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**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. 2011 - \_\_\_\_**  
**RIN \_\_\_\_**

**FEDERAL DEPOSIT INSURANCE CORPORATION**  
**12 CFR Part 372**  
**Docket No. 2011 - \_\_\_\_**  
**RIN 3064-AD56**

**DEPARTMENT OF THE TREASURY**  
**Office of Thrift Supervision**  
**12 CFR Part 563h**  
**Docket No. OTS-2011-0037**  
**RIN 1550-AC49**

**NATIONAL CREDIT UNION ADMINISTRATION**  
**12 CFR Parts 741 and 751**  
**RIN 3133-AD88**

**SECURITIES AND EXCHANGE COMMISSION**  
**17 CFR Part 248**  
**Release no. XXX; File no.**  
**RIN 3235-AL06**

**FEDERAL HOUSING FINANCE AGENCY**  
**12 CFR Part 1232**  
**Docket No. 2011 - \_\_\_\_**  
**RIN 2590-AA42**

#### **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); Office

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of Thrift Supervision, Treasury (OTS); National Credit Union Administration (NCUA); U.S. Securities and Exchange Commission (SEC); and Federal Housing Finance Agency (FHFA).

**ACTION:** Proposed Rule.

**SUMMARY:** The OCC, Board, FDIC, OTS, NCUA, SEC, and FHFA (the Agencies) are proposing rules to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed rule would require the reporting of incentive-based compensation arrangements by a covered financial institution and prohibit incentive-based compensation arrangements at a covered financial institution that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to material financial loss.

**DATES:** Comments must be received by [INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

**ADDRESSES:** Although the Agencies will jointly review all 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 financial 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

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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 <http://www.regulations.gov>. Select “Document Type” of "Proposed Rule", and in “Enter Keyword or ID Box”, enter Docket ID "OCC-2011-0001", and click "Search." On “View By Relevance” tab at bottom of screen, in the “Agency” column, locate the proposed rule for OCC, in the “Action” column, click on “Submit a Comment” or "Open Docket Folder" to submit or view public comments and to view supporting and related materials for this proposed rule.
- Click on the “Help” tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.
- **E-mail:** [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.
- **Fax:** (202) 874-5274.
- **Hand Delivery/Courier:** 250 E Street, SW., Mail Stop 2-3, 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

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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 <http://www.regulations.gov>. Select “Document Type” of “Public Submission,” in “Enter Keyword or ID Box,” enter Docket ID “OCC-2011-0001”, and click “Search.” Comments will be listed under “View By Relevance” tab at bottom of screen. If comments from more than one agency are listed, the “Agency” column will indicate which comments were received by the OCC.
- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC, 250 E 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) 874-4700. 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.
- **Docket:** You may also view or request available background documents and project summaries using the methods described above.

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Board of Governors of the Federal Reserve System: You may submit comments, identified by Docket No. R-\_\_\_\_, 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](mailto:regs.comments@federalreserve.gov). Include the docket number in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20<sup>th</sup> 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 in Room MP-500 of the Board's Martin Building (20<sup>th</sup> and C Streets, NW.) between 9:00 a.m. and 5:00 p.m. on weekdays.

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

- Agency Web Site: <http://www.FDIC.gov/regulations/laws/federal/notices.html>. Follow instructions for submitting comments on the Agency Web Site.

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- **E-mail:** [Comments@FDIC.gov](mailto:Comments@FDIC.gov). Include the RIN number on the subject line of the message.
- **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17<sup>th</sup> 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.

**Instructions:** All comments received must include the agency name and RIN for this rulemaking and will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose.html>, including any personal information provided.

**Office of Thrift Supervision:** You may submit comments, identified by OTS–2011–0037, by any of the following methods:

- **Federal eRulemaking Portal – Regulations.gov:** Go to <http://www.regulations.gov> and follow the directions.
- **E-mail:** [regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov). Please include OTS–2011–0037 in the subject line of the message and include your name and telephone number in the message.
- **Mail:** Regulation Comments, Chief Counsel’s Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: OTS–2011–0037.
- **Facsimile:** (202) 906–6518.
- **Hand Delivery/Courier:** Guard’s Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days, Attention: Regulation Comments, Chief Counsel’s Office, Attention: OTS–2011–0037.

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- Instructions: All submissions received must include the agency name and docket number for this rulemaking. All comments received will be entered into the docket and posted on Regulations.gov without change, including any personal information provided. Comments, including attachments and other supporting materials received, 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.
- Viewing Comments On-Site: You may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), or send a facsimile transmission to (202) 906-6518. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10:00 a.m. and 4:00 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

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.

- NCUA Web site:  
<http://www.ncua.gov/Resources/RegulationsOpinionsLaws/ProposedRegulations.aspx>.  
Follow the instructions for submitting comments.

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- E-mail: Address to [regcomments@ncua.gov](mailto: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 Mary Rupp, 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/Resources/RegulationsOpinionsLaws/ProposedRegulations.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](mailto:OGCMail@ncua.gov).

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

Electronic Comments

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/exorders.shtml>);  
or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-\_\_-10 on the subject line; or

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- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549

All submissions should refer to File Number S7-XX-11. 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 Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F St., 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 Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Federal Housing Finance Agency: You may submit your written comments on the proposed rulemaking, identified by RIN number 2590-AA42, by any of the following methods:

- E-mail: Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at [RegComments@fhfa.gov](mailto: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

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[RegComments@fhfa.gov](mailto:RegComments@fhfa.gov) to ensure timely receipt by the Agency. Please include “RIN 2590-AA42” 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 2590-AA42, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.
- Hand Delivery/Courier: The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA42, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. A hand-delivered package should be logged at the Guard Desk, First Floor, on business days between 9:00 a.m. and 5:00 p.m.

All comments received by the deadline will be posted for public inspection on the FHFA Website at <http://www.fhfa.gov>. 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.

**FOR FURTHER INFORMATION CONTACT:**

OCC: Michele Meyer, Assistant Director, and Patrick Tierney, Counsel, Legislative and Regulatory Activities, (202) 874-5090, and Karen Kwilosz, Director, Operational Risk Policy, (202) 874-5350, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

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BOARD: Michael Waldron, Counsel, (202) 452-2798, or Amanda Allexon, Counsel, (202) 452-3818, Legal Division; William F. Treacy, Advisor, (202) 452-3859, or Meg Donovan, Supervisory Financial Analyst, (202) 452-7542, Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, D.C. 20551.

FDIC: Steven D. Fritts, Associate Director, Risk Management Policy Branch DSC, (202) 898-3723; Melinda West, Chief, Policy & Program Development, DSC, (202) 898-7221, George Parkerson, Senior Policy Analyst, (202) 898-3648; Rose Kushmeider, Senior Financial Economist, (202) 898-3861; Daniel Lonergan, Counsel, (202) 898-6791, Rodney Ray, Counsel, (202) 898-3556, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

OTS: Mary Jo Johnson, Senior Project Manager, Examination Programs, (202) 906-5739, Richard Bennett, Senior Compliance Counsel, Regulations and Legislation Division, (202) 906-7409; Robyn Dennis, Director, Examination Programs, (202) 906-5751; James Caton, Managing Director, Economic and Industry Analysis, (202) 906-5680, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

NCUA: Regina Metz, Staff Attorney, Office of General Counsel, (703) 518-6561; or Vickie Apperson, Program Officer, Office of Examination & Insurance, (703) 518-6385, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314.

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SEC: Raymond A. Lombardo, Branch Chief, Division of Trading & Markets, (202) 551-5755; Timothy C. Fox, Special Counsel, Division of Trading & Markets, (202) 551-5687; Nadya B. Roytblat, Assistant Chief Counsel, Division of Investment Management, (202) 551-6823; or Jennifer R. Porter, Attorney-Advisor, Division of Investment Management, (202) 551-6787, United States Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549.

FHFA: Alfred M. Pollard, General Counsel, (202) 414-3788 or Patrick J. Lawler, Associate Director and Chief Economist (202) 414-3746, Federal Housing Finance Agency, Fourth Floor, 1700 G Street NW., Washington, DC 20552. The telephone number of the Telecommunications Device for the Deaf is (800) 877-8339.

## **SUPPLEMENTARY INFORMATION:**

### **I. BACKGROUND**

#### Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or the “Act”) (Pub. L. 111-203, section 956, 124 Stat. 1376, 2011-2018 (2010)), which was signed into law on July 21, 2010, requires the Agencies to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. Specifically, section 956 of the Dodd-Frank Act (codified at 12 U.S.C. 5641) requires that the Agencies prohibit incentive-based payment arrangements, 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. Under the Act, a covered financial institution also must disclose

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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 as part of this requirement.

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 the Agencies to ensure that any standards adopted with regard to excessive compensation under section 956 of the Act are comparable to the compensation-related safety and soundness standards applicable to insured depository institutions under section 39 of the FDIA (12 U.S.C. 1831p-1(c)),<sup>1</sup> and to take the compensation standards described in section

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<sup>1</sup> 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 12 CFR part 30, Appendix A (OCC); 12 CFR part 208, Appendix D-1 (Board); 12 CFR part 364, Appendix A (FDIC); 12 CFR part 570, Appendix A (OTS).

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39 of the FDIA into consideration in establishing compensation standards under section 956 of the Act.

Compensation arrangements are critical tools in the successful management of financial institutions. These arrangements serve several important objectives, including attracting and retaining skilled staff, promoting better organizational and individual employee performance, and providing retirement security to employees.

At the same time, improperly structured compensation arrangements can provide executives and employees with incentives to take imprudent risks that are not consistent with the long-term health of the organization. The Agencies believe that flawed incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007.

Shareholders and, for a credit union, members of a covered financial institution have an interest in aligning the interests of managers and other employees of the institution with its long-term health. Aligning the interests of shareholders or members and employees, however, is not always sufficient to protect the safety and soundness of an organization, deter excessive compensation, or deter behavior that could lead to material financial loss at the organization. Managers and employees of a covered financial institution may be willing to tolerate a degree of risk that is inconsistent with broader public policy goals. In addition, particularly at larger institutions, shareholders or members may have difficulty effectively monitoring and controlling the incentive-based compensation arrangements throughout the institution that may materially affect the institution's risk profile, even with increased disclosure provisions. As a result, supervision and regulation of incentive compensation, as with other aspects of financial

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oversight, can play an important role in helping ensure that incentive compensation practices at covered financial institutions do not threaten their safety and soundness, are not excessive, or do not lead to material financial loss.

## **II. OVERVIEW OF THE PROPOSED RULE**

The Agencies have elected to propose rules, rather than guidelines, in order to establish general requirements applicable to the incentive-based compensation arrangements of all covered financial institutions (“Proposed Rule”). The Proposed Rule would supplement existing rules, guidance, and ongoing supervisory efforts of the Agencies.

The Proposed Rule has the following components:

- The Proposed Rule would prohibit incentive-based compensation arrangements at a covered financial institution that encourage executive officers, employees, directors, or principal shareholders (“covered persons”) to expose the institution to inappropriate risks by providing the covered person excessive compensation. As described further below, consistent with the directive of section 956, the Agencies propose to use standards comparable to those developed under section 39 of the FDIA for purposes of determining whether incentive-based compensation is “excessive” in a particular case.
- The Proposed Rule would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the covered financial institution that could lead to material financial loss. The Agencies propose to adopt standards for determining whether an incentive-based compensation

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arrangement may encourage inappropriate risk-taking that are consistent with the key principles established for incentive compensation in the Interagency Guidance on Sound Incentive Compensation Policies (“Banking Agency Guidance”) adopted by the Federal banking agencies.<sup>2</sup> The Proposed Rule would also require deferral of a portion of incentive-based compensation for executive officers of larger covered financial institutions. The Proposed Rule would also require that, at larger covered financial institutions, the board of directors or a committee of such a board identify those covered persons (other than executive officers) that 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. The Proposed Rule would require that the board of directors, or a committee thereof, of the institution approve the incentive-based compensation arrangement for such individuals, and maintain documentation of such approval. The term “larger covered financial institution” for the Federal banking agencies and the SEC means those covered financial 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 are larger covered financial institutions. For the FHFA, all Federal Home Loan Banks with total consolidated assets of \$1 billion or more are larger covered financial institutions.

- In connection with these restrictions, the Proposed Rule would require covered financial institutions to maintain policies and procedures appropriate to their size,

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<sup>2</sup> Guidance on Sound Incentive Compensation Policies, 75 FR 36395 (Jun. 25, 2010), adopted by the Federal banking agencies, meaning the OCC, Board, FDIC, and OTS.

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complexity, and use of incentive-based compensation to help ensure compliance with these requirements and prohibitions.

- The Proposed Rule also would require covered financial institutions to provide certain information to their appropriate Federal regulator(s) concerning their incentive-based compensation arrangements for covered persons.

The Proposed Rule would supplement existing rules and guidance adopted by the Agencies regarding compensation and incentive-based compensation.<sup>3</sup> These include the Banking Agency Guidance, the Standards for Safety and Soundness adopted by the Federal banking agencies,<sup>4</sup> the compensation-related disclosure requirements adopted by the SEC for public companies,<sup>5</sup> the rules and guidance adopted by the FHFA for regulatory oversight of the executive compensation practices of its regulated entities<sup>6</sup> and the compensation rules adopted by the NCUA for institutions under its supervision.<sup>7</sup> Each Agency may issue supplemental guidance specific to their regulated entities, including guidance as necessary to clarify the regulatory requirements proposed in this rulemaking. Covered financial institutions supervised

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<sup>3</sup> See, e.g., Banking Agency Guidance, *supra* note 2.

<sup>4</sup> 60 FR 35674 (July 10, 1995), as amended at 61 FR 43948 (Aug. 27, 1996).

<sup>5</sup> See, e.g., Item 402(s) of Regulation S-K, 17 CFR 229.402(s), adopted in Securities Act Release No. 9089 (Dec. 16, 2009), 74 FR 68334 (Dec. 23, 2009).

<sup>6</sup> 12 CFR 1770.1 (b) (1) requires the FHFA Director to prohibit the excessive compensation of executive officers. Section 1770.4 provides specific details as to the categories of information that are required to be submitted to the FHFA pertaining to the prohibition of excessive compensation (Sept. 12, 2001). FHFA's examination guidance (PG-06-002), "Examination for Compensation Practices," sets forth the disclosure requirements pertaining to the compensation and benefits programs of Fannie Mae and Freddie Mac (together, the Enterprises) (Nov. 8, 2006). In carrying out its corporate governance requirements, the FHFA is guided by the provisions set forth in 12 CFR 1710.13. FHFA's Advisory Bulletin (2009-AB-02), "Principles for Executive Compensation at the Federal Home Loan Banks and the Office of Finance," provides guidance to the Home Loan Banks on reporting requirements (Oct. 27, 2009). FHFA's proposed rule on executive compensation, 74 FR 26989 (Jun. 5, 2009), includes incentive compensation in its prohibition on excessive compensation. For the FHFA, the regulated entities are, collectively: the Enterprises, the Federal Home Loan Banks, and the Office of Finance.

<sup>7</sup> See, e.g., 12 U.S.C. 1761a; 12 CFR 701.2 & 12 CFR 701 App. A, Art. VII. §8; 12 CFR 701.21(c)(8)(i); 12 CFR 701.23(g) (1); 12 CFR 701.33; 12 CFR 702.203 & 702.204; 12 CFR 703.17; 12 CFR 704.19 & 704.20; 12 CFR part 708a; 12 CFR 712.8; 12 CFR 721.7; 12 CFR part 750; and NCUA Examiners Guide Ch. 7 at [http://www.ncua.gov/GenInfo/GuidesManuals/examiners\\_guide/chapters/Chapter07.pdf](http://www.ncua.gov/GenInfo/GuidesManuals/examiners_guide/chapters/Chapter07.pdf);

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by the Federal banking agencies should continue to consult the Banking Agency Guidance for additional information on how to balance risk and financial rewards.

