DATE: April 20, 2016

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Notice of Proposed Rulemaking: Incentive-based Compensation Arrangements

RECOMMENDATION: Staff recommends that the FDIC Board of Directors (Board) authorize for publication the attached second joint *Notice of Proposed Rulemaking: Incentive-based Compensation Arrangements* ("NPR" or "proposed rule") to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (section 956). The NPR would be issued jointly by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the National Credit Union Administration, the Securities and Exchange Commission, and the Federal Housing Finance Agency (collectively, the "appropriate Federal regulators" and herein "Agencies").

Section 956 requires the Agencies to jointly prescribe regulations with respect to incentive-based compensation practices at certain financial institutions. If approved by the Board, and subject to the other Agencies' approval processes, the NPR would be published jointly by the Agencies in the *Federal Register*. The Agencies are requesting public comment on the proposed rule by July 22, 2016.

Concurrence:

Charles Yi
General Counsel

I. Background

Section 956 addresses incentive-based compensation arrangements offered by "covered financial institutions" (depository institutions, depository institution holding companies, credit unions, broker-dealers, investment advisers, the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and other financial institutions that the Agencies jointly determine should be treated as covered financial institutions) with total assets of $1 billion or more.

Section 956 requires:

- that the Agencies prohibit any types of incentive-based compensation arrangements, or any feature of any such arrangements, that the Agencies determine encourage inappropriate risks by a covered financial institution:
    - by providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or
    - that could lead to material financial loss to the covered financial institution; and
- that a covered financial institution 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.

Section 956 does not require a covered financial institution to report the actual compensation of particular individuals. In establishing compensation standards under Section 956, the Agencies must ensure that such standards are comparable to the standards in section 39 of the Federal Deposit Insurance Act ("FDI Act"),[1] and must consider the compensation standards described in section 39(c) of the FDI Act.[2] Finally, Section 956 provides an enforcement scheme for any regulations issued under the statute.[3]

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[1] See 12 U.S.C. 1831p-1.
[2] See 12 U.S.C. 1831p-1(c).
[3] Section 956 provides that the implementing rules shall be enforced under section 505 of the Gramm-Leach-Bliley Act, 15 U.S.C. 6805.

2011 NPR

In April 2011, the Agencies published a joint notice of proposed rulemaking to implement section 956 ("2011 NPR").[4] The 2011 NPR would have prohibited incentive-based compensation arrangements that could encourage inappropriate risks. It would have required compensation practices at covered financial institutions to be consistent with three key principles—that incentive-based compensation arrangements should (1) appropriately balance risk and financial rewards, (2) be compatible with effective risk management and controls, and (3) be supported by strong corporate governance. The Agencies proposed that covered 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 appropriate Federal regulator describing the structure of their incentive-based compensation arrangements.

The 2011 NPR included two additional requirements for "larger financial institutions," which were defined as covered financial institutions with $50 billion or more in total assets. 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 NPR, including from private individuals, community groups, members of Congress, pension funds, labor federations, academic faculty, covered institutions, financial industry associations, and industry consultants. The vast majority of the comments received consisted of form letters either expressing general support for an incentive-based compensation rulemaking, while making some suggestions to improve the proposals, or disagreeing with aspects of the proposed rule.

Staff reviewed the comments received on the 2011 NPR, and considered supervisory experience and international developments in incentive-based compensation regulation that have

[4] 76 FR 21170 (April 14, 2011).

occurred since 2011, in developing the new proposed rule. As with the 2011 NPR, the Agencies have opted to propose a joint rule rather than guidelines to enable a uniform set of enforceable standards to be applied across the varied financial institutions supervised by the Agencies. The following summarizes the major provisions of the NPR and notes where it differs from the 2011 NPR.

