awarded for the current performance period, including amounts payable under long-term incentive plans.

(2) Events triggering forfeiture and downward adjustment review. At a minimum, a Level 1 or Level 2 credit union must consider forfeiture and downward adjustment of incentive-based compensation of senior executive officers and significant risk-takers described in paragraph (b)(3) of this section due to any of the following adverse outcomes at the credit union:

(i) Poor financial performance attributable to a significant deviation from the risk parameters set forth in the credit union's policies and procedures;

(ii) Inappropriate risk taking, regardless of the impact on financial performance;

(iii) Material risk management or control failures;

(iv) Non-compliance with statutory, regulatory, or supervisory standards that results in:

(A) Enforcement or legal action against the credit union brought by a federal or state regulator or agency; or

(B) A requirement that the credit union report a restatement of a financial statement to correct a material error; and

(v) Other aspects of conduct or poor performance as defined by the credit union.

(3) Senior executive officers and significant risk-takers affected by forfeiture and downward adjustment. A Level 1 or Level 2 credit union must consider forfeiture and downward adjustment for a senior executive officer or significant risk-taker with direct responsibility, or responsibility due to the senior executive officer's or significant risk-taker's role or position in the credit union's organizational structure, for the events related to the forfeiture and downward adjustment review set forth in paragraph (b)(2) of this section.

(4) Determining forfeiture and downward adjustment amounts. A Level 1 or Level 2 credit union must consider, at a minimum, the following factors when determining the amount or portion of a senior executive officer's or significant risk-taker's incentive-based compensation that should be forfeited or adjusted downward:

(i) The intent of the senior executive officer or significant risk-taker to operate outside the risk governance framework approved by the credit union's board of directors or to depart from the credit union's policies and procedures;

(ii) The senior executive officer's or significant risk-taker's level of participation in, awareness of, and responsibility for, the events triggering the forfeiture and downward adjustment review set forth in paragraph (b)(2) of this section;

(iii) Any actions the senior executive officer or significant risk-taker took or could have taken to prevent the events triggering the forfeiture and downward adjustment review set forth in paragraph (b)(2) of this section;

(iv) The financial and reputational impact of the events triggering the forfeiture and downward adjustment review set forth in paragraph (b)(2) of this section to the credit union, the line or sub-line of business, and individuals involved, as applicable, including the magnitude of any financial loss and the cost of known or potential subsequent fines, settlements, and litigation;

(v) The causes of the events triggering the forfeiture and downward adjustment review set forth in paragraph (b)(2) of this section, including any decision-making by other individuals; and

(vi) Any other relevant information, including past behavior and past risk outcomes attributable to the senior executive officer or significant risk-taker.

(c) Clawback. A Level 1 or Level 2 credit union must include clawback provisions in incentive-based compensation arrangements for senior executive officers and significant risk-takers that, at a minimum, allow the credit union to 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 credit union determines that the senior executive officer or significant risk-taker engaged in:

(1) Misconduct that resulted in significant financial or reputational harm to the credit union;

(2) Fraud; or

(3) Intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation.

§ 751.8 Additional prohibitions for Level 1 and Level 2 credit unions

An incentive-based compensation arrangement at a Level 1 or Level 2 credit union will be considered to provide incentives that appropriately balance risk and reward for purposes of § 751.4(c)(1) only if such credit union complies with the following prohibitions.

(a) Hedging. A Level 1 or Level 2 credit union must not purchase a hedging instrument or similar instrument on behalf of a covered person to hedge or offset any decrease in the value of the covered person's incentive-based compensation.

(b) Maximum incentive-based compensation opportunity. A Level 1 or Level 2 credit union must not award incentive-based compensation to:

(1) A senior executive officer in excess of 125 percent of the target amount for that incentive-based compensation; or

(2) A significant risk-taker in excess of 150 percent of the target amount for that incentive-based compensation.

(c) Relative performance measures. A Level 1 or Level 2 credit union must not use incentive-based compensation performance measures that are based solely on industry peer performance comparisons.

(d) Volume driven incentive-based compensation. A Level 1 or Level 2 credit union must not provide incentive-based compensation to a covered person that is based solely on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management.

§ 751.9 Risk management and controls requirements for Level 1 and Level 2 credit unions

An incentive-based compensation arrangement at a Level 1 or Level 2 credit union will be considered to be compatible with effective risk management and controls for purposes of § 751.4(c)(2) only if such credit union meets the following requirements.

(a) A Level 1 or Level 2 credit union must have a risk management framework for its incentive-based compensation program that:

(1) Is independent of any lines of business;

(2) Includes an independent compliance program that provides for internal controls, testing, monitoring, and training with written policies and procedures consistent with § 751.11; and

(3) Is commensurate with the size and complexity of the credit union's operations.