The Agencies propose to make the terms of the Proposed Rule, if adopted, effective six months after publication of the final rule in the Federal Register, with annual reports due within 90 days of the end of each covered financial institution's fiscal year. The Agencies request specific comment on whether these dates will provide sufficient time for covered financial institutions to comply with the rule and, if not, why. Commenters are also asked to address whether the Agencies should designate different compliance dates for different types of covered financial institutions, or consider designating different compliance dates for different parts of the Proposed Rule (e.g., disclosure, prohibition, and policies and procedures).

A detailed description of the Proposed Rule with a request for comments is set forth below. Although this is a joint-interagency rulemaking, each Agency will codify its version of the rule in its specified portion of the Code of Federal Regulations in order to accommodate differences between regulated entities as well as other applicable statutory and regulatory requirements. Any significant differences between the Proposed Rules issued by individual agencies are noted below.<sup>8</sup>

### **III. SECTION-BY-SECTION DESCRIPTION OF THE PROPOSED RULE**

§ \_\_\_\_.1 Authority. Section \_\_\_\_.1 provides that this rule is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L No. 111-203). Certain Agencies also have listed their general rulemaking authority in their respective authority citations.

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<sup>8</sup> Since the Agencies' proposed rules use consistent section numbering, relevant sections are cited, for example, as "section \_\_\_\_.1."

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§ \_\_\_\_.2 Scope and Purpose. Section \_\_\_\_.2 provides that this rule applies to a covered financial institution that has total consolidated assets of \$1 billion or more that offers incentive-based compensation arrangements to covered persons. This section also notes that this rule would in no way limit the authority of any Agency under other provisions of applicable law and regulations.

§ \_\_\_\_.3 Definitions. Section \_\_\_\_.3 defines the various terms used in the Proposed Rule. If a term is defined in section 956 of the Dodd-Frank Act, the Proposed Rule generally incorporates that definition.<sup>9</sup>

Compensation. The Proposed Rule defines “compensation” to mean all direct and indirect payments, fees or benefits, 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 financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement. For credit unions, the definition of compensation specifically excludes reimbursement for reasonable and proper costs incurred by covered persons in carrying out official credit union business; provision of reasonable health, accident and related types of personal insurance protection; and indemnification. This is consistent with NCUA’s regulations at 12 CFR 701.33. The Agencies seek comment on this proposed definition.

Covered Financial Institution. As noted above, only “covered financial institutions” that have total consolidated assets of \$1 billion or more would be subject to the Proposed Rule.

Under the Proposed Rule, a “covered financial institution” would include:

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<sup>9</sup> These definitions are proposed for purposes of administering Section 956 and are not intended to affect the interpretation or construction of the same or similar terms for purposes of any other statute or regulation administered by the Agencies.

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- In the case of the OCC, a national bank and Federal branch and agency of a foreign bank;
- In the case of the Board, a state member bank; a bank holding company; a state-licensed uninsured branch or agency of a foreign bank; and the U.S. operations of a foreign bank with more than \$1 billion of U.S. assets that is treated as a bank holding company pursuant to section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a)). A covered financial institution includes the subsidiaries of the institution;
- In the case of the FDIC, a state nonmember bank and an insured U.S. branch of a foreign bank;
- In the case of the OTS, a savings association as defined in 12 U.S.C. 1813(b) and a savings and loan holding company as defined in 12 U.S.C. 1467a(a). (A covered financial institution also includes an operating subsidiary of a federal savings association as defined in 12 CFR 559.2.) The Board, OCC, and FDIC will assume supervisory and rulemaking responsibility for these entities on the transfer date provided in Title III of the Dodd-Frank Act. These agencies expect to adopt, or incorporate, as appropriate, any final rule adopted by OTS as part of this rulemaking for relevant covered financial institutions that come under their respective supervisory authority after the transfer date;
- 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;

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- In the case of the SEC, a broker-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);<sup>10</sup>
- The FHFA, because it proposes to extend the requirements of the rule to the Federal Home Loan Bank System's Office of Finance,<sup>11</sup> which is not a financial institution, is not proposing to use the term "covered financial institution," but rather the term "covered entity," defined to mean Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Office of Finance.

As indicated in the above listing, the Agencies propose to expand the definition of a covered financial institution beyond those specifically identified in section 956, as authorized by section 956(e)(2)(G) of the Dodd-Frank Act. Consistent with the principle of national treatment and equality of competitive opportunity, the Agencies propose to include as covered financial institutions the uninsured branches and agencies of a foreign bank, 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. These offices and operations currently are subject to the Banking Agency Guidance, and are subject to section 8 of the FDIA, which prohibits institutions from engaging in unsafe or unsound practices to the same extent as insured depository institutions and bank holding companies.<sup>12</sup>

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<sup>10</sup> By its terms, the definition of "covered financial institution" in section 956 includes any firm that meets the definition of "investment adviser" under the Investment Advisers Act of 1940 ("Investment Advisers Act"), regardless of whether the firm 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.

<sup>11</sup> The Office of Finance is a joint agency of the twelve Federal Home Loan Banks and is described and regulated in the FHFA's rules at 12 C.F.R. part 1273.

<sup>12</sup> See 12 U.S.C. 1813(c)(3) and 1818(b)(4).

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The Agencies also propose including the Federal Home Loan Banks because they pose similar risks and should be subject to the same regulatory regime. FHFA also proposes to subject the Office of Finance to the Proposed Rule, using authority other than section 956.<sup>13</sup>

Commenters are specifically asked to address whether there are there other types of financial institutions, such as a credit union service organization (“CUSO”), that the Agencies should treat as a covered financial institution to better promote the purpose of section 956 and competitive equity. Currently no CUSOs wholly owned by a federally insured credit union have total consolidated assets of \$1 billion or more.

Covered Person. Only incentive-based compensation paid to “covered persons” would be subject to the requirements of this Proposed Rule. A “covered person” would be any executive officer, employee, director, or principal shareholder of a covered financial institution. No specific categories of employees are excluded from the scope of the Proposed Rule, although it is the underlying purpose of this rulemaking to address those incentive-based compensation arrangements for covered persons or groups of covered persons that encourage inappropriate risk because they provide excessive compensation or pose a risk of material financial loss to a covered financial institution. Accordingly, as will be discussed later in this **Supplementary Information** section, certain prohibitions in the Proposed Rule apply only to a subset of covered persons. As a result, the proposal contains separate definitions of director, executive officer, and

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<sup>13</sup> The Office of Finance is an agent of the Federal Home Loan Banks in issuing the hundreds of billions of dollars' worth of Federal Home Loan Bank System obligations that are outstanding at any time. It is not a financial institution, but because of its critical role in the mortgage finance system, it is proposed to be made subject to the provisions of the Proposed Rule that apply to financial institutions with assets of over \$50 billion. Because it is not a financial institution and hence not within the scope of section 956, FHFA bases its authority over the Office of Finance for this purpose not on section 956 but on the Federal Housing Enterprises Financial Safety and Soundness Act, which in section 1311(b)(2) (12 U.S.C. 4511(b)(2)) grants FHFA general regulatory authority over the Office of Finance.

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principal shareholder. For federal credit unions, only one director, if any, may be considered a covered person since, under the Federal Credit Union Act section 112 (12 U.S.C. 1761a) and NCUA's regulations at 12 CFR 701.33, only one director may be compensated as an officer of the board.

Director and Board of Directors. The Proposed Rule defines "director" of a covered financial institution as a member of the board of directors of the covered financial institution or of a board or committee performing a similar function to a board of directors. For NCUA's proposed rule, the director is always a member of the credit union's board of directors so the definition is omitted. The Proposed Rule also defines "board of directors" as the governing body of any covered financial institution performing functions similar to a board of directors. For a foreign banking organization, "board of directors" refers to the relevant senior management or oversight body for the firm's U.S. branch, agency or operations, consistent with the foreign banking organization's overall corporate and management structure. The Agencies seek comment on these proposed definitions.

Executive Officer. As discussed in more detail later in this Supplementary Information, the Proposed Rule would apply certain restrictions to the incentive-based compensation of "executive officers" of larger covered financial institutions.<sup>14</sup> The Proposed Rule defines "executive officer" of a covered financial institution as a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following

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<sup>14</sup> As discussed previously, the term "larger covered financial institution" for the Federal banking agencies and the SEC means those covered financial 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 are larger covered financial institutions. For the FHFA, Fannie Mae, Freddie Mac, and all of the Federal Home Loan Banks with total consolidated assets of \$1 billion or more are larger covered financial institutions. In addition, the FHFA proposes to make the same requirements applicable to the Office of Finance.

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positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.<sup>15</sup>

- The Agencies seek comment on whether the types of positions identified in this proposed definition are appropriate, whether additional positions should be included, or if certain positions should be removed.
- Should the Agencies define “head of a major business line?”

Incentive-based Compensation. Consistent with section 956 of the Dodd-Frank Act, the Proposed Rule would apply only to incentive-based compensation arrangements. The Proposed Rule defines “incentive-based compensation” to mean any variable compensation that serves as an incentive for performance. The definition is broad and principles-based to address the objectives of section 956 in a manner that provides for flexibility as forms of compensation evolve. The form of payment, whether it is cash, an equity award, or other property, does not affect whether compensation meets the definition of “incentive-based compensation.”

There are types of compensation that would not fall within the scope of this definition. Generally, compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary) would not be considered incentive-based compensation. Similarly, a compensation arrangement that provides rewards solely for activities or behaviors

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<sup>15</sup> For the FHFA, the Safety and Soundness Act of 1992, as reflected in 12 CFR 1770.3 (g)-(1), defines the term Executive Officer to mean, for Fannie Mae and Freddie Mac, the Chairman of the Board of Directors, chief executive officer, chief financial officer, chief operating officer, president, vice chairman, any executive vice president, and any individual who performs functions similar to such positions whether or not the individual has an official title; and any senior vice president or other individual with similar responsibilities, without regard to title: (A) who is in charge of a principal business unit, division or function, or (B) who reports directly to the chairman of the board of directors, vice chairman, president or chief operating officer. The Proposed Rule adopts a modified version of the definitions for Fannie Mae and Freddie Mac, and a definition for the Federal Home Loan Banks and for the Office of Finance that the FHFA has determined is appropriate for them.

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that do not involve risk-taking (for example, payments solely for achieving or maintaining a professional certification or higher level of educational achievement) would not be considered incentive-based compensation under the proposal. In addition, the Agencies do not envision that this definition would include compensation arrangements that are determined based solely on the covered person's level of fixed compensation and do not vary based on one or more performance metrics (e.g., employer contributions to a 401(k) retirement savings plan computed based on a fixed percentage of an employee's salary). The proposed definition also would not include dividends paid and appreciation realized on stock or other equity instruments that are owned outright by a covered person. However, stock or other equity 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 (irrespective of whether such deferral is mandatory).

The Agencies request comment generally on this proposed definition. Comment is also requested on the following questions:

- Is the definition of incentive-based compensation sufficiently broad to include all types of compensation that should be covered under the rule?
- Are there any particular forms of compensation that should be specifically designated as incentive-based compensation?
- Are there any other forms of compensation that the Agencies should clarify are not incentive-based compensation?

Principal Shareholder. Under the Proposed Rule, a "principal shareholder" means an individual that directly or indirectly, or acting through or in concert with one or more persons,

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owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.<sup>16</sup> The Agencies request comment on this proposed definition. The NCUA's proposed rule does not include this definition since credit unions are not-for-profit financial cooperatives with member owners.

Total Consolidated Assets. As provided in section 956, the Proposed Rule would apply to all covered financial institutions that have total consolidated assets of \$1 billion or more. Additional requirements would apply to certain larger covered financial institutions. With the exception of the FHFA, the Agencies have specified how total consolidated assets should be calculated in their agency specific rule text.

- OCC: Total consolidated assets means (i) for a national bank, calculating the average of the total assets reported in the bank's four most recent Consolidated Reports of Condition and Income ("Call Report") and (ii) for a Federal branch and agency, calculating the average of the total assets reported in the Federal branch or agency's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks - FFIEC 002.
- Board: For a state member bank, total consolidated assets as determined based on the average of the bank's four most recent Consolidated Reports of Condition and Income ("Call Report"); for a bank holding company, total consolidated assets as determined based on the average of the company's four most recent Consolidated Financial Statements for Bank Holding Companies ("FR Y-9C"); for a state-licensed uninsured branch or agency of a foreign bank, total consolidated assets as determined based on the

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<sup>16</sup> The 10 percent threshold used in the definition of "principal shareholder" is also used in a number of bank regulatory contexts. See e.g., 12 CFR 215.2(m), 12 CFR 225.2(n)(2), 12 CFR 225.41(c)(2).

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average of the branch or agency's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks - FFIEC 002; and for the U.S. operations of a foreign bank, total consolidated U.S. assets as determined by the Board.

- **FDIC**: For state nonmember banks, asset size would be determined by calculating the average of the total assets reported in the institution's four most recent Call Reports. For insured U.S. branches of foreign banks, asset size will be determined by calculating the average of the total assets reported in the branch's four most recent Reports of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks.
- **OTS**: For covered financial institutions regulated by the OTS, asset size will be determined by calculating the average of total assets reported in the institution's four most recent Thrift Financial Reports.
- **NCUA**: For credit unions, asset size will be determined by calculating the average of the total assets reported in the credit union's four most recent 5300 Call Reports.
- **SEC**: For brokers or dealers registered with the SEC, asset size would be determined by the total consolidated assets reported in the firm's most recent year-end audited Consolidated Statement of Financial Condition filed pursuant to Rule 17a-5 under the Securities Exchange Act of 1934. For investment advisers, asset size would be determined by the adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year end. The proposed method of calculation for investment advisers is consistent with the SEC's recent proposal that each investment adviser filing Form ADV Part 1A indicate whether the adviser had \$1 billion or more in "assets," defined as the

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total assets shown on the balance sheet for the adviser's most recent fiscal year end.<sup>17</sup> In connection with that proposal, the SEC requested comment on the reporting requirement and the proposed method that advisers would use to determine the amount of their assets (i.e., total assets as shown on the adviser's balance sheet). Commenters are asked to provide additional comments on the proposed method of determining asset size for investment advisers, and specifically to address whether the determination of total assets should be further tailored for certain types of advisers, such as advisers to hedge funds or private equity funds, and if so, why and in what manner.

- **FHFA**: The FHFA is not including a definition of total consolidated assets in its proposed rule because it is proposing to make all requirements of the rule applicable to all the entities it regulates without regard to asset size.<sup>18</sup>

The Agencies believe that by generally establishing a rolling average for asset size (with the exception of the SEC and the FHFA), the frequency that an institution may fall in or out of covered financial institution status would be minimized. If a covered financial institution has fewer than four reports, the institution must average total assets from its existing reports for purposes of determining total consolidated assets. If a covered financial institution has a mix of two or more different types of reports covering the relevant period, those should be averaged for purposes of determining asset size (e.g., an institution with two Call Reports and two Thrift

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<sup>17</sup> See Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Release No. 3110, nn. 194-196 and related text (Nov. 19, 2010) 75 FR 77052 (Dec. 10, 2010).

<sup>18</sup> Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are all far larger than the \$1 billion asset threshold in section 956, while the FHFA is basing its regulatory authority over the Office of Finance on a different statute. And, for policy reasons, the FHFA is proposing not to distinguish "larger" entities from others for purposes of this rule.

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Financial Reports as its four most recent reports would have its total assets from all four reports averaged).

Should all of the Agencies use a uniform method to determine whether an institution has \$1 billion or more in assets? If so, what would commenters suggest as such a uniform method?

If different calculations are required for each type of institution, should any of the Agencies define total consolidated assets differently than the proposed calculations described above?