II. Overview of the NPR

Scope and Applicability to Covered Institutions

The NPR would apply to a covered institution[5] with average total consolidated assets greater than or equal to $1 billion that offers incentive-based compensation to covered persons.[6] The NPR proposes to apply a tiered approach to three size categories of institutions based on average total consolidated assets, recognizing the potential for greater risk-taking at the largest, most complex financial institutions. The three categories of covered institutions would be: Level 1 ($250 billion or more); Level 2 ($50 billion or more, but less than $250 billion); and Level 3 ($1 billion or more, but less than $50 billion). All covered institutions would be subject to a basic set of prohibitions and disclosure requirements, and additional prohibitions and requirements would apply to incentive-based compensation arrangements at Level 1 and Level 2 covered institutions.[7]

For covered institutions that are subsidiaries of other covered institutions, levels generally would be determined by reference to the average total consolidated assets of the top-tier

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[5] The NPR uses the term "covered institution" rather than the statutory term "covered financial institution." Each Agency's proposed rule contains a definition of "covered institution" that specifies the entities to which that Agency's rule applies. A state nonmember bank, state savings association, and a state insured branch of a foreign bank, and certain subsidiaries thereof, would be a "covered institution" under the FDIC's proposed rule. The Agencies have also jointly determined that the following types of institutions with total assets over $1 billion should be considered covered institutions: Federal Home Loan Banks; 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); 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); and state member non-depository trust companies.

[6] In the NPR, a "covered person" would be defined as any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution.

[7] The NPR 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 the NPR applicable to Level 1 or Level 2 institutions (subject to notice of the proposed action and opportunity for response), if the covered institution's complexity of operations or compensation practices become consistent with a Level 1 or Level 2 covered institution.

depository institution holding company. Covered institutions that are subsidiaries within a Level 1 or Level 2 depository institution holding company structure (i.e. with total consolidated assets greater than or equal to $50 billion) would be subject to the requirements of the proposed rule applicable to the top-tier holding company, including mandatory deferral for senior executive officers and significant risk takers.

Provisions Applicable to All Covered Institutions

Certain provisions in the NPR would be applicable to all covered institutions. These requirements are similar, but not identical, to requirements in the 2011 NPR, and differences are noted, where applicable:

- Consistent with section 956, the NPR would prohibit incentive-based compensation arrangements at covered institutions that would encourage inappropriate risks by providing a "covered person" with compensation that is "excessive" or "could lead to material financial loss" to the covered institution. Under the NPR, compensation would be considered "excessive" when amounts paid are "unreasonable or disproportionate" to the services performed by the "covered person." Factors for determining whether amounts paid are unreasonable or disproportionate are set forth in the NPR and would be consistent with the compensation standards in section 39(c) of the FDI Act.
- The NPR would provide that an incentive-based compensation arrangement would be considered to 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.
- Unlike the 2011 NPR, the NPR would specify 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 NPR also contains provisions similar to requirements included in the 2011 NPR that would require the board of directors, or a committee thereof, of a covered institution to: oversee of the incentive-based compensation program; approve incentive-based compensation arrangements for senior executive officers; and approve material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers.
- The annual reporting requirement in the 2011 NPR has been replaced by a recordkeeping and disclosure requirement. Specifically, covered institutions would be required to create annually, and maintain for seven years, records that document the structure of incentive-based compensation arrangements and that demonstrate compliance with the NPR, which would be available to the appropriate Federal regulator upon request.

Additional Provisions Applicable to Level 1 and Level 2 Covered Institutions

The NPR would replace the additional requirements for "larger financial institutions" in the 2011 NPR with more specific, and stringent, requirements on Level 1 (total consolidated assets of $250 billion or more) and Level 2 (total consolidated assets of $50 billion or more, but less than $250 billion) covered institutions. These provisions largely affect the senior executive officers and significant risk takers of such covered institutions, and establish the deferral requirements that would be applied to their incentive-based compensation arrangements, including the risk of downward adjustment and forfeiture. Significant provisions that would be applicable to Level 1 and Level 2 covered institutions are as follows:

<u>*Significant Risk Takers (SRTs)*</u>: Specific thresholds are set forth for identifying SRTs as those covered persons – other than senior executives officers – who received annual base salary and incentive-based compensation of which at least one-third was incentive-based compensation, and: (1) were among the most-highly compensated covered persons (top 5 percent for Level 1 and top 2 percent for Level 2 covered institutions); or (2) could commit or expose 0.5 percent or more of the covered institution's equity capital. Additionally, the appropriate Federal regulator would be able to designate a person as an SRT, if the 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, subject to notice of the proposed action and opportunity for response. Furthermore, the NPR would provide that an Agency may determine 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 and may therefore apply a 2 percent SRT threshold (instead of 5 percent).

Deferral: A Level 1 covered institution would be required to defer at least 60 percent of a senior executive officer's qualifying incentive-based compensation and 50 percent of a SRT's qualifying incentive-based compensation for at least four years. The term "qualifying incentive-based compensation" is defined as all incentive-based compensation awarded in a performance period *other than* compensation awarded under a long-term incentive plan.

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 SRT's qualifying incentive-based compensation for at least three years.

The NPR would provide for shorter deferral periods for long-term incentive plans. The NPR 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. 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 at the end of a performance period if the employee meets certain performance measures over the three-year period. 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 and reduce the award before the end of performance period, if appropriate. Therefore, the NPR would allow a shorter deferral period for incentive-based compensation delivered in the form of a long-term incentive plan.

A Level 1 covered institution would be required to defer for at least two years at least 60 percent of a senior executive officer's incentive-based compensation awarded under a long-term incentive plan, and 50 percent of a SRT's incentive-based compensation awarded under a long-term incentive plan. A Level 2 covered institution would be required to defer for at least one year 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 SRT's incentive-based compensation awarded under a long-term incentive plan.

Deferred compensation could vest no faster than on a pro rata, annual basis. For covered institutions that issue equity or are subsidiaries of covered institutions that issue equity, the deferred amount of compensation would be required to consist of substantial amounts of both deferred cash and equity-like instruments throughout the deferral period. The requirement to include substantial amounts of deferred cash is in recognition of aligning compensation with more closely with the interests of the covered institution's debt holders and other creditors.

Additionally, if a senior executive officer or SRT receives incentive-based compensation in the form of options, the amount of such options used to meet the minimum required deferred compensation could not exceed 15 percent of the amount of total incentive-based compensation awarded for the performance period. The limitation on options recognizes that such options present little downside risk to the recipient and therefore may have less utility as method for balancing risk and financial rewards. Further, the proposed rule would prohibit the acceleration of payment of deferred compensation, other than for death or disability, because the acceleration of compensation payments would minimize effects of deferral and eliminate the opportunity for forfeiture of incentive-based compensation during the deferral period.

Forfeiture, Downward Adjustment, and Clawback: The NPR would provide detailed requirements for Level 1 and Level 2 covered institutions to reduce incentive-based compensation for senior executive officers and significant risk-takers. The NPR would define "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. "Forfeiture" would be a reduction in the amount of deferred incentive-based compensation awarded to a person that has not vested.

The proposed rule would require a Level 1 or Level 2 covered institution to make subject to forfeiture all unvested deferred incentive-based compensation and make subject to downward adjustment all incentive-based compensation amounts not yet awarded. 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 by a covered person, 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.

The NPR would also require a Level 1 or Level 2 covered institution to include clawback provisions in the incentive-based compensation arrangements for senior executive officers and SRTs. The term "clawback" refers to a mechanism by which vested incentive-based compensation can be recovered if certain events occur. The proposed rule would require clawback provisions that, at a minimum, allow the covered institution to recover incentive-based compensation for seven years following vesting, if it is determined that the senior executive officer or SRT engaged in misconduct that resulted in significant financial or reputational harm[8] 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 NPR did not include a clawback requirement.