(b) A Level 1 or Level 2 credit union must:

(1) Provide individuals engaged in control functions with the authority to influence the risk-taking of the business areas they monitor; and

(2) Ensure that covered persons engaged in control functions are compensated in accordance with the achievement of performance objectives linked to their control functions and independent of the performance of those business areas.

(c) A Level 1 or Level 2 credit union must provide for the independent monitoring of:

(1) All incentive-based compensation plans in order to identify whether those plans provide incentives that appropriately balance risk and reward;

(2) Events related to forfeiture and downward adjustment reviews and decisions of forfeiture and downward adjustment reviews in order to determine consistency with § 751.7(b) of this part; and

(3) Compliance of the incentive-based compensation program with the credit union's policies and procedures.

§ 751.10 Governance requirements for Level 1 and Level 2 credit unions

An incentive-based compensation arrangement at a Level 1 or Level 2 credit union will not be considered to be supported by effective governance for purposes of § 751.4(c)(3), unless:

(a) The credit union establishes a compensation committee composed solely of directors who are not senior executive officers to assist the board of directors in carrying out its responsibilities under § 751.4(e) of this part; and

(b) The compensation committee established pursuant to paragraph (a) of this section obtains:

(1) Input from the risk and audit committees of the credit union's board of directors, or groups performing similar functions, and risk management function on the effectiveness of risk measures and adjustments used to balance risk and reward in incentive-based compensation arrangements;

(2) A written assessment of the effectiveness of the credit union's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the risk profile of the credit union, submitted on an annual or more frequent basis by the management of the credit union and developed with input from the risk and audit committees of its board of

directors, or groups performing similar functions, and from the credit union's risk management and audit functions; and

(3) An independent written assessment of the effectiveness of the credit union's incentive-based compensation program and related compliance and control processes in providing risk-taking incentives that are consistent with the risk profile of the credit union, submitted on an annual or more frequent basis by the internal audit or risk management function of the credit union, developed independently of the credit union's management.

§ 751.11 Policies and procedures requirements for Level 1 and Level 2 credit unions

A Level 1 or Level 2 credit union must develop and implement policies and procedures for its incentive-based compensation program that, at a minimum:

(a) Are consistent with the prohibitions and requirements of this part;

(b) Specify the substantive and procedural criteria for the application of forfeiture and clawback, including the process for determining the amount of incentive-based compensation to be clawed back;

(c) Require that the credit union maintain documentation of final forfeiture, downward adjustment, and clawback decisions;

(d) Specify the substantive and procedural criteria for the acceleration of payments of deferred incentive-based compensation to a covered person, consistent with § 751.7(a)(1)(iii)(B) and § 751.7(a)(2)(iii)(B));

(e) Identify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions, including when discretion is authorized;

(f) Describe how discretion is expected to be exercised to appropriately balance risk and reward;

(g) Require that the credit union maintain documentation of the establishment, implementation, modification, and monitoring of incentive-based compensation arrangements, sufficient to support the credit union's decisions;

(h) Describe how incentive-based compensation arrangements will be monitored;

(i) Specify the substantive and procedural requirements of the independent compliance program consistent with **§ 751.**9(a)(2); and

(j) Ensure appropriate roles for risk management, risk oversight, and other control function personnel in the credit union's processes for:

(1) Designing incentive-based compensation arrangements and determining awards, deferral amounts, deferral periods, forfeiture, downward adjustment, clawback, and vesting; and

(2) Assessing the effectiveness of incentive-based compensation arrangements in restraining inappropriate risk-taking.

§ 751.12 Indirect actions

A credit union must not indirectly, or through or by any other person, do anything that would be unlawful for such credit union to do directly under this part. The term "any other person" includes a credit union service organization described in 12 U.S.C. 1757(7)(I) or established under similar state law.

§ 751.13 Enforcement

The provisions of this part shall be enforced under section 505 of the Gramm-Leach-Bliley Act and, for purposes of such section, a violation of this part shall be treated as a violation of subtitle A of title V of such Act.

§ 751.14 Credit unions in conservatorship or liquidation

(a) Scope. This section applies to federally insured credit unions for which any one or more of the following parties are acting as conservator or liquidating agent:

(1) The National Credit Union Administration Board;

(2) The appropriate state supervisory authority; or

(3) Any party designated by the National Credit Union Administration Board or by the appropriate state supervisory authority.

(b) Compensation requirements. For a credit union subject to this section, the requirements of this part do not apply. Instead, the conservator or liquidating agent, in its discretion and according to the circumstances deemed relevant in the judgment of the conservator or liquidating agent, will determine the requirements that best fulfill the requirements and purposes of 12 U.S.C. 5641. The conservator or liquidating agent may determine appropriate transition terms and provisions in the event that the credit union ceases to be within the scope of this section.