§ \_\_\_\_4 Required Reports. Section 956(a)(1) of the Dodd-Frank Act requires that a covered financial institution submit an annual report to its appropriate Federal regulator disclosing the structure of its incentive-based compensation arrangements that is sufficient to determine whether the incentive-based compensation structure provides covered persons with excessive compensation, fees, or benefits, or could lead to material financial loss to the covered financial institution. In order to fulfill this requirement, the Proposed Rule would establish the general rule that a covered financial institution must submit a report annually to its appropriate regulator or supervisor in a format specified by its appropriate Federal regulator that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons. The report must contain:

(1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(2) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;

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(3) For larger covered financial institutions, a succinct description of any specific incentive compensation policies and procedures for the institution's executive officers, and other covered persons who the board, or a committee thereof determines under § \_\_.5(b)(3)(ii) of the Proposed Rule 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;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report was submitted; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered financial institution by providing covered persons with excessive compensation or incentive-based compensation that could lead to material financial loss to the covered financial institution.

In developing the proposed reporting provisions, the Agencies have taken into account that substantially all the covered financial institutions are already supervised and/or subject to examination by one or more of the Agencies. Accordingly, in the Proposed Rule, the Agencies have tailored the annual reporting requirement to the types of information that would most efficiently assist the relevant Agency in determining whether there are any areas of potential concern with respect to the structure of the covered financial institution's incentive-based compensation arrangements. Generally, each Agency has reporting, examination and enforcement authority for substantially all of the covered financial institutions under its respective jurisdiction that the Agency may use if the information provided under section 956 were to indicate that the structure of a covered financial institution's incentive-based

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compensation arrangements may provide excessive compensation or encourage inappropriate risk-taking.<sup>19</sup> In this way, the Proposed Rule seeks to achieve the objective of section 956 in a manner that limits unnecessary reporting burden on covered financial institutions and leverages the existing supervisory framework for institutions.

The Agencies note that they have intentionally chosen phrases like “clear narrative description” and “succinct description” to describe the disclosures being sought. The Agencies also note that the use of the word “specific” in the Proposed Rule is designed to elicit statements that are direct and meaningful explanations of why a covered financial institution believes its incentive-based compensation plan properly addresses the “excessive compensation” and “material financial loss” components of section 956. These provisions are designed to help ensure that covered financial institutions will provide the Agencies with a streamlined set of materials that will help the Agencies promptly and effectively identify and address any areas of concern, rather than with voluminous materials that may obfuscate the actual structure and likely effects of an institution’s incentive-based compensation arrangements. Further, in light of the nature of the information that will be provided to the Agencies under section \_\_.4 of the Proposed Rule, and the purposes for which the Agencies are requiring the information, the Agencies generally will maintain the confidentiality of the information submitted to the Agencies, and the information will be nonpublic, to the extent permitted by law.<sup>20</sup> The nature of

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<sup>19</sup> NCUA would likely consult with the appropriate state regulator in cases involving a state-chartered credit union.  
<sup>20</sup> The Freedom of Information Act (“FOIA”) provides at least two pertinent exemptions under which the Agencies have authority to withhold certain information. FOIA Exemption 4 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 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).

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the reported information likely will be sensitive for a variety of reasons, including competitive reasons.

The volume and detail of information provided annually by a covered financial institution should be commensurate with the size and complexity of the institution, as well as the scope and nature of its incentive-based compensation arrangements. As such, the Agencies expect that the volume and detail of information provided by a large, complex institution that uses incentive-based arrangements to a significant degree would be substantially greater than that submitted by a smaller institution that has only a few incentive-based compensation arrangements or arrangements that affect only a limited number of covered persons.

The Agencies request comment on all aspects of the reporting provisions in the Proposed Rule. Specifically, the Agencies request comment on the following:

- Does the Proposed Rule fulfill the requirement to obtain meaningful and useful descriptions of incentive-based compensation arrangements for supervisory and compliance purposes?
- Does the Proposed Rule impose a reasonable burden and minimize the potential for voluminous boilerplate disclosure?
- Is the language in the Proposed Rule sufficiently clear in describing the kinds of information the Agencies intend to solicit from covered financial institutions?
- Are there simpler and less burdensome methods of reporting to the Agencies that would still be sufficiently robust to help the Agencies assess whether the institution's compensation arrangements appropriately balance risk and financial rewards? For example, would setting up an electronic means of filing the required disclosure lessen the

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burden on covered financial institutions, and are there specific factors the Agencies should consider in developing such a disclosure mechanism?

- Are there any additional types of information that the Agencies should solicit in order to more accurately assess whether incentive-based compensation arrangements are consistent with the objectives of section 956?
- Should the Agencies consider modifying the Proposed Rule to require covered financial institutions to update their incentive-based compensation disclosure -- between annual disclosure cycles -- if any material changes to their respective incentive-based compensation plans occur?

§ \_\_\_\_.5 Prohibitions. Section \_\_\_\_.5 of the Proposed Rule would implement section 956(b) of the Dodd-Frank Act by prohibiting a covered financial institution from having incentive-based compensation arrangements that may encourage inappropriate risks (a) by providing excessive compensation or (b) that could lead to material financial loss to the covered financial institution. Consistent with section 956(c), the Proposed Rule also would establish standards for determining whether an incentive-based compensation arrangement violates these prohibitions.

Excessive Compensation. The Proposed Rule would establish a general rule that a covered financial institution 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 covered financial institution by providing a covered person with excessive compensation. As noted previously, section 956 requires the Agencies to ensure that any compensation standards established under section 956 are comparable to those established under section 39 of the FDIA. In light of this directive, the Proposed Rule includes standards for

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determining whether an incentive-based compensation arrangement provides excessive compensation that are comparable to, and based on, the standards established under section 39 of the FDIA. Specifically, under the Proposed Rule, incentive-based compensation for a covered person would be considered excessive when amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed by the covered person. In making such a determination, the Agencies will consider:

- (1) The combined value of all cash and non-cash benefits provided to the covered person;
- (2) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
- (3) The financial condition of the covered financial institution;
- (4) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets;
- (5) For postemployment benefits, the projected total cost and benefit to the covered financial institution;
- (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 covered financial institution;
- and
- (7) Any other factors the Agency determines to be relevant.

The Agencies request comment on these standards, including comment on the appropriate factors to consider when evaluating comparable compensation practices at comparable institutions.

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Should additional factors be included, such as the nature of the operations at the comparable institutions?

Inappropriate Risks that May Lead to 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. 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. Accordingly the Agencies have considered the language and purpose of section 956, existing supervisory guidance that addresses incentive-based compensation arrangements that may encourage excessive risk-taking,<sup>21</sup> the Principles for Sound Compensation Practices and the related Implementation Standards adopted by the Financial Stability Board,<sup>22</sup> and other relevant material in considering how to implement this aspect of section 956.

As an initial matter, the Agencies note that section 956 is focused on incentive-based compensation arrangements that could lead to material financial loss to a covered financial institution. Accordingly, this prohibition would apply only to those incentive-based compensation arrangements for individual covered persons, or groups of covered persons, whose activities may expose the covered financial institution to material financial loss. Such covered persons include:

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<sup>21</sup> See, e.g., Banking Agency Guidance.

<sup>22</sup> Financial Stability Board, FSF Principles for Sound Compensation Practices, Basel, Switzerland (April 2009); Financial Stability Board, FSB Principles for Sound Compensation Practices: Implementation Standards, Basel, Switzerland (September 2009).

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- Executive officers and other covered persons who are responsible for oversight of the covered financial institution's firm-wide activities or material business lines;
- Other individual covered persons, including non-executive employees, whose activities may expose the covered financial institution to material financial loss (e.g., traders with large position limits relative to the covered financial institution's overall risk tolerance); and
- Groups of covered persons who are subject to the same or similar incentive-based compensation arrangements and who, in the aggregate, could expose the covered financial institution to material financial loss, even if no individual covered person in the group could expose the covered financial institution to material financial loss (e.g., loan officers who, as a group, originate loans that account for a material amount of the covered financial institution's credit risk).

To implement section 956(b)(2) of the Act, section \_\_\_\_5(b)(1) of the Proposed Rule would prohibit a covered financial institution from establishing or maintaining any type of incentive compensation arrangement, or any feature of any such arrangement, for these covered persons or groups of covered persons, that could lead to material financial loss to the covered financial institution. Section \_\_\_\_5(b)(2) of the Proposed Rule provides that an incentive-based compensation arrangement established or maintained by a covered financial institution for one or more covered persons does not comply with section \_\_\_\_5(b)(1) unless it:

- Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

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- Is compatible with effective controls and risk management; and
- Is supported by strong corporate governance.

These three standards are consistent with the principles for sound compensation practices in the Banking Agency Guidance.

The following describes these proposed standards in greater detail. In order to help ensure that the incentive-based compensation arrangements of covered financial institutions are consistent with their standards, section \_\_\_\_\_.6 of the Proposed Rule would require that covered financial institutions establish and maintain policies and procedures related to these standards.

#### Balance of Risk and Financial Rewards

Incentive-based compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the covered financial 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 yield higher short-term revenue, and a covered person who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to expose the institution to more risk.<sup>23</sup>

Accordingly, to be consistent with section 956, incentive-based compensation arrangements at a covered financial institution should balance risk and financial rewards in a manner that does not provide covered persons with incentives to take inappropriate risks that could lead to material financial loss at the covered financial institution. The Agencies would deem an incentive-based compensation arrangement to be balanced when the amounts paid to a

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<sup>23</sup> See Banking Agency Guidance at 36407.

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covered person appropriately take into account the risks, as well as the financial benefits, from the covered person's activities and the impact of those activities on the covered financial institution.

In assessing whether incentive-based compensation arrangements are balanced, the Agencies will consider the full range of risks associated with a covered person's activities, as well as the time horizon over which those risks may be realized. The activities of a covered person may create a wide range of risks for a covered financial institution, including credit, market, liquidity, operational, legal, compliance, and reputational risks. Some of these risks may be realized in the short term, while others may become apparent only over the long term.

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: Under this method of making a covered person's incentive-based compensation appropriately risk-sensitive, the amount of the person's incentive-based compensation award is adjusted based on measures that take into account the risk the covered person's activities pose to the covered financial institution. Such measures may be quantitative, or the size of a risk adjustment may be set based on managerial judgment, subject to appropriate oversight.

Deferral of Payment: Under this method, the actual payout of an award to a covered person is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses to the covered financial institution or other aspects of performance that become clear only during the deferral period. Deferred payouts may be altered according to risk outcomes either formulaically or based on managerial judgment, though extensive use of

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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.

Longer Performance Periods: 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.

Reduced Sensitivity to Short-Term Performance: A covered financial institution using this method reduces the rate at which awards increase as a covered person achieves higher levels of the relevant performance measure(s) used in the person's incentive-based compensation arrangement. Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives.

The Agencies recognize that these methods for achieving balance are not exclusive, and additional methods or variations of these approaches may exist or be developed.<sup>24</sup> Methods and practices for making compensation sensitive to risk-taking are likely to evolve during the next few years. Moreover, each method has its own advantages and disadvantages that may differ

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<sup>24</sup> See Banking Agency Guidance at 36407.

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depending upon the situation in which they are used. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for inappropriate risk-taking. This is because risk adjustment potentially can take account of the full range and time horizon of risks, rather than just those risk outcomes that occur or become evident during the deferral period. On the other hand, deferral of payment may be more effective than risk adjustment in mitigating incentives to take hard-to-measure risks (such as the risks of new activities or products, or certain risks such as reputational or operational risk that may be difficult to measure with respect to particular activities), especially if such risks are likely to be realized during the deferral period. In some cases, two or more methods may be needed in combination for an incentive-based compensation arrangement to be balanced. The greater the potential incentives that an arrangement creates for a covered person to increase the risks borne by the covered financial institution, the stronger the effect should be of the methods applied to achieve balance.<sup>25</sup>

#### Compatibility with Effective Controls and Risk Management

A covered financial institution's risk management processes and internal controls should reinforce and support the development and maintenance of balanced incentive-based compensation arrangements.<sup>26</sup> In particular, under this proposed standard, the Agencies would expect a covered financial institution to have strong controls governing its processes for designing, implementing and monitoring incentive-based compensation arrangements, and for ensuring that risk-management personnel have an appropriate role in the institution's processes for designing incentive-based compensation arrangements, monitoring their use, and assessing

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<sup>25</sup> See Banking Agency Guidance at 36409.

<sup>26</sup> See Banking Agency Guidance at 36410 - 11.

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whether they achieve balance. Covered financial institutions should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk management and other functions. Such controls are important because covered persons may seek to evade or weaken an institution's processes to achieve balanced incentive-based compensation arrangements in order to increase their own compensation. For example, in order to increase his or her own incentive compensation, an covered person may seek to influence inappropriately the risk measures, information, or judgments used to balance the covered person's compensation. These activities can have additional damaging effects on the institution's financial health if they result in the weakening of the information or processes that the institution uses for other risk management, internal control, or financial purposes.<sup>27</sup>

#### Strong Corporate Governance

Strong and effective corporate governance is critical to the establishment and maintenance of sound compensation practices.<sup>28</sup> The board of directors of a covered financial institution, or committee thereof, should actively oversee incentive-based compensation arrangements and is ultimately responsible for ensuring that the covered financial institution's incentive compensation arrangements are appropriately balanced. Accordingly, the board of directors, or a committee thereof, should actively oversee the development and operation of a covered financial institution's incentive-based compensation systems and related control processes. For example, the board of directors, or a committee thereof, should review and approve the overall goals and purposes of the covered financial institution's incentive-based

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<sup>27</sup> See Banking Agency Guidance at 36411.

<sup>28</sup> See Banking Agency Guidance at 36412.

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compensation system and ensure its consistency with the institution's overall risk tolerance. In addition, the board of directors, or committee thereof, should receive data and analysis to assess whether the overall design, as well as the performance, of the institution's incentive compensation arrangements are consistent with section 956.

The Agencies request comment on all aspects of section \_\_\_\_.5 of the Proposed Rule. The Agencies also request comment on whether there are additional factors that should be considered in evaluating whether compensation is excessive or could lead to material financial loss and whether the Proposed Rule should include additional details about each of these standards.

#### Larger Covered Financial Institutions

##### Deferral arrangements required for Executive Officers

Paragraph (b)(3) of section \_\_\_\_.5 of the Proposed Rule would establish a deferral requirement for larger covered financial institutions (i.e., generally those with \$50 billion or more in total consolidated assets).<sup>29</sup> At these larger covered financial institutions, at least 50 percent of the incentive-based compensation of an "executive officer" (as previously defined), would have to be deferred over a period of at least three years. The Proposed Rule also would require that deferred amounts paid be adjusted for actual losses of the covered financial institution or other measures or aspects of performance that are realized or become better known during the deferral period.

The Agencies believe that incentive-based compensation arrangements for executive officers at larger covered financial institutions are likely to be better balanced if they involve the

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<sup>29</sup> As noted above, the FHFA is proposing to adopt this requirement for all the entities it regulates – Fannie Mae, Freddie Mac, the twelve Federal Home Loan Banks, and the Office of Finance, without regard to asset size, except for covered entities in conservatorship, receivership, or bridge status.

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deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance. The decisions of executive officers have a significant impact on the entire organization and often involve substantial strategic or other risks that are difficult to measure and model -- particularly at larger covered financial institutions -- and therefore difficult to address adequately by ex ante risk adjustments.

Requiring deferral for executive officers is consistent with international standards<sup>30</sup> that establish the expectation that large interconnected firms require the deferral of a substantial portion of incentive-based compensation (identified as 40 to 60 percent of the incentive award, or more) for certain employees for a fixed period of time not less than three years and that incentives be correctly aligned with the nature of the business, its risks, and the activities of the employees in question. Because the risks of strategic and other high-level decisions of executive officers may not be apparent or become better known for many years, the Proposed Rule would require that the deferral arrangement for executive officers at these larger covered financial institutions extend for at least three years. Larger covered financial institutions tend to have more diverse business operations, which can make it more difficult to immediately recognize and assess risks for the organization as a whole. Furthermore, in enacting the Dodd-Frank Act, Congress recognized that larger organizations may pose a greater risk to the financial system by requiring the creation of enhanced prudential standards for certain bank holding companies with total consolidated assets greater than \$50 billion.<sup>31</sup>

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<sup>30</sup> See supra note 22.