Other Prohibitions: The NPR also has several additional prohibitions for Level 1 and Level 2 covered institutions that were not in the 2011 NPR. These prohibitions would apply to:

- The purchase of hedging instruments for covered persons that offset any decrease in the value of incentive-based compensation arrangements.
- Maximum incentive-based compensation opportunities (sometimes referred to as "leverage"), which could not exceed the target opportunities by more than 125 percent for senior executive officers or by more than 150 percent for SRTs at the time of the award. Additionally, awarded but unvested incentive-based compensation would not allowed to be adjusted upwards.

[8] 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 clawback policies. 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.

- Performance metrics based solely on comparison to industry peer performance.
- Incentive-based compensation based solely on transaction volume or revenue without regard to transaction quality or compliance with sound risk management.

Risk Management, Controls, Governance, and Recordkeeping: The NPR has more extensive requirements covering the risk management, governance, and recordkeeping for Level 1 and Level 2 covered institutions. These more extensive requirements (that also were not addressed in the 2011 NPR) would include:

- Establish a compensation committee composed solely of directors who are not senior executive officers;
- Adopt detailed policies and procedures that among other things, address forfeiture, downward adjustment, and clawback processes;
- Have a risk management framework for incentive-based compensation programs that is independent of any lines of business and that includes an independent compliance program that provides for internal controls, testing, monitoring, and training;
- Provide individuals in control functions (e.g., audit and risk management personnel) 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: incentive-based compensation plans; events and decisions related to forfeiture and downward adjustment; and compliance of the incentive-based compensation program with the covered institution's policies and procedures.
- In addition to the basic disclosure and recordkeeping requirements, Level 1 and Level 2 covered institutions would be required to document: (1) the covered institution's senior executive officers and SRTs, listed by legal entity, job function, organizational hierarchy, and line of business; (2) the incentive-based compensation arrangements for senior executive officers and SRTs; (3) any forfeiture and downward adjustment or clawback reviews and decisions for senior executive officers and SRTs; and (4) any material changes to the covered institution's incentive-based compensation arrangements and policies.

FDIC Covered Institutions

As of December 31, 2015, there were 6,182 FDIC-insured institutions, of which 348 were FDIC-supervised and had total consolidated assets of $1 billion or more. Of these institutions, the FDIC supervised no Level 1 covered institutions, 13 Level 2 covered institutions,[9] and 335 Level 3 covered institutions. Of the Level 3 covered institutions, 17 had total consolidated assets of $10 billion, but less than $50 billion, and were not already within a Level 1 or Level 2 ownership structure. In addition, there were 9 FDIC-insured branches of foreign banks, 5 of which were FDIC-supervised and had total assets of $1 billion or more, bringing the total of FDIC-supervised Level 3 covered institutions to 340.

Implementation Period

Following consideration of comments received, any final rule adopted would be effective 30 days after publication in the *Federal Register*. Covered institutions would be required to comply beginning the first calendar quarter that begins 540 days (18 months) after the final rule is so published.

Comments Requested

The NPR solicits comments on all areas, including: definitions; deferral; forfeiture, downward adjustment, and clawback; prohibitions; disclosure and recordkeeping; risk management and corporate governance; policies and procedures; and implementation period.

III. CONCLUSION

For the reasons explained above, staff recommends that the Board approve the attached NPR and authorize its publication in the *Federal Register* with a public comment period ending on July 22, 2016. The proposed rule would be published in the *Federal Register* after each Agency has completed its approval process. Staff also recommends the Board authorize the

[9] As of December 31, 2015 there were 41 Level 1 and Level 2 depository institution holding companies (total consolidated assets of $50 billion or more) that controlled 69 depository institutions, including 57 covered depository institutions (total assets of $1 billion or more). The FDIC supervises 11 of these covered depository institutions.

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:

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Attachments: Resolution, NPR