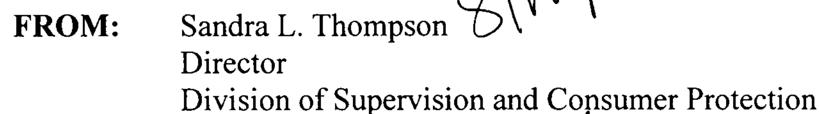
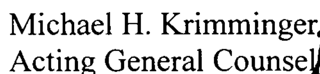
February 7, 2011

TO: Board of Directors



FROM: Sandra L. Thompson
Director
Division of Supervision and Consumer Protection

Michael H. Krimminger
Acting General Counsel



SUBJECT: INCENTIVE-BASED COMPENSATION ARRANGEMENTS: NOTICE OF PROPOSED RULEMAKING TO IMPLEMENT SECTION 956 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

RECOMMENDATION

Staff recommends that the Board approve a *Notice of Proposed Rulemaking* (NPR) to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. § 5641) (Dodd-Frank Act), Enhanced Compensation Structure Reporting, which addresses incentive-based compensation arrangements. The NPR will be issued jointly with other "appropriate federal regulators" (Agencies), as defined by the Act, which includes the other Federal banking agencies – the Board of Governors of the Federal Reserve System (FRS), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) – as well as the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC) and the Federal Housing Finance Agency (FHFA).

Section 956 of the Dodd-Frank Act specifies that its provisions be implemented through measures adopted jointly by the seven participating Agencies. All agencies have begun this process and are expected to complete their respective internal review and approval procedures in the near term. If approved by the Board, the NPR will be published jointly by the Agencies in

the *Federal Register* with a 45-day public comment period after all of the Agencies have completed their review and approval procedures.

DISCUSSION

Background

Section 956 of the Dodd-Frank Act, addresses incentive-based compensation arrangements offered by "covered financial institutions" (banks, credit unions, broker-dealers, investment advisors, and other financial institutions with total assets of $1 billion or more). Under the statute, the Agencies are required to jointly prescribe "regulations or guidelines," within nine months after enactment or April 21, 2011. The Agencies have opted to issue regulations.

As described more fully below, the implementing regulations are required to address a new disclosure requirement, as well as two prohibitions relating to incentive-based compensation arrangements. The annual disclosure addressing the nature of each institution's incentive based compensation arrangements is to be made by covered financial institutions to their appropriate Federal regulator, and is required to be sufficiently detailed to allow the regulator to determine whether the incentive-based compensation structure at each covered institution provides a "covered person" (executive officer, employee, director, or principal shareholder) with compensation that is "excessive" or "could lead to a material financial loss" to the institution. In addition to this disclosure requirement, the regulations must prohibit incentive-based compensation arrangements that the Federal regulators determine can encourage inappropriate risks to the institution by providing incentive-based compensation that is "excessive" or that "could lead to a material financial loss" to the institution.

Notice of Proposed Rulemaking

The NPR has four main components that would: 1) prohibit incentive-based compensation arrangements for "covered persons" that would encourage inappropriate risks by providing "excessive" compensation; 2) prohibit incentive-based compensation arrangements for "covered persons" that would expose the institution to inappropriate risks by providing compensation that "could lead to a material financial loss" at an institution; 3) require policies and procedures for incentive-based compensation arrangements that are commensurate with the size and complexity of the institution, as well as the nature and extent of its use of such arrangements; and 4) require annual reports on incentive compensation structures to the institution's appropriate Federal regulator. Although not specifically required by section 956 of the Dodd-Frank Act, the agencies are proposing the policies and procedures requirements to further the aims of the statue. A discussion of each of these four areas follows:

1) Prohibition against "excessive" compensation: The Dodd-Frank Act prohibits incentive-based payment arrangements that encourage inappropriate risks by providing employees with "excessive" compensation. To address this requirement, the NPR incorporates elements of existing interagency safety-and-soundness standards governing compensation. Consistent with these standards, the NPR describes "excessive" incentive-compensation payments as those amounts that are "unreasonable or disproportionate" to the services performed by the covered person, considering the seven factors listed in section 39(c) of the FDI Act (12 U.S.C. 1831p–1(c)(2)).
2) Prohibition against incentive compensation arrangements that "could lead to a material financial loss" at a covered financial institution: The Dodd-Frank Act prohibits incentive-based compensation arrangements that encourage inappropriate risk-taking by

providing employees with compensation that "could lead to a material financial loss" at a covered institution. The NPR outlines a tiered approach based on the total consolidated asset size of the covered financial institution. The NPR first identifies steps that all institutions must take, and then more specifically outlines several additional steps for a defined group of larger institutions (in the case of insured institutions, those with $50 billion or more in total consolidated assets).