<sup>31</sup> 12 U.S.C. 5635.

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The Proposed Rule recognizes that requiring deferral for this discrete group of individuals at larger covered institutions, where ex ante risk adjustment measures are less likely to be effective in and of themselves, is likely to be a useful balancing tool that allows a period of time for risks not previously discerned or quantifiable to ultimately materialize, and concurrently provides for adjustment of unreleased (or “unvested”) deferral payments on the basis of observed consequences and actual performance as opposed to only predicted results.

If a covered financial institution is required to use deferral, the Proposed Rule provides it with flexibility in administering its specific deferral program. A covered financial institution may decide to release (or allow vesting of) the full deferred amount in a lump-sum only at the conclusion of the deferral period; alternatively, the institution may release the deferred amounts (or allow vesting) in equal increments, pro rata, for each year of the deferral period. However, in no event may the release or vesting of amounts required to be deferred under § \_\_\_\_.5(b)(3) of the Proposed Rule be faster than a pro rata equal-annual-increments distribution. For instance, an institution required to apply a three-year deferral to a \$150,000 deferral amount could release a maximum of \$50,000 each year or could withhold the entire sum for the entire period and distribute it as a lump-sum at the conclusion of the three-year period. The institution could also employ an alternate distribution that is less rapid than a pro-rata equal-annual-increments schedule, such as releasing no amount after the first year, releasing a maximum of \$100,000 the second year, and then \$50,000 for the third year.

Specific comment is solicited on all aspects of the scope, and specific requirements, of this proposed deferral requirement. In particular, commenters are asked to address whether it is appropriate to mandate deferral for executive officers at larger covered financial institutions to

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promote the alignment of employees' incentives with the risk undertaken by such employees.

For example, comment is solicited on whether deferral is generally an appropriate method for achieving balanced incentive compensation arrangements for each type of executive officer at these institutions or whether there are alternative or more effective ways to achieve such balance.

Commenters are also asked to address the possible impact that the required minimum deferral provisions for senior executives may have on larger covered financial institutions and whether the proposed or different deferral requirements should apply to senior executives at institutions other than larger covered financial institutions. For example, would it be prudent to mandate deferred incentive-based compensation for certain types of covered financial institutions but not require such deferral for other institutions (e.g., investment advisers) based on the business, risks inherent to that business, or other relevant factors? Are there additional considerations, such as tax or accounting considerations, that may affect the ability of larger covered financial institutions to comply with the proposed deferral requirement or that the Agencies should consider in designing this provision in the rule? Comment is also sought on whether the mandatory deferral provisions of the rule should apply to a differently defined group of individuals at larger covered financial institutions, such as the institution's top 25 earners of incentive-based compensation? Commenters also are asked to address whether the three-year and 50 percent of incentive-based compensation minimums are appropriate? Should the minimum required deferral period be extended to, for example, five years?

#### Special Review and Approval Requirement for Other Designated Individuals

Other individuals at a larger covered financial institution, beyond the institution's executive officers may have the ability to expose the institution to possible losses that are

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substantial in relation to the institution's size, capital, or overall risk tolerance. In order to help ensure that the incentive compensation arrangements for these individuals are appropriately balanced, and do not encourage the individual to expose the institution to risks that could pose a risk of material financial loss to the covered financial institution, the Proposed Rule would require that, at a larger covered financial institution, the board of directors, or a committee thereof, identify those covered persons (other than executive officers) that 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.<sup>32</sup> The proposal notes that these covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution. In addition, the Proposed Rule would require that the board of directors, or a committee thereof, of the institution approve the incentive-based compensation arrangement for such individuals, and maintain documentation of such approval.

Under the proposal, the board of directors, or committee thereof, of a larger covered financial institution may not approve the incentive-based compensation arrangement for an individual identified by the board of directors, or committee thereof, unless the board (or committee) determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity. The proposal recognizes that the methods used

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<sup>32</sup> In addition to the compensation-deferral requirement described above, the FHFA proposes to apply this requirement too to all of the entities it regulates without regard to asset size.

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to balance the rewards and risks of the individual's activities may include deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods, or other appropriate methods. However, the board of directors, or committee thereof, must determine that the method(s) used effectively balance the financial rewards to the covered person and the range and time horizons of the risks associated with the covered person's activities. In performing its duties in this regard, the board, or committee thereof, must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person, as well as the ability of the methods used to make payments sensitive to the full range of risks presented by that covered person's activities, including those risks that may be difficult to predict, measure, or model.

The Agencies request comment on these proposed additional identification, review, and approval requirements for larger covered financial institutions with respect to individuals that 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. Is the proposed special treatment of these covered persons necessary or appropriate, or is their incentive compensation adequately addressed by the prohibitions applicable to all other covered persons (other than executive officers at larger covered financial institutions) under the proposal? Is it sufficient that, as under the proposal, such covered persons are not subject to mandatory deferral but instead are separately identified by the institution's board and the board is required to approve the incentive-based compensation arrangement for the covered person after ensuring it is balanced and

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sensitive to risk? Should further guidance be provided as to the meaning of the phrase “substantial in relation to the institution’s size, capital, or overall risk tolerance”?

§ \_\_\_\_.6 Policies and Procedures. As noted above, the Agencies believe that the incentive-based compensation practices of covered financial institutions should be supported by policies and procedures, appropriate to the size and complexity of the covered financial institution, to foster transparency of each covered financial institution’s incentive-based compensation practices and to promote compliance and accountability regarding the practices that the Agencies propose to prohibit. Accordingly, the Proposed Rule would require covered financial institutions to have policies and procedures governing the award of incentive-based compensation as a way to help ensure the full implementation of the prohibitions in the Proposed Rule.

The Agencies believe that the policies and procedures developed by each covered financial institution in this area should be appropriately tailored to balance risk and reward for an institution of its size, complexity, and business activity, as well as the scope and nature of the covered financial institution’s incentive-based compensation arrangements. Therefore, the policies and procedures of smaller covered financial institutions with less complex incentive-based compensation programs would be expected to be less extensive than those of larger covered financial institutions with relatively complex programs and business activities. The Agencies note, however, that no categories of covered financial institutions using incentive-based compensation would be systematically or completely exempt from developing, maintaining, and documenting their incentive-based compensation policies and procedures.

As noted above, the prohibition on incentive-based compensation arrangements that could lead to material financial loss would affect only those arrangements for covered persons

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that, either individually or as a group, may expose the institution to material financial loss.

Accordingly, the policies and procedures of an institution related to this prohibition should be focused on these covered persons. Depending on the facts and circumstances of the individual covered financial institution, certain jobs and classes of jobs may not have the ability to expose the organization to material financial loss and, as a result, incentive-based compensation arrangements for these covered persons within these job classes may be outside the scope of these restrictions. Examples of jobs and classes of jobs that may be unlikely to expose the institution to material risk include tellers, bookkeepers, couriers, or data processing personnel.

Paragraph (b)(1) of section \_\_\_\_\_.6 of the Proposed Rule would require that the policies and procedures, at a minimum, be designed to address the section \_\_\_\_\_.4 reporting requirements and the section \_\_\_\_\_.5 prohibitions.<sup>33</sup> Requiring such policies and procedures of covered financial institutions that award incentive-based compensation would promote compliance with the prohibitions in practice.

In order to help ensure that the risks inherent in a covered person's actions are appropriately captured, the Agencies believe that risk-management, risk-oversight, and internal-control personnel should be involved in all phases of the process for designing incentive-based compensation arrangements. Risk-management and risk-oversight personnel also should have responsibility for ongoing assessment of incentive-based compensation policies to help to ensure that the covered financial institution's processes remain up-to-date and effective relative to its incentive compensation practices. The ongoing involvement of such personnel in the evaluation

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<sup>33</sup> In addition, for U.S. operations of foreign banking organizations ("FBOs"), the organization's policies, including management, review, and approval requirements for its U.S. operations, should be coordinated with the FBO's group-wide policies developed in accordance with the rules of the FBO's home country supervisor. The policies of the FBO's U.S. operations should also be consistent with the FBO's overall corporate and management structure, as well as its framework for risk-management and internal controls.

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of incentive-based compensation arrangements also helps to ensure that risks are properly understood and evaluated as such risks change over time in light of a continuously changing business environment. Accordingly, paragraph (b)(2) of section \_\_\_\_.6 of the Proposed Rule would make such a requirement part of the covered financial institution's policies and procedures governing incentive-based compensation.

Paragraph (b)(3) of section \_\_\_\_.6 would require that a covered financial institution's policies and procedures provide for the monitoring by a group or person independent of the covered person, where practicable in light of the institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive-based compensation payments are reduced to reflect adverse risk outcomes or high levels of risk taken. To be considered independent under the Proposed Rule, the group or person at the covered financial institution monitoring or assessing incentive-based compensation awards must have a separate reporting line to senior management from the covered person who is creating the risks so as to help ensure that the analysis of risk is unbiased. Given the dynamic nature of risk management, the Proposed Rule also provides for incentive-based compensation awards to be monitored in light of risks taken and outcomes to determine whether incentive-based payments should be modified. The Agencies contemplate that the procedures relating to the adjustment of deferred amounts would be used by covered financial institutions required to defer a portion of their incentive-based compensation under section \_\_\_\_.6 of this Rule to augment their compliance with the deferral obligation.

Paragraph (b)(4) of section \_\_\_\_.6 would require a covered financial institution to develop and maintain policies and procedures designed to ensure that the covered financial institution's

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board of directors, or a committee thereof, receive data and analysis from management and other sources sufficient to allow it to assess whether the overall design and performance of the firm's incentive-based compensation arrangements are consistent with section 956 of the Act. As with other provisions of the Proposed Rule, the scope and nature of the data and analysis should be appropriate to the size and complexity of the covered financial institution and its use of incentive-based compensation. The Agencies expect that the board of directors, or committee thereof, would take into consideration the firm's overall risk management policies and procedures and the requirements of section 956(b) of the Act when assessing compliance with the Act.

Paragraph (b)(5) of section \_\_\_\_6 of the Proposed Rule would specify that the policies and procedures of a covered financial institution must provide that the institution maintains sufficient documentation of the institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements sufficient to enable the institution's appropriate Federal regulator to determine the covered financial institution's compliance with section 956 of the Act and the Proposed Rule. Given that the determinations to be made regarding incentive-based compensation are fact-specific, the Agencies believe that effective documentation of the covered financial institution's policies, procedures and actions related to incentive-based compensation is essential both to help promote the risk-based discipline that section 956 of the Act seeks to foster with respect to covered financial institutions and to facilitate meaningful oversight and examination. In this context, the Agencies would expect the documentation maintained by a covered financial institution under the Proposed Rule to include, but not be limited to, the following:

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- (1) A copy of the covered financial institution's incentive-based compensation arrangement(s) or plan(s);
- (2) The names and titles of individuals covered by such arrangement(s) or plan(s);
- (3) A record of the incentive-based compensation awards made under the arrangement(s) or plan(s); and
- (4) Records reflecting the persons or units involved in the approval and ongoing monitoring of the arrangement(s) or plan(s).

Paragraph (b)(6) of section \_\_\_\_\_.6 of the Proposed Rule would provide that, where a covered financial institution uses deferral in connection with an incentive-based compensation arrangement, the institution's policies and procedures provide for deferral of any such payments in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution.<sup>34</sup> Further, proposed paragraph (b)(6) would require that any such deferred amounts paid be adjusted for actual losses or other measures or aspects of performance that are realized or become better known during the deferral period. The Agencies believe that risk-management personnel at the covered financial institution would play a substantial role in identifying and evaluating risks that become better known with the passage of time. The Agencies contemplate that the procedures relating to the adjustment of deferred amounts would be used by covered financial institutions required to defer a portion of

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<sup>34</sup> The Proposed Rule would require deferral for at least three years of at least 50 percent of the incentive-based compensation for executive officers of larger covered financial institutions (generally those with \$50 billion or more in total consolidated assets). Most covered financial institutions with total consolidated assets under \$50 billion would be required to adopt procedures applicable to deferred compensation only when the firm elects to use deferral in its incentive-based compensation program.

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their incentive-based compensation under section \_\_\_\_5 of the Proposed Rule to facilitate their compliance with the deferral obligation.

Given the importance of incentive-based compensation arrangements to a covered financial institution's safety and soundness, paragraph (b)(7) of section \_\_\_\_6 would require the policies and procedures to subject any incentive-based compensation arrangement or component thereof to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee of the board of directors. As discussed above, covered financial institutions should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors. The Agencies believe that the board of directors or a committee thereof is ultimately responsible for a covered institution's incentive-based compensation arrangements, which should appropriately balance risk and rewards. Therefore, the board or its committee should engage in regular oversight of the covered financial institution's incentive-based compensation arrangements.

The Agencies are aware that covered persons at certain covered financial institutions who have been awarded equity as part of a deferred incentive-based compensation arrangement may wish to use personal hedging strategies as a way to lock in value for equity compensation that is vested over time. The Agencies are concerned that undertaking such hedging strategies during deferral periods could diminish the alignment between risk and financial rewards that may be achieved through these types of deferral arrangements. The Agencies have not included policies and procedures regarding such personal hedging strategies in the Proposed Rule, but the Agencies are concerned that, to the extent personal hedging strategies may be widespread, such practices would serve to diminish the effectiveness of a covered financial institution's policies

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and procedures. Thus, the Agencies are considering whether a covered financial institution's policies and procedures should be required to specifically include limits on personal hedging strategies. To assist in the evaluation of such a provision, in addition to requesting comment on all aspects of section \_\_\_\_.6 of the Proposed Rule, the Agencies are requesting commenters to describe the extent to which covered financial institutions prohibit such practices among their covered persons today. Would prohibiting the use of financial derivatives, insurance contracts or other similar mechanisms to hedge against the market risk of equity-based incentive-based compensation be an effective means to help to ensure that incentive-based compensation arrangements remain aligned with the risk assumed by covered persons? Are there other factors the Agencies should take into account when considering if, or how, to address personal hedging activity by covered persons?

§ \_\_\_\_.7 Evasion. Section \_\_\_\_.7 of the Proposed Rule would prohibit a covered financial institution from evading the restrictions of the rule by doing any act or thing indirectly, or through or by any other person, that would be unlawful for the covered institution to do directly under the Proposed Rule. This anti-evasion provision is designed to prevent covered financial institutions from, for example, making substantial numbers of its covered persons independent contractors for the purpose of evading this subpart. The Agencies do not intend, however, to disrupt bona fide independent contractor relationships of covered financial institutions.

Comments are invited on whether greater specificity is required in identifying possible evasion tactics, and on all aspects of section \_\_\_\_.7.

#### **IV. REQUEST FOR COMMENTS**

The Agencies encourage comment on any aspect of this proposal and especially on those

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issues specifically noted in this preamble.

### **Solicitation of Comments on Use of Plain Language**

Section 722 of the Gramm-Leach-Bliley Act, Pub. L. 106-102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), 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 your comments on how to make this proposal easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?
- Does the proposed regulation 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 regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could we do to make the regulation easier to understand?

### **NCUA Agency Regulatory Goal**

NCUA's goal is to promulgate clear and understandable regulations that impose minimal regulatory burden. We request your comments on whether the proposed rule is understandable and minimally intrusive if implemented as proposed.

## **V. REGULATORY ANALYSIS:**

### **A. Regulatory Flexibility Act**

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**OCC:** Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b) (RFA), the 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 \$175 million) and publishes its certification and a short, explanatory statement in the Federal Register along with its proposed rule.

Consistent with section 956(f) of the Dodd-Frank Act, the OCC's proposed rule only would apply to national banks and Federal branches and agencies that have total consolidated assets of \$1 billion or more. The Proposed Rule would not apply to any small national banks and Federal branches and agencies, as defined by the RFA. Therefore, the OCC certifies that the Proposed Rule would not, if promulgated, have a significant economic impact on a substantial number of small entities.

**Board:** The Board has considered the potential impact of the Proposed Rule on small banking organizations in accordance with the Regulatory Flexibility Act (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 Act a covered financial institution also must disclose to its appropriate Federal regulator the structure

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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 financial institutions” as defined in section 956 of the Dodd-Frank Act. Covered financial 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 financial 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 \$175 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 financial institution to submit a report annually to its appropriate regulator or supervisor in a format specified by its appropriate Federal regulator that describes the structure of the covered financial institution’s incentive-based compensation arrangements for covered persons. The volume and detail of information provided annually by a covered financial institution should be commensurate with the size and complexity of the institution, as well as the scope and nature of its incentive-based compensation arrangements. As such, the Board expects that the volume and detail of information provided by a large, complex institution that uses incentive-based arrangements to a significant degree would be substantially greater than that submitted by a smaller institution that has only a few incentive-based compensation arrangements or arrangements that affect only a limited number of covered persons.

The Proposed Rule would implement section 956(b) of the Dodd-Frank Act by prohibiting a covered financial institution from having incentive-based compensation

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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 and other requirements for certain covered persons at covered financial institutions with total consolidated assets of more than \$50 billion. 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 Banking Agency Guidance, as defined in the “Supplementary Information” above).

The Proposed Rule would require covered financial institutions to have policies and procedures governing the award of incentive-based compensation as a way to help ensure the full implementation of the prohibitions in the Proposed Rule. The Board believes that the policies and procedures developed by each covered financial institution in this area should be appropriately tailored to balance risk and reward for an institution of its size, complexity, and business activity, as well as the scope and nature of the covered financial institution’s incentive-based compensation arrangements. Therefore, the policies and procedures of smaller covered financial institutions with less complex incentive-based compensation programs would be expected to be less extensive than those of larger covered financial institutions with relatively complex programs and business activities.

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As noted above, because the Proposed Rule applies to institutions that have more than \$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 Regulatory Flexibility Act. 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 organizations 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 Regulatory Flexibility Act, 5 U.S.C. 601-612 (RFA), an agency must publish an initial regulatory flexibility analysis with its Proposed Rule, unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. For purposes of the RFA, small entities are defined to include banks with less than \$175 million in assets.

Consistent with section 956 of the Dodd-Frank Act, the FDIC's Proposed Rule would only apply to a State nonmember bank and an insured U.S. branch of a foreign bank that has total consolidated assets of \$1 billion or more and offers incentive compensation. The Proposed Rule would not apply to any small banks as defined by the RFA. Thus, the FDIC certifies that the Proposed Rule, if promulgated, would not have a significant economic impact on a substantial number of small entities.

**OTS:** Pursuant to § 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b) (RFA), the regulatory flexibility analysis otherwise required under § 603 of the RFA is not required if the

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agency certifies that the proposed rule, if promulgated, will not have a significant economic impact on a substantial number of small entities and publishes its certification and a short, explanatory statement in the Federal Register along with its proposed rule. OTS certifies that the Proposed Rule would not have a significant impact on a substantial number of small entities. The Small Business Administration has defined “small entities” for banking purposes as a bank or savings association with \$175 million or less in assets. 13 CFR 121.201. Since OTS’s Proposed Rule only applies to savings associations and savings and loan holding companies with \$1 billion or more of assets, it will not apply to any small entities.

**FHFA:** Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 601 et seq., FHFA hereby certifies that the Proposed Rule will not have a significant economic impact on a substantial number of small entities.

**NCUA:** In accordance with the Regulatory Flexibility Act, 5 U.S.C. 601-612 (RFA), NCUA must publish an initial regulatory flexibility analysis with its Proposed Rule, unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities, meaning those credit unions under \$10 million in assets. NCUA Interpretive Ruling and Policy Statement 03-2, 68 FR 31949 (May 29, 2003). The Dodd-Frank Act section 956 and the NCUA’s proposed rule only apply to credit unions of \$1 billion in assets or more. Accordingly, NCUA certifies that the Proposed Rule would not have a significant economic impact on a substantial number of small entities and, therefore, a regulatory flexibility analysis is not required.

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**SEC:** The Commission has prepared the following Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act<sup>35</sup> regarding proposed Sections 248.201 through 248.207. The Commission encourages comments with respect to any aspect of this IRFA, including comments with respect to the number of small entities that may be affected by the proposed rules. Comments should specify the costs of compliance with the proposed rules and suggest alternatives that would accomplish the goals of the rules. Comments will be considered in determining whether a Final Regulatory Flexibility Analysis is required and will be placed in the same public file as comments on the proposed rules. Comments should be submitted to the Commission at the addresses previously indicated.

#### **1. Small Entities Subject to the Rule**

As described in more detail above, the proposed rules would implement Section 956 of the Dodd-Frank Act, codified as 12 U.S.C. 5641. For purposes of Commission rulemaking in connection with the RFA, a small entity includes a broker-dealer: (i) with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act, and (ii) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in this section.<sup>36</sup> Commission rules further provide that, for the purposes of the Investment Advisers Act of 1940, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than \$25 million; (ii) did not have total assets of \$5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another

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<sup>35</sup> 5 U.S.C. 603.

<sup>36</sup> 17 CFR 240.0-10(c). See 17 CFR 240.17a-5(d).

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investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had \$5 million or more on the last day of its most recent fiscal year (“small adviser”).<sup>37</sup>

Section 956 of the Dodd-Frank Act requires regulators, including the Commission, to jointly promulgate rules that apply to covered financial institutions with assets of at least \$1 billion. The Commission believes that broker-dealers and investment advisers that would be subject to the proposed rule would either have \$1 billion in assets or be affiliated with a firm that is characterized by at least \$1 billion in assets. Therefore, the Commission preliminarily believes that there should not be any small broker-dealers or investment advisers impacted by this proposed rule.

## **2. Duplicative, Overlapping, or Conflicting Federal Rules**

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed rules.

## **3. Significant Alternatives**

Pursuant to section 3(c) of the RFA,<sup>38</sup> the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part of the rule, for small entities.

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<sup>37</sup> Rule 0-7(a). 17 CFR 275.0-7(a).

<sup>38</sup> 5 U.S.C. 603(c).

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The Commission does not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities; or summarily exempt small entities from coverage of the rule, or any part of the rule because the proposed rule will not apply to any small entities.

#### **4. Request for Comments**

The Commission encourages the submission of comments to any aspect of this portion of the IRFA. In particular, comments are encouraged on whether any small entities would be subject to the terms of the proposed rule. Comments should specify costs of compliance with the proposed rules and suggest alternatives that would accomplish the objective of the proposed rules.

#### **B. Paperwork Reduction Act**

##### Request for Comment on Proposed Information Collection

In accordance with section 3512 of the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. § 3501-3521), 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 have been submitted by the FDIC, OCC, OTS, 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 C.F.R. § 1320). For the FHFA, the proposed rule does not contain any information collected from Fannie Mae Freddie Mac and the Federal Home Loan Banks, including the Office of Finance, that requires the approval of OMB under the Paperwork

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Reduction Act (44 U.S.C. § 3501 et seq.). The Board reviewed the proposed rule under the authority delegated to the Board by OMB. The proposed rule contains requirements subject to the PRA. The reporting requirements are found in section \_\_.4 and the recordkeeping requirements are found in sections \_\_.5(b)(3)(ii)(B), \_\_.6(a), and \_\_.6(b)(5).

Comments are invited on:

- (a) Whether the collection of information is necessary for the proper performance of the agencies' functions, including whether the information has practical utility;
- (b) The accuracy of the estimate of the burden of the information collection, including the validity of the methodology and assumptions used;
- (c) Ways to enhance the quality, utility, and clarity of the information to be collected;
- (d) Ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology; and
- (e) Estimates of capital or startup costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Comments should be addressed to:

**FDIC:** You may submit written comments, identified by the RIN, by any of the following methods:

- Agency Web Site: <http://www.fdic.gov/regulations/laws/federal/propose.html>. Follow the instructions for submitting comments on the FDIC website.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.

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- E-mail: [Comments@FDIC.gov](mailto:Comments@FDIC.gov). Include RIN 3064-AD56 on the subject line of the message.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, FDIC, 550 17<sup>th</sup> Street, NW., Washington, DC 20429.
- Hand Delivery/Courier: Comments may be hand delivered to the guard station at the rear of the 550 17<sup>th</sup> Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

Public Inspection: All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose.html> including any personal information provided. Comments may be inspected at the FDIC Public Information Center, Room E-1002, 3501 Fairfax Drive, Arlington, VA 22226, between 9:00 a.m. and 5:00 p.m. on business days.

**OCC:** You should direct all written comments to: Communications Division, Office of the Comptroller of the Currency, Public Information Room, Mailstop 2-3, Attention: 1557-NEW, 250 E Street, SW., Washington, DC 20219. In addition, comments may be sent by fax to 202-874-5274, or by electronic mail to [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov). You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling 202-874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

**OTS:** Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552; send a facsimile transmission to 202-906-6518; or

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send an e-mail to [infocollection.comments@ots.treas.gov](mailto:infocollection.comments@ots.treas.gov). OTS will post comments and the related index on the OTS Internet site at <http://www.ots.treas.gov>. In addition, interested persons may inspect the comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment, call 202-906-5922, send an e-mail to [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), or send a facsimile transmission to 202-906-7755.

**NCUA:** 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.
- NCUA website:  
<http://www.ncua.gov/RegulationsOpinionsLaws/proposedregs/proposedregs.html>.  
Follow the instructions for submitting comments.
- E-mail: Address to [regcomments@ncua.gov](mailto:regcomments@ncua.gov). Include “[Your name] Comments on Notice of Proposed Rulemaking 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 David Chow, Deputy Chief Information Officer, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314-3428.
- Hand Delivery/Courier: Same as mail address.

Additionally, you should send a copy of your comments to the OMB Desk Officer for the NCUA, by mail to U.S. Office of Management and Budget, 725 17<sup>th</sup> Street, NW., 10235, Washington, DC 20503, or by fax to 202-395-6974. The Paperwork Reduction Act requires

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OMB to make a decision concerning the collection of information contained in the proposed regulation between 30 and 60 days after publication of this document in the Federal Register.

Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the NCUA on the proposed regulation.

**SEC:** Comments should be directed to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and commenters also should send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090, and refer to File No. XX. We will post all public comments we receive without change, including any personal information you provide, such as your name and address, on the SEC website at <http://www.sec.gov>. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. XX, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE., Washington, DC 20549-0213. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release in the *Federal Register*. A comment to OMB is best assured of having full effect if OMB receives it within 30 days after publication of this release.

**Board:** You may submit comments, identified by Docket No. R-XX, by any of the following methods:

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- Agency website: <http://www.federalreserve.gov>. Follow the instructions for submitting comments on the <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](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- FAX: 202-452-3819 or 202-452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's website at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20<sup>th</sup> and C Streets, NW.) between 9:00 a.m. and 5:00 p.m. on weekdays.

#### Proposed Information Collection

*Title of Information Collection:* Reporting and Recordkeeping Requirements Associated with Incentive-based Compensation Arrangements.

*Frequency of Response:* Annual.

*Affected Public:* Businesses or other for-profit.

*Respondents:*

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*FDIC:* State nonmember banks or an insured U.S. branch of a foreign bank that has total consolidated assets of \$1 billion or more.

*OCC:* National banks and Federal branches and agencies of foreign banks with \$1 billion or more in total assets.

*OTS:* Savings associations and savings and loan holding companies with \$1 billion or more in total assets.

*NCUA:* Credit unions with \$1 billion or more in total assets, and their executive officers, directors, and employees

*SEC:* Broker-dealers registered under section 15 of the Securities Exchange Act of 1934<sup>39</sup> with \$1 billion or more in total assets and investment advisers, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940, with \$1 billion or more in total assets<sup>40</sup> (collectively “covered BDs and IAs”).

*Board:* State member banks, bank holding companies, and state-licensed uninsured branches and agencies of foreign banks with more than \$1 billion in total assets, and the U.S. operations of foreign banking organizations with \$1 billion or more in U.S. assets.

*Abstract:* Section 956 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

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<sup>39</sup> 15 U.S.C. 78o.

<sup>40</sup> 15 U.S.C. 80b-2(a)(11). By its terms, the definition of “covered financial institution” in Section 956 includes any firm that meets the definition of “investment adviser” under the Investment Advisers Act of 1940 (“Investment Advisers Act”), regardless of whether the firm is registered as an investment adviser under the 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.

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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(a) would require covered financial institutions that have total consolidated assets of \$1 billion or more to submit a report annually to the Agency that describes the structure of the covered financial institution’s incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the institution.

Section \_\_.4(b) would require the following minimum standards:

- (1) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons;
- (2) A succinct description of the covered financial institution’s policies and procedures governing its incentive-based compensation arrangements;
- (3) If the covered financial institution has total consolidated assets of \$50 billion or more,<sup>39</sup> an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution’s:
  - (i) Executive officers; and

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<sup>39</sup> For credit unions, \$10 billion or more.

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(ii) Other covered persons who the board of directors, or a committee thereof, of the institution has identified and determined under § \_\_.5(b)(3)(ii) of this part 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;

(4) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted under paragraph (a)(1) of this section; and

(5) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan: (i) does not provide covered persons incentives to engage in behavior that is likely to cause the covered financial institution to suffer material financial loss; and (ii) does not provide covered persons with excessive compensation.

Section \_\_.5(b)(3)(ii)(B) would require the board of directors of covered financial institutions that have total consolidated assets of \$50 billion or more to approve and document the identification of those covered persons that 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.

Section \_\_.6(b)(5) would ensure that documentation of the institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the Agency to determine the institution's compliance with 12 U.S.C. § 5641.

Estimated Burden:

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## FDIC

Number of respondents: 301 (12 institutions with total consolidated assets of \$50 billion or more and 289 institutions with total consolidated assets between \$1 billion and \$50 billion; 4,466 institutions with total consolidated assets below \$1 billion are exempt). .

Burden per respondent for initial set up: 180 hours for institutions with \$50 billion or more in total assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between \$1 billion and \$50 billion in total assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with \$50 billion or more in total assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between \$1 billion and \$50 billion in total assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total FDIC annual burden: 30,455 hours (22,390 hours for initial set-up and 8,065 hours for ongoing compliance).

## OCC

Number of respondents: 158 (18 institutions with total consolidated assets of \$50 billion or more and 140 institutions with total consolidated assets between \$1 billion and \$50 billion; 1,215 institutions and 67 trust companies with total consolidated assets below \$1 billion are exempt). .

Burden per respondent for initial set up: 180 hours for institutions with \$50 billion or more in total assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between \$1 billion and \$50 billion in total assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

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Burden per respondent for ongoing compliance: 70 hours for institutions with \$50 billion or more in total assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between \$1 billion and \$50 billion in total assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total OCC annual burden: 17,800 hours (13,040 hours for initial set-up and 4,760 hours for ongoing compliance).

### OTS

Number of respondents: 163 (17 institutions with total consolidated assets of \$50 billion or more and 146 institutions with total consolidated assets between \$1 billion and \$50 billion).

Burden per respondent for initial set up: 180 hours for institutions with \$50 billion or more in total assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between \$1 billion and \$50 billion in total assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with \$50 billion or more in total assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between \$1 billion and \$50 billion in total assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total OTS annual burden: 18,120 hours (13,280 hours for initial set-up and 4,840 hours for ongoing compliance).

### NCUA

Number of respondents: 184 (6 institutions with total consolidated assets of \$10 billion or more and 178 institutions with total consolidated assets between \$1 billion and \$10 billion).