a. *All covered institutions*: Covered institutions are prohibited from maintaining any incentive-based compensation arrangement that encourages a covered person, either individually or as part of a group, to expose the institution to inappropriate risks that could lead to a material financial loss at the covered financial institution. All covered institutions must adopt substantive policies and procedures setting forth corporate governance guidelines for developing, monitoring, and evaluating their incentive compensation arrangements.

b. *Larger covered financial institutions:* The NPR proposes the following specific requirements for two defined categories of employees for covered financial institutions with consolidated assets of $50 billion or more:

Executive Officers: For individuals in major policy-making positions (generally, the most senior officers and heads of material business lines), larger institutions must expressly provide for the deferral of at least 50 percent of incentive awards for a period of at least three years, with the release of deferred amounts to occur no faster than on a pro rata basis. The deferred amount must also be adjusted to reflect actual losses or other measures of performance that become better known during the deferral period. The purpose of payment deferral is to allow time for any losses or other risk exposures

attributable to the employee's activities to become evident and to reduce or eliminate the actual incentive award payments if warranted.

Other covered persons presenting particular loss exposure: The board of directors or a committee thereof must also identify those covered persons – other than executive officers – that individually have the ability to expose the institution to substantial losses in relation to the institution's size, capital, or overall risk tolerance (for example: traders with large position limits or other individuals who have authority to place a substantial portion of the institution's capital at risk).

For this group of identified covered persons presenting particular loss exposure, the board of directors or appropriate board committee: must approve the compensation arrangement and document such approval; may only approve arrangements that effectively balance risks to the institution and financial rewards to the employee; and must do so only after considering the overall effectiveness of the balancing methods used in reducing incentives for inappropriate risk-taking. The NPR highlights four common methods for balancing risk and financial rewards.

3) Policies and procedures: The Agencies are proposing in the NPR that covered institutions also adhere to the following minimum standards for policies and procedures. To the extent incentive-based compensation arrangements are used, covered institutions must establish policies and procedures that ensure compliance with the proposed rule's requirements and prohibitions. Such policies and procedures must also specifically address and ensure the following: appropriate involvement by risk-management and internal control personnel; independent monitoring of awards and payments; informed board analysis and informative reporting to the board; sufficient program documentation;

appropriate use of payment deferrals in relation to associated risks; and an effective corporate governance framework.

As provided in the Dodd-Frank Act, the proposed rule only applies to institutions with total assets of $1 billion or more. Moreover, as expressly stated in the NPR, the policies and procedures and related practices of each covered institution should be tailored to its size and complexity, as well as to the nature and scope of its use of incentive-based compensation arrangements.

4) Enhanced reporting: The Dodd-Frank Act also requires institutions to disclose to its appropriate federal regulator a narrative description of its incentive compensation arrangements in sufficient detail to allow regulators to assess the institution's compliance with the statute. Accordingly, covered institutions would be required to annually file a report that includes the following: a narrative description of the components of its incentive-based compensation arrangements; a summary description of the policies and procedures governing incentive-based compensation; any material changes in incentive-based compensation polices and procedures since the previous filing; and the reasons why the institution believes its incentive-based compensation arrangements are structured to comply with the rule. In addition, institutions with $50 billion or more in total assets would need to provide a description of the incentive-based compensation policies and procedures for the institution's "executive officers" and "other covered persons presenting particular exposure."

Consistent with section 956 of the new law, the proposed rule specifically does not require reporting the actual compensation of particular individuals.

Implementation Period

Following consideration of comments received, any final rule adopted would be effective six months after publication in the *Federal Register* with annual reports due within 90 days of the end of each covered institution's fiscal year.

Comments Requested

The NPR solicits comments on all areas including reporting and disclosure, definitions, policies and procedures, and implementation period.

CONCLUSION

For the reasons explained above, staff recommends that the Board approve the attached NPR and authorize its publication in the *Federal Register* after all Agencies have completed their review and approval procedures. Staff also recommends the Board authorize the Executive Secretary and General Counsel, or their respective designees, to make technical, non-substantive, or conforming changes to the text of the proposed rule, including non-substantive changes to accommodate the ongoing review and approval procedures of the other Agencies, where necessary to ensure the Agencies can jointly publish the NPR, and to take such other actions and issue such other documents as they deem necessary or appropriate to fulfill the Board's objectives.

Staff members who are knowledgeable about this case:

Steven D. Fritts (x8-3723)
Division of Supervision and
Consumer Protection

Mindy West (x8-7221)
Division of Supervision and
Consumer Protection

Daniel Lonergan (x8-6791)
Legal Division

Rodney Ray (x8-3556)
Legal Division

Rose Kushmeider (x8-3861)
Division of Insurance and Research

Attachments:

- Resolution, NPR