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Burden per respondent for initial set up: 180 hours for institutions with \$10 billion or more in total assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between \$1 billion and \$10 billion in total assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with \$10 billion or more in total assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between \$1 billion and \$10 billion in total assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total NCUA annual burden: 18,410 hours (13,540 hours for initial set-up and 4,870 hours for ongoing compliance).

## SEC

Number of respondents: The proposed rule would establish additional reporting and recordkeeping burdens for broker-dealers that are covered financial institutions (“covered BDs and IAs”) with assets of at least \$50 billion, as compared to covered BDs and IAs with assets between \$1 billion and \$50 billion. The Commission estimates that approximately 200 respondents (approximately 130 broker-dealers and approximately 70 investment advisers) would be affected generally by the proposed rules, and that approximately 30 of the 200 respondents would be affected by proposed Section 248.204(c)(3) and Section 248.205(b)(3)(ii)(B).<sup>40</sup>

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<sup>40</sup> Each Federal regulator has proposed how to calculate a firm’s “total consolidated assets”. For broker-dealers, the determination of whether the broker-dealer had \$1 billion in assets would be made by reference to the broker-dealer’s year-end audited consolidated statement of financial condition filed with the Commission pursuant to Rule 17a-5. For investment advisers, asset size would be determined by the adviser’s total assets shown on the balance sheet for the adviser’s most recent fiscal year end. Data from the SEC’s Office of Risk, Strategy and Financial Innovation indicates that there are 132 registered broker-

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#### **A) Proposed Section 248.204 (Required Reports)**

The Commission, jointly with the other Agencies, proposes that covered BDs and IAs be required to describe the structure of the firms' incentive-based compensation arrangements for covered persons in a manner that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the firm. Proposed Section 248.204(c)(1) would require a narrative description of the components of the incentive-based compensation arrangements applicable to covered persons, specifying the types of covered persons to which they apply. Proposed Section 248.204(c)(2) would require that covered BDs and IAs provide a succinct description of their incentive-based compensation policies and procedures. Proposed Section 248.204(c)(3) would require that covered BDs and IAs with total consolidated assets of \$50 billion or more provide the Commission with a succinct description of incentive-based compensation policies and procedures applicable to executive officers and other covered persons whom the board of directors, or a committee thereof, has identified as having the ability to expose the institution to possible losses that are substantial in relation to the firm's size, capital, or overall risk tolerance. Proposed Section 248.204(c)(4) would require covered BDs and IAs to describe the material changes to the firm's incentive based

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dealers with assets of \$1 billion or more and 18 broker-dealers with assets of at least \$50 billion. Most investment advisers currently do not report to the Commission the amount of their own assets, so the Commission is unable to determine how many have \$1 billion or more in assets and \$50 billion or more in total consolidated assets. See Form ADV, Part 1A, Item 12. The Commission estimates that advisers with assets under management of \$100 billion or more would have total consolidated assets of \$1 billion or more. Based on data from the Investment Adviser Registration Depository ("IARD"), the SEC's Division of Investment Management estimates that 68 registered advisers with assets under management of at least \$100 billion would have assets of \$1 billion or more, and 7 registered advisers with assets under management of at least \$500 billion would have total consolidated assets of at least \$50 billion. The Commission has rounded these numbers to 70 and 10 for purposes of its analysis.

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compensation arrangements. Proposed Section 248.204(c)(5) would require each covered BD and IA to describe the specific reasons why it believes the structure of its incentive-based compensation does not encourage inappropriate risks by the covered financial institution by providing covered persons with excessive compensation or incentive-based compensation that could lead to material financial loss to the covered financial institution.

Based on the initial and ongoing burden the Commission estimated in connection with the adoption of the executive compensation reporting requirements for public companies filing Form 10-Ks under the Exchange Act (i.e. Item 402 of Regulation S-K), the Commission estimates that the burden for the covered BD and IA respondents imposed by the proposed reporting requirements would be 100 hours.<sup>41</sup> Since the proposed rule does not provide for different reporting requirements for smaller covered BDs and IAs with assets between \$1 billion and \$50 billion and for larger firms with assets of at least \$50 billion, the Commission has not estimated separate reporting burdens for larger covered BDs and IAs. Therefore, the Commission estimates a collective reporting burden of 20,000 hours for covered BDs and IAs.<sup>42</sup>

**B) Documentation of Determining Designated Persons (Section 248.205(b)(3)(ii)(B))**

For covered BDs and IAs with assets of at least \$50 billion, proposed Section 248.205(b)(3)(ii)(B) would require a firm's board of directors, or a committee thereof, to identify those covered persons (other than executive officers) that individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or

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<sup>41</sup> The Commission estimated that public company respondents would incur approximately 95 hours of annual burden in connection with the adoption of Item 402 of Regulation S-K. See Securities Act of 1933 Release No. 8432A and Securities Exchange Act Release No. 54302A (August 29, 2006), 71 FR 53158, 53217 (September 8, 2006) (S7-03-06). The Commission is rounding this number up to 100 for the instant proposed rule estimate.

<sup>42</sup> 200 covered BDs and IAs x 100 hours = 20,000 hours.

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overall risk tolerance. These covered persons may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution. The Agencies propose that the compensation decisions applicable to such persons must be approved by the firm's board of directors or a committee of the board and that the covered BD or IA document the compensation decisions made by the board or its committee.

The Commission estimates that each covered BD and IA with assets of at least \$50 billion would incur 20 hours of burden initially to comply with the proposed recordkeeping requirements associated with the proposed rule and 10 hours of burden on an ongoing basis. Therefore, the Commission estimates an initial collective recordkeeping burden in connection with the documentation requirement provided in Section 248.205(b)(3)(ii)(B) is 600 hours for covered BDs and IAs with assets of at least \$50 billion.<sup>43</sup> The Commission estimates the ongoing collective recordkeeping burden in connection with this requirement to be 300 hours for covered BDs and IAs with assets of at least \$50 billion.<sup>44</sup>

### **C) Required Policies and Procedures**

Proposed Section 248.206(a) would require covered financial institutions to adopt and maintain policies and procedures reasonably designed to ensure and monitor compliance with 12 U.S.C. 5641, commensurate with the size and complexity of the organization and the scope and nature of its use of incentive-based compensation. As described in further detail above, proposed Section 248.206(b) would require that the policies and procedures, at a minimum, are consistent with the disclosure requirements and prohibitions in other parts of the proposed rule, ensure that

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<sup>43</sup> 30 covered BDs and IAs with assets of at least \$50 billion x 20 hours = 600 hours.

<sup>44</sup> 30 covered BDs and IAs with assets of at least \$50 billion x 10 hours = 300 hours.

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risk management or oversight personnel have a role in designing and assessing incentive-based compensation arrangements, provide for independent monitoring of the incentive-based compensation awards, risks taken and actual outcomes, require that a covered financial institution's board receive data and analysis from management and other sources sufficient to enable the board to assess whether the incentive-based compensation arrangements are consistent with 12 U.S.C. 5641, and require sufficient documentation of the covered financial institution's incentive-based compensation arrangements to enable the Commission to determine the covered BDs or IAs compliance with 12 U.S.C. 5641. In addition, the proposal would require that the covered BDs' and IAs' policies and procedures include certain features when a firm uses deferral in connection with an incentive-based compensation arrangement, and that the policies and procedures subject incentive-based compensation arrangements to a corporate governance framework.

Many covered BDs and IAs are already conforming to the incentive-based compensation standards reflected in the Guidance because they are affiliated with banking organizations supervised by the FRB, OCC, OTS or FDIC that have already altered their incentive-based compensation arrangements and policies and procedures following the publication of the Guidance. The Guidance applies to all banking organizations supervised by the FRB, OCC, OTS or FDIC, including national banks, State member banks, State nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, the U.S. operations of foreign banks with a branch, agency or commercial lending company in the United States, and Edge and agreement corporations (collectively "banking organizations").<sup>45</sup> Based

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<sup>45</sup> See Guidance 75 FR at 36398.

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upon information filed with the Commission and the staff's discussions with a number of BDs and its review of the public filings of covered BDs, IAs and certain parent companies, the Commission believes that covered BDs and IAs affiliated with banking organizations ("covered bank BDs and IAs") have already altered their incentive-based compensation policies and procedures and corresponding arrangements in conjunction with their affiliated banking organizations that are subject to the Guidance. Based on public filings with the Commission, the SEC estimates that there are approximately 25 covered bank BDs and IAs with total consolidated assets of at least \$50 billion and approximately 85 covered bank BDs and IAs with total consolidated assets between \$1 billion and \$50 billion.<sup>46</sup> Therefore, covered bank BDs and IAs should bear significantly less burden than those covered BDs and IAs not already subject to the Guidance ("covered non-bank BDs and IAs") to develop and maintain policies and procedures as required in the proposed rules. The Commission requests comment on its estimated number of covered bank BDs and IAs.

The Commission believes that the covered bank BDs and IAs would incur approximately the same recordkeeping burden as the banking organizations. Based on the initial estimates of recordkeeping burden provided by FRB, OCC, FDIC and OTS for proposed Section 248.206, the Commission estimates an initial recordkeeping burden of 80 hours for each covered bank BD and IA with \$50 billion or more in total consolidated assets and 40 hours of initial recordkeeping

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<sup>46</sup> The Commission estimates that there are approximately 20 covered bank BDs with assets of at least \$50 billion and 35 covered bank BDs with assets between \$1 billion and \$50 billion. The Commission bases the estimates for covered bank BDs upon data submitted to the Commission in FOCUS reports (i.e. Form X-17A-5 Part II). The Commission estimates that there are approximately 5 covered bank IAs with assets of at least \$50 billion and 50 covered bank IAs with assets between \$1 billion and \$50 billion. The estimates for covered bank IAs are based upon data submitted to the Commission in Form ADV (i.e. Form ADV Part 1A, Items 6.A.(6) and 7.A.(5)).

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burden for each covered bank BD and IA with total consolidated assets between \$1 billion and \$50 billion. Based on the ongoing estimates of recordkeeping burden provided by FRB, OCC, FDIC and OTS, the Commission believes that each covered bank BD and IA respondent with total consolidated assets of at least \$50 billion would incur approximately 30 hours of ongoing recordkeeping burden and each covered bank BD and IA respondent with total consolidated assets between \$1 billion and \$50 billion would incur approximately 10 hours of recordkeeping burden on an ongoing basis.

For covered non-bank BDs and IAs, the Commission estimates a significantly higher burden, namely the amount of burden that the banking agencies originally estimated in the Guidance (480 hours of initial burden, rounded up to 500 in the instant proposal and 40 hours of ongoing burden)<sup>47</sup> in addition to the amounts that the FRB, OTS, FDIC and OCC estimated in connection with the instant proposed rule. The Commission estimates that there are approximately 75 covered non-bank BDs with assets between \$1 billion and \$50 billion, 10 covered non-bank IAs with assets between \$1 billion and \$50 billion and 5 covered non-bank IAs with assets of at least \$50 billion.<sup>48</sup>

Therefore, for covered non-bank BDs and IAs, the Commission estimates an initial recordkeeping burden estimate of 580 hours<sup>49</sup> for covered BDs and IAs with \$50 billion or more

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<sup>47</sup> See Guidance, 75 FR at 36403.

<sup>48</sup> The Commission estimates that there are approximately 75 covered non-bank BDs with assets between \$1 billion and \$50 billion. The Commission estimates that there are approximately 5 covered non-bank IAs with assets of at least \$50 billion and 10 covered non-bank IAs with assets between \$1 billion and \$50 billion. The Commission bases these estimates upon data submitted to the Commission in FOCUS reports (*i.e.* Form X-17A-5 Part II) and in Form ADV (*i.e.* Form ADV Part 1A, Items 6.A.(6) and 7.A.(5)). See *supra* note 46. It is difficult to determine whether any unregistered advisers are non-bank IAs that are not subject to the Guidance.

<sup>49</sup> 500 hours (from Guidance) + 80 hours (from the estimate provided by the Fed, OCC, FDIC and OTS in instant proposed rule) = 580 hours.

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in total consolidated assets and 540 hours<sup>50</sup> of recordkeeping burden for covered BDs and IAs with total consolidated assets between \$1 billion and \$50 billion. The Commission estimates that covered non-bank BD and IA respondents with total consolidated assets of at least \$50 billion would incur approximately 70 hours<sup>51</sup> of ongoing recordkeeping burden while those covered non-Bank BDs and IAs with total consolidated assets between \$1 billion and \$50 billion would incur approximately 50 hours<sup>52</sup> of ongoing recordkeeping burden.

Total SEC initial and annual recordkeeping and reporting burdens (from proposed Section 248.205(b)(iii)(2)(B) and proposed Section 248.206):

|                                  | <u>Covered bank<br/>BDs and IAs<br/>(\$50B +)</u> | <u>Covered bank<br/>BDs and IAs<br/>(\$1B-\$50B)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$50B +)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$1B-\$50B)</u> |
|----------------------------------|---|--|--|---|
| <u>Initial Reporting</u>         | 2,500 hours <sup>53</sup>                         | 8,500 hours <sup>54</sup>                            | 500 hours <sup>55</sup>                                | 8,500 hours <sup>56</sup>                                 |
| <u>Initial<br/>Recordkeeping</u> | 2,500 hours <sup>57</sup>                         | 3,400 hours <sup>58</sup>                            | 3,000 hours <sup>59</sup>                              | 46,000 hours <sup>60</sup>                                |

<sup>50</sup> 500 hours (from Guidance) + 40 hours (from the estimate provided by the Fed, OCC, FDIC and OTS in instant proposed rule) = 540 hours.

<sup>51</sup> 40 hours (from Guidance) + 30 hours (from the estimate provided by the Fed, OCC, FDIC and OTS in instant proposed rule) = 70 hours.

<sup>52</sup> 40 hours (from Guidance) + 10 hours (from the estimate provided by the Fed, OCC, FDIC and OTS in instant proposed rule) = 50 hours.

<sup>53</sup> (20 covered bank BDs with assets of at least \$50B + 5 covered bank IAs with assets of at least \$50B) x 100 hours = 2,500 hours.

<sup>54</sup> (35 covered bank BDs with assets between \$1B and \$50B + 50 covered bank IAs with assets between \$1B and \$50B) x 100 hours = 8,500 hours.

<sup>55</sup> 5 covered non-bank IAs with assets of at least \$50B x 100 hours = 500 hours.

<sup>56</sup> (75 covered non-bank BDs with assets between \$1B and \$50B + 10 covered non-bank IAs with assets between \$1B and \$50B) x 100 hours = 8,500 hours.

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|                                  | <u>Covered bank<br/>BDs and IAs<br/>(\$50B +)</u> | <u>Covered bank<br/>BDs and IAs<br/>(\$1B-\$50B)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$50B +)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$1B-\$50B)</u> |
|----------------------------------|---|--|--|---|
| <u>Ongoing Reporting</u>         | 2,500 hours <sup>61</sup>                         | 8,500 hours <sup>62</sup>                            | 500 hours <sup>63</sup>                                | 8,500 hours <sup>64</sup>                                 |
| <u>Ongoing<br/>Recordkeeping</u> | 1,000 hours <sup>65</sup>                         | 1,000 hours <sup>66</sup>                            | 400 hours <sup>67</sup>                                | 4,300 hours <sup>68</sup>                                 |

<sup>57</sup> (20 covered bank BDs with assets of at least \$50B + 5 covered bank IAs with assets of at least \$50B) x 80 hours + ((20 covered bank BDs + 5 covered bank IAs) x 20 hours in connection with proposed Section 248.205(b)(3)(ii)(B)) = 2,500 hours.

<sup>58</sup> (35 covered bank BDs with assets between \$1B and \$50B + 50 covered bank IAs with assets between \$1B and \$50B ) x 40 hours = 3,400 hours.

<sup>59</sup> 5 covered non-bank IAs with assets of at least \$50B x 580 hours + ((5 covered non-bank IAs with assets of at least \$50B) x 20 hours in connection with proposed Section 248.205(b)(3)(ii)(B)) = 3,000 hours.

<sup>60</sup> (75 covered non-bank BDs with assets between \$1B and \$50B + 10 covered non-bank IAs with assets between \$1B and \$50B) x 540 hours = 45,900 hours.

<sup>61</sup> (20 covered bank BDs with assets of at least \$50B + 5 covered bank IAs with assets of at least \$50B) x 100 hours = 2,500 hours.

<sup>62</sup> (35 covered bank BDs with assets between \$1B and \$50B + 50 covered bank IAs with assets between \$1B and \$50B ) x 100 hours = 8,500 hours.

<sup>63</sup> 5 covered non-bank IAs with assets of at least \$50B x 100 hours = 500 hours.

<sup>64</sup> (75 covered non-bank BDs with assets between \$1B and \$50B + 10 covered non-bank IAs with assets between \$1B and \$50B) x 100 hours = 8,500 hours.

<sup>65</sup> (20 covered bank BDs with assets of at least \$50B + 5 covered bank IAs with assets of at least \$50B) x 30 hours + ((20 covered bank BDs + 5 covered bank IAs) x 10 hours in connection with proposed Section 248.205(b)(3)(ii)(B)) = 900 hours.

<sup>66</sup> (35 covered bank BDs with assets between \$1B and \$50B + 50 covered bank IAs with assets between \$1B and \$50B) x 10 hours = 850 hours.

<sup>67</sup> 5 covered non-bank IAs with assets of at least \$50B x 70 hours + (5 covered non-bank IAs with assets of at least \$50B x 10 hours in connection with proposed Section 248.205(b)(3)(ii)(B)) = 400 hours.

<sup>68</sup> (75 covered non-bank BDs with assets between \$1B and \$50B + 10 covered non-bank IAs with assets between \$1B and \$50B) x 50 hours = 4,250 hours.

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#### **D. External Costs**

The Commission also believes that the proposed rules would likely generate external costs to the covered BDs and IAs, particularly at the stage of preparing the initial reports required by Section 248.204 and initially developing and implementing the policies and procedures in compliance with Section 248.206. Covered BDs and IAs may elect to hire various types of professionals, including attorneys, benefits consultants, and accountants. The Commission estimates that the covered BDs and IAs would hire professionals to prepare the necessary reports and develop and maintain the necessary policies and procedures at approximately the same hourly level as the covered BDs and IAs assume internally (e.g. covered bank BDs and IAs with at least \$50 billion in assets would collectively use approximately the equivalent of 2,500 hours worth of professionals' time to prepare the required reports, in addition to the covered bank BDs' and IAs' internal burden to prepare them).

The Commission believes that there would be approximately an equal balance of attorneys,<sup>69</sup> benefits consultants,<sup>70</sup> actuaries<sup>71</sup> and accountants<sup>72</sup> that are hired at each covered

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<sup>69</sup> An outside attorney's salary range is estimated at \$400 an hour based on industry sources. See Securities Exchange Act Release No. 62174 (May 26, 2010) at note 510, 75 FR 32556 (June 8, 2010) (S7-15-09). The Commission requests comment on this estimate.

<sup>70</sup> An outside management consultant's salary range (national averages) is available from [www.payscale.com](http://www.payscale.com). Using their data from the 75<sup>th</sup> percentile, adjusting it for an 1800-hour work year, and multiplying by the 5.35 factor which normally is used to include benefits but here is used as an approximation to offset the fact that New York salaries are typically higher than the rest of the country, the result is \$596 per hour (rounded to \$600). The Commission requests comment on this estimate.

<sup>71</sup> An outside actuary's salary range (national averages) is available from [www.payscale.com](http://www.payscale.com). Using their data from the 75<sup>th</sup> percentile, adjusting it for an 1800-hour work year, and multiplying by the 5.35 factor which normally is used to include benefits but here is used as an approximation to offset the fact that New York salaries are typically higher than the rest of the country, the result is \$330 per hour. The Commission requests comment on this estimate.

<sup>72</sup> An outside accountant's salary range is available from the U.S. Bureau of Labor Statistics, Occupational Employment Statistics website. Using their data for median salaries from New York State, which has the highest

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BD or IA. The chart below summarizes the external costs that the Commission estimates covered BDs and IAs would assume collectively in connection with the proposed rule. The Commission requests comments on these external cost estimates, including the hourly rate that the Commission estimates for external attorneys, benefits consultants, actuaries and accountants.

Total SEC estimated external recordkeeping costs:

|                                  | <u>Covered bank<br/>BDs and IAs<br/>(\$50B +)</u> | <u>Covered bank<br/>BDs and IAs<br/>(\$1B-\$50B)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$50B +)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$1B-\$50B)</u> |
|----------------------------------|---|--|--|---|
| <u>Initial Reporting</u>         | \$1 million <sup>73</sup>                         | \$3.4 million <sup>74</sup>                          | \$200,000 <sup>75</sup>                                | \$3.4 million <sup>76</sup>                               |
| <u>Initial<br/>Recordkeeping</u> | \$1 million <sup>77</sup>                         | \$1.3 million <sup>78</sup>                          | \$1.2 million <sup>79</sup>                            | \$18 million <sup>80</sup>                                |

rates in the country, and multiplying by the 5.35 factor which is used to include benefits, the result is \$250 per hour. The Commission requests comment on this estimate.

$$^{73} \quad 2,500 \text{ hours} \times [(25\% \times \$400/\text{hour}) + (25\% \times \$600/\text{hour}) + (25\% \times \$330/\text{hour}) + (25\% \times \$250/\text{hour})] = \$987,500.$$

$$^{74} \quad 8,500 \text{ hours} \times [(25\% \times \$400/\text{hour}) + (25\% \times \$600/\text{hour}) + (25\% \times \$330/\text{hour}) + (25\% \times \$250/\text{hour})] = \$3,357,500.$$

$$^{75} \quad 500 \text{ hours} \times [(25\% \times \$400/\text{hour}) + (25\% \times \$600/\text{hour}) + (25\% \times \$330/\text{hour}) + (25\% \times \$250/\text{hour})] = \$197,500$$

$$^{76} \quad 8,500 \text{ hours} \times [(25\% \times \$400/\text{hour}) + (25\% \times \$600/\text{hour}) + (25\% \times \$330/\text{hour}) + (25\% \times \$250/\text{hour})] = \$3,357,500.$$

$$^{77} \quad 2,500 \text{ hours} \times [(25\% \times \$400/\text{hour}) + (25\% \times \$600/\text{hour}) + (25\% \times \$330/\text{hour}) + (25\% \times \$250/\text{hour})] = \$987,500.$$

$$^{78} \quad 3,400 \text{ hours} \times [(25\% \times \$400/\text{hour}) + (25\% \times \$600/\text{hour}) + (25\% \times \$330/\text{hour}) + (25\% \times \$250/\text{hour})] = \$1,343,000.$$

$$^{79} \quad 3,000 \text{ hours} \times [(25\% \times \$400/\text{hour}) + (25\% \times \$600/\text{hour}) + (25\% \times \$330/\text{hour}) + (25\% \times \$250/\text{hour})] = \$1,185,000.$$

$$^{80} \quad 46,000 \text{ hours} \times [(25\% \times \$400/\text{hour}) + (25\% \times \$600/\text{hour}) + (25\% \times \$330/\text{hour}) + (25\% \times \$250/\text{hour})] = \$18,170,000.$$

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|                                  | <u>Covered bank<br/>BDs and IAs<br/>(\$50B +)</u> | <u>Covered bank<br/>BDs and IAs<br/>(\$1B-\$50B)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$50B +)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$1B-\$50B)</u> |
|----------------------------------|---|--|--|---|
| <u>Ongoing Reporting</u>         | \$1 million <sup>81</sup>                         | \$3.4 million <sup>82</sup>                          | \$200,000 <sup>83</sup>                                | \$3.4 million <sup>84</sup>                               |
| <u>Ongoing<br/>Recordkeeping</u> | \$400,000 <sup>85</sup>                           | \$400,000 <sup>86</sup>                              | \$150,000 <sup>87</sup>                                | \$1.7 million <sup>88</sup>                               |

Board

Number of respondents: 664 (59 institutions with total consolidated assets of \$50 billion or more and 605 institutions with total consolidated assets between \$1 billion and \$50 billion).

Burden per respondent for initial set up: 180 hours for institutions with \$50 billion or more in total consolidated assets (80 hours for reporting requirements and 100 hours for recordkeeping requirements) and 70 hours for institutions between \$1 billion and \$50 billion in total

<sup>81</sup> 2,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$987,500.

<sup>82</sup> 8,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$3,357,500.

<sup>83</sup> 500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$197,500.

<sup>84</sup> 8,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$3,357,500.

<sup>85</sup> 1,000 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$395,000

<sup>86</sup> 1,000 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$395,000

<sup>87</sup> 400 hours X [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$158,000

<sup>88</sup> 4,300 hours X [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$1,698,500

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consolidated assets (30 hours for reporting requirements and 40 hours for recordkeeping requirements).

Burden per respondent for ongoing compliance: 70 hours for institutions with \$50 billion or more in total consolidated assets (40 hours for reporting requirements and 30 hours for recordkeeping requirements) and 25 hours for institutions between \$1 billion and \$50 billion in total consolidated assets (15 hours for reporting requirements and 10 hours for recordkeeping requirements).

Total Board annual burden: 72,225 hours (52,970 hours for initial set-up and 19,255 hours for ongoing compliance).

### **C. OTS Executive Order 12866 Determination**

Executive Order 12866 requires federal agencies to prepare a regulatory impact analysis for agency actions that are “significant regulatory actions.” Significant regulatory action means any regulatory action that is likely to result in a rule that may:

(1) Have an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or

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(4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive order.<sup>89</sup>

Based on its initial assessment, OTS anticipates that the proposed rule (if the final rule is the same as the proposed rule) would not be economically significant. Nonetheless, OTS solicits comment on the economic impact.

OTS does not anticipate that the proposal would create a serious inconsistency or otherwise interfere with an action taken or planned by another agency. OTS's proposal is essentially the same as the proposal of every other federal agency regulating the financial services industry. Thus, rather than creating any inconsistency, by being part of this joint interagency proposal, OTS's portion adds to the consistency of regulations on incentive-based compensation that will encompass the financial services industry.

OTS does not anticipate that the proposal would materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof. The proposal does not have any provisions related to those subjects.

The Office of Management and Budget's Office of Information and Regulatory Affairs has designated this proposed rule to be a significant regulatory action that is likely to result in a rule that may raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in Executive Order 12866. OTS notes that the proposal does raise some similar issues as were raised by the Banking Agency Guidance issued June 25, 2010, and the 1995 federal banking agency guidelines implementing the compensation-related and

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<sup>89</sup> See 58 FR 51735 (Oct. 4, 1993), as amended.

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other safety and soundness standards in section 39 of the FDIA (codified at 12 CFR pt. 570, App. A).

#### Need for Regulatory Action

The proposed rule is required by Section 956 of the Dodd-Frank Act. Thus, the proposal is needed to fulfill the statutory mandate that OTS and the other agencies participating in this joint rulemaking prescribe regulations or guidelines that:

1. Prohibit incentive-based payment arrangements, or any feature of any such arrangement, at a covered financial institution that the Agencies determine encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to a material financial loss.
2. Require covered financial institutions to 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.
3. Are comparable to the existing compensation-related safety and soundness standards applicable to insured depository institutions under section 39 of the FDIA (12 U.S.C. 1831p-1(c)) (12 CFR pt. 570, App. A for OTS).

The legislative history of the Dodd-Frank Act provides background on the need that Congress perceived to exist that led to the enactment of section 956.<sup>90</sup> Further information and

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<sup>90</sup> See H.R. Rep. 111-236, Corporate and Financial Institution Compensation Fairness Act of 2009, at 6 (2009) and Compensation Structure and Systemic Risk: Hearing Before the H. Comm. on Financial Services, 111<sup>th</sup> Cong. (2009).

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analysis is contained in the Final Report of the Financial Crisis Inquiry Commission.<sup>91</sup> OTS's portion of the proposed rule is intended to enhance the regulatory oversight of incentive compensation schemes at larger OTS-regulated savings associations and savings and loan holding companies so as to help ensure that compensation at such institutions is neither excessive in itself nor encourages excessive risk taking.

#### Scope of Proposed Rule

Section 956 of the Dodd-Frank Act defines "covered financial institutions" to include depository institutions and depository institution holding companies, as defined in section 3 of the FDIA, with assets of \$1 billion or more. OTS's portion of the proposed rule applies to savings associations and savings and loan holding companies with \$1 billion or more in total consolidated assets that have incentive-based compensation programs.

With regard to savings associations, as of December 31, 2010, OTS supervised 731 savings associations with a combined total of \$932 billion in assets. The largest savings association had assets of \$88 billion. Only three other savings associations had assets greater than \$50 billion. The smallest savings association had assets of \$3.5 million. Of the 731 savings associations, 103 have more than a \$1 billion each in total assets and thus are covered by the proposed rule (assuming they all have incentive-based compensation programs). Those 103 savings associations represent 85% of all thrift industry assets (\$793 billion of the total \$932 billion). To put this in context, however, the latest available data on commercial banks (dated September 30, 2010) show 508 commercial banks with assets of \$1 billion or more, but with

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<sup>91</sup> Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011, available at [http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic\\_final\\_report\\_full.pdf](http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf).

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combined total assets of \$11 trillion, more than eleven times the amount of assets compared to OTS supervised savings associations of \$1 billion or more.

With regard to savings and loan holding companies, as of December 31, 2010, OTS-supervised 102 savings and loan holding companies. Savings and loan holding companies are companies that own or control one or more savings associations. Excluding 42 shell holding companies that do not have incentive-based compensation programs, there are 60 savings and loan holding companies that are covered by the proposed rule (assuming they all have incentive-based compensation programs). These companies have consolidated assets ranging from \$1 billion to over \$750 billion, and vary in complexity as well as size. They conduct a wide range of activities beyond those conducted by the saving association(s) they control. These range from activities closely related to banking, such as insurance and securities brokerage, to activities conducted by large, multinational corporations, such as retailing and manufacturing.

Therefore, altogether, OTS's portion of the proposed rule would affect a maximum of 163 OTS-supervised institutions (103 savings associations and 60 savings and loan holding companies).

OTS further notes that the Board, OCC, and FDIC will assume supervisory and rulemaking responsibility for entities currently supervised and regulated by OTS on the transfer date provided in Title III of the Dodd-Frank Act. These agencies expect to adopt, or incorporate, as appropriate, any final rule adopted by OTS as part of this rulemaking for relevant covered financial institutions that come under their respective supervisory authority after the transfer date.

#### Types of Impact of Proposed Rule

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OTS reviewed existing practices at a subset of these 163 institutions to determine how much the rule would add to the current cost of administering incentive-based compensation programs. A covered financial institution would have to:

1. Submit an annual report to OTS describing the structure of its incentive-based compensation program in sufficient detail for OTS to determine whether the program provides excessive compensation or compensation that could lead to material loss to the institution. The annual report would have to include an analysis of the characteristics of the incentive-based compensation program that prevent excessive compensation and/or mitigate risk of material financial loss.
2. Review and, if necessary, redesign its incentive-based compensation system to ensure it has the elements necessary to adequately manage the risks arising from incentive-based compensation. The rule would contain a list of the minimum elements to be included in the policies and procedures.
3. Conduct ongoing monitoring and, as appropriate, auditing of the incentive-based compensation program to ensure that it does, in fact, allocate incentive-based compensation in a way that is not excessive and does not encourage inappropriate risks.

In estimating the implementation costs to covered financial institutions, OTS assumed that costs would generally fall in four areas:

1. Initially reviewing incentive-based compensation programs to determine whether program modifications are needed;
2. Modifying incentive-based compensation programs, where needed;

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3. Ongoing monitoring of incentive-based compensation programs to ensure continued compliance; and
4. Preparing and submitting required annual reports on the programs to OTS.

Almost all of the covered financial institutions have incentive-based compensation programs. Each covered financial institution, therefore, would need to perform an initial review to determine whether modifications would be needed. This initial review would also include the analysis necessary to prepare the first report to OTS.

Those institutions needing modifications would have to expend further resources to design and implement compliant systems that fit the institution's business strategy and internal structure. The complexity and length of this process would vary depending on the size of the institution, the scope of the institution's incentive-based compensation program, and the extent of necessary modifications.

The rule's burden would be minimized by granting covered financial institutions the latitude to employ a variety of means to mitigate the risks posed by their current incentive-based compensation programs. While institutions would have to develop policies and procedures that provide clear expectations, institutions could choose the incentive-based compensation risk balancing measures that best address their employees and their risks.<sup>92</sup>

OTS's provisional assessment is that most covered financial institutions would have to make minimal changes to their systems covering:

1. Compensation to executives;
2. The oversight exercised by the board and compensation committee;

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<sup>92</sup> The Federal Banking Agency Guidance presents and discusses these measures.

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3. The scope of risk management; and
4. The role of internal audit.

Some of the key restrictions in the proposed rule are restrictions that covered financial institutions are already observing. Section 563h.5(a) would provide that a covered financial institution 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 covered financial institution by providing a covered person with excessive compensation. Section 563h.5(b) would provide that a covered financial institution 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 covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution.

OTS and the other federal banking regulators have long required depository institutions to conform their compensation practices to principles of safety and soundness.<sup>93</sup> Since 1995, OTS and the other federal banking regulators have specifically prohibited depository institutions from paying compensation, fees, and benefits that are excessive or that could lead to material financial loss to the institutions.<sup>94</sup> Since 1995, OTS and the other federal banking regulators have also specified that compensation that could lead to material financial loss to an institution is prohibited as an unsafe and unsound practice.<sup>95</sup> The standards specified in section 563h.5(a)(2)

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<sup>93</sup> See section 39(c) of FDIA, 12 U.S.C. 1831p-1(c).

<sup>94</sup> See 12 CFR pt. 570, App. A, paragraph II.I.

<sup>95</sup> See 12 CFR pt. 570, App. A, paragraph III.B.

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for determining whether an incentive-based compensation arrangement provides excessive compensation are taken directly from the existing 1995 guidelines.<sup>96</sup>

Since June 25, 2010, OTS and the other federal banking regulators have maintained guidance designed to help ensure that incentive-based compensation policies at banking organizations do not encourage imprudent risk-taking and are consistent with the safety and soundness of the organization, including guidance on methods such as deferral that make compensation more sensitive to risk. The requirements specified in section 563h.5(b)(2) for avoiding incentive-based compensation arrangements that could lead to material financial loss are taken directly from the this guidance.<sup>97</sup> Most covered financial institutions, therefore, already have the listed elements in place. Further, a recent report of the Basel Committee on Banking Supervision (BCBS) noted that most larger institutions already use management accounting to map company performance to business units, and largely employ risk-adjusted return to capital and other economic efficiency measures to assess performance when making incentive-based compensation allocation decisions.<sup>98</sup>

Even the reporting requirements of section 563h.4 of the proposed rule would not be completely new for many institutions. Publicly listed institutions already disclose their incentive-based compensation systems.<sup>99</sup>

As a group, covered financial institutions are likely to have to make more significant changes to incentive-based compensation programs for non-executive employees and, to some

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<sup>96</sup> See 12 CFR pt. 570, App. A, paragraph III.A.

<sup>97</sup> 75 FR at 36405.

<sup>98</sup> BCBS Consultative paper: Range of Methodologies for Risk and Performance Alignment of Remuneration, available at <http://www.bis.org/publ/bcbs178.pdf>.

<sup>99</sup> SEC regulation 17 CFR 229.402(a)(2) requires listed companies to disclose all elements of the compensation provided to “named executive officers” and “directors.”

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degree, principal shareholders. While institutions have in place most of the internal policies and procedures necessary to run an incentive-based compensation program for these two groups, modifications would likely be necessary to ensure full compliance.

Larger institutions, defined as having total consolidated assets of \$50 billion or more, would have to defer at least 50 percent of the annual incentive-based compensation of executive officers for at least three years. These institutions would also apply special review and approval requirements for the incentive-based compensation arrangements for material risk takers.

Among OTS-supervised institutions, 13 holding companies and 4 thrifts would be subject to this requirement. These 17 institutions would likely need to make changes to their compensation programs, as it appears that none of them currently defers the required percentage of incentive-based compensation for the required amount of time.

Finally, institutions have an ongoing requirement to prepare annual reports and administer their incentive-based compensation program in compliance with the rule. The administration of the program would include calculating the amount of compensation subject to risk-based adjustment (e.g., deferral), calculating the performance metrics upon which incentive compensation are based, ensuring that independent review of compensation awards is conducted, and assessing the effectiveness of risk-based adjustments to incentive-based compensation payouts. As previously mentioned, institutions generally take these actions to comply with existing safety and soundness regulations and guidance.

#### Assessment of Impact of Proposed Rule

OTS believes that an institution would spend several hundred person hours conducting an initial review of its incentive-based compensation program and making any necessary

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modifications. All institutions of \$1 billion in total consolidated assets or more would have to conduct the review, and most institutions would have to make some modification to their incentive-based compensation programs.

OTS estimates that smaller institutions (those with less than \$50 billion in assets) would spend, at most, eight weeks (320 person hours) to perform the initial steps necessary to comply. Among the covered financial institutions, 146 fall into this category. Using \$150 as an estimate of hourly cost,<sup>100</sup> the total cost to the smaller institutions as a group would be \$7 million ( $\$150 \times 320 \text{ hours} \times 146 \text{ institutions}$ ). At larger institutions, these modifications would be more extensive because of the number of individuals involved and the amount the institution would have to expand and/or adjust risk sensitivity measures. The larger institutions may require as much as twice the time as smaller institutions to implement the rule, for an estimated cost of \$1.6 million ( $\$150 \times 640 \text{ hours} \times 17 \text{ institutions}$ ). The total initial implementation costs, therefore, should come to approximately \$8.6 million.

The subsequent ongoing costs associated with monitoring and managing incentive-based compensation programs, once established, are unlikely to be significantly greater than the costs associated with the administration of current incentive-based programs. OTS, therefore, believes that the ongoing annual costs of the rule would not exceed \$100 million. As previously discussed, institutions already have in place most of the mechanisms necessary to implement the rule's requirements. Once the institution makes adjustments indicated by its initial analysis, these mechanisms would continue to function as they do now.

Any ongoing costs in addition to those already incurred would be for:

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<sup>100</sup> OTS estimates that legal and administrative expenses would average, at most, \$150 per hour.

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1. Production of an annual report;
2. Administration of incentive-based compensation for a broader range of employees;
3. Administration of a more complex deferral scheme at some institutions; and
4. More sophisticated risk sensitivity mechanisms.

With respect to item 1, OTS believes that the costs of the annual report would be minimal. Reports after the first submitted would only need to document significant changes to the incentive-based compensation program. Human resource departments maintain descriptions of their incentive-based compensation programs for internal administrative purposes; these descriptions could serve as the basis for regulatory reporting.

With respect to items 2, 3, and 4, OTS anticipates that institutions would use some additional human resources and risk management expertise to administer the programs. For the 17 larger institutions, OTS estimates that the cost of these additional resources would be about \$24,000 per institution annually. For the 146 smaller institutions, the additional resources would entail additional personnel and other expenses of less than \$12,000 per institution per year.<sup>101</sup> Therefore, OTS estimates the annual cost to be about \$2.2 million (17 larger institutions x \$24,000 = \$0.4 million; 146 smaller institutions x \$12,000 = \$1.8 million).

In summary, OTS estimates the costs to the institutions of implementing the rule as proposed as follow:

First year: \$8.6 million + \$2.2 million = \$10.8 million.

Second and subsequent years: \$2.2 million.

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<sup>101</sup> OTS estimates that for institutions with assets between \$1 billion and \$50 billion, the costs of managing the additional elements of the program would entail some personnel and Information Technology (IT) support. As institutions already have personnel management software systems in place, either in house or contracted out, the incremental costs of IT support would be negligible.

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Beyond the costs of implementation, OTS assumes that the broader economic impact of the rule would be negligible. The overall level of compensation, as set by the forces of supply and demand in the labor market, is unlikely to change. Any variations in compensation levels that may occur would be minimal and, given the small number of covered financial institutions, have no effect on overall demand in the economy.

If the rule has its desired effect, institutions will take a more measured approach in their assessment of risk and return. As a result, the amount of lending in some excessively risky business areas may be reduced, which in turn may have an economic impact on the areas served by the 163 OTS-supervised covered financial institutions. Incentive-based compensation programs that appropriately balance risk and reward will entail reductions only of economic activity that is unsound and which, ultimately, entails more cost than benefit to the economy as a whole. Any reduction in inappropriately risky lending brought about by the rule, therefore, would be a net economic gain.

The recent crisis in financial markets demonstrated the significant costs that can arise from financial instability; the purpose of the rule is to enhance the financial stability of the financial sector by diminishing incentives for excessive risk taking. Because the benefits of financial stability are largely intangible, OTS made no attempt to quantify them here. Whatever benefits occur would have positive economic impact.

### Conclusion

OTS estimates that the annualized cost of this rule to the 163 OTS-supervised covered financial institutions as a group would be substantially less than \$100 million. Moreover, the overall annual economic impact would not be significant. OTS seeks industry comment on the

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economic impact of this proposed rule, including especially the various elements discussed in this economic impact assessment.

#### **D. OCC Unfunded Mandates Reform Act of 1995 Determination**

Section 202 of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1532), requires the OCC to prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate 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). 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, OCC has not prepared a budgetary impact statement.

#### **E. OTS Unfunded Mandates Reform Act of 1995 Determination**

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more (adjusted annually for inflation) in any one year. (The inflation adjusted threshold for 2010 is \$141 million or more.) If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

OTS has determined that this proposed rule will not result in expenditures by State, local, and tribal governments, or the private sector, in excess of the threshold. Accordingly, OTS has not prepared a budgetary impact statement.

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#### **F. 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, the NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5) voluntarily complies with the Executive Order. The Proposed Rule applies to credit unions with \$1 billion in assets and over and would not have substantial direct effects on the states, on the connection between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. The NCUA has determined that the Proposed Rule does not constitute a policy that has federalism implications for purposes of the Executive Order.

#### **G. NCUA and FDIC: The Treasury and General Government Appropriations Act, 1999-Assessment of Federal Regulations and Policies on Families**

The NCUA and FDIC have determined that this Proposed Rule would not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

#### **H. SEC Economic Analysis**

##### **ECONOMIC ANALYSIS**

As discussed above, 12 U.S.C. 5641 requires the Commission, jointly with other appropriate federal regulators, to prescribe regulations or guidelines to require covered financial institutions to disclose information about their incentive-based compensation arrangements sufficient for the Agencies to determine whether their compensation structure provides an executive officer, employee, director or principal shareholder with excessive compensation, fees

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or benefits or could lead to material financial loss to the firm.<sup>102</sup> 12 U.S.C. 5641 also requires the Agencies to prescribe joint regulations or guidelines that prohibit any type of incentive-based compensation arrangements that the Agencies determine encourages inappropriate risks by covered financial institutions by providing excessive compensation to officers, employees, directors, or principal shareholders (“covered persons”) or that could lead to material financial loss to the covered financial institution.<sup>103</sup>

The Agencies have determined that it is appropriate to propose rules, instead of guidelines, as permitted under 12 U.S.C. 5641. The Commission believes that broker-dealers and investment advisers would benefit from the greater predictability afforded by rules. Such greater predictability would facilitate broker-dealers’ and investment advisers’ ability to design compliance policies and procedures. The rule being proposed by the Agencies consists of a reporting section, a prohibition section, and a policies and procedures section. The reporting section requires enhanced reporting of incentive-based compensation arrangements for covered persons by a covered financial institution to such institution’s appropriate federal regulator. The prohibition section forbids incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risks by providing the covered person excessive compensation and prohibits incentive-based compensation arrangements that encourage covered persons to expose the covered financial institutions to inappropriate risks that could lead to a material financial loss. The policies and procedures section requires that the covered financial institutions maintain policies and procedures to ensure compliance with these requirements and prohibitions. The Commission is sensitive to the costs and benefits imposed on broker-dealers

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<sup>102</sup> 12 U.S.C. 5641(a).

<sup>103</sup> 12 U.S.C. 5641(b).

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registered with the Commission under Section 15 of the Securities Exchange Act (“registered broker-dealers”) and investment advisers, as defined in Section 202(a)(11) of the Investment Advisers Act of 1940 (“investment advisers”). The discussion below focuses on the costs and benefits applicable to registered broker-dealers and investment advisers that meet the definition of “covered financial institution” under the proposed rule (collectively “covered BDs and IAs”). The discussion addresses the decisions made jointly by the Agencies to fulfill the mandates of the Dodd-Frank Act within the Agencies’ permitted discretion, rather than the costs and benefits of the mandates of the Dodd-Frank-Act itself. However, to the extent that the Commission’s discretion is exercised to realize the benefits intended by the Dodd-Frank Act or to impose the costs associated with the Dodd-Frank Act, the two types of benefits and costs are not entirely separable. Therefore, the Paperwork Reduction Act (“PRA”) hourly burden estimates made in accordance with the requirements of the PRA, and their corresponding dollar cost estimates, are included in the calculations below.

**A. Report of Incentive-Based Compensation Arrangements**

In order to fulfill the requirement imposed by 12 U.S.C. 5641(a) relating to the disclosure of incentive-based compensation arrangements, the proposal would require a covered financial institution to submit a report annually to, and in the format directed by, its regulator, that describes the structure of the covered financial institution’s incentive-based compensation arrangements for covered persons. Similar to the policies and procedures requirements under the proposed rule, the annual report would be commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation arrangements. As such, institutions with no incentive-based compensation arrangements or

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arrangements that affect only a few covered persons, would need to submit only limited information. The report would be required to contain:

- a clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons, specifying the categories of covered persons to which they apply;
- a succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements;
- for covered financial institutions with total consolidated assets of at least \$50 billion, an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's executive officers and other covered persons who the institution's board of directors (or a committee of the board) has identified and determined 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;
- a description of any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted this section; and
- the specific reasons the covered financial institution believes the structure of its incentive-based compensation arrangements does not provide covered persons incentives to engage in behavior that is likely to cause the covered financial institution to suffer a material financial loss and does not provide covered persons with excessive compensation.

1. Benefits

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The Commission believes that the information that would be required to be reported to the Commission under proposed Section 248.205 would assist Commission examiners to determine whether covered BDs and IAs are fulfilling the requirements of Section 956 of the Dodd-Frank Act. The report is designed to elicit pointed, succinct explanations about issues that would likely be of high interest to an examiner, such as a clear narrative description of the firm's incentive-based compensation plan, a succinct description of the firm's incentive-based compensation policies and procedures and any changes thereto, and reasons that the compensation structure will not encourage behavior that violates the principles of 12 U.S.C. 5641. The Commission anticipates that examiners would find these descriptions a useful starting point in an examination to make a risk-assessment as to which areas of a firm's incentive-based compensation arrangements merit further examination. Persons within covered BDs and IAs responsible for determining compensation levels, as well as persons receiving incentive-based compensation would be able to review the incentive-based compensation policies, which should promote the balance of the incentive-based compensation process at covered BDs and IAs. The Commission also believes that the reporting of incentive-based compensation information would foster a climate of accountability at covered BDs and IAs by raising the profile of incentive-based compensation at firms, and thereby improving the care with which the firms design their incentive-based compensation programs. By including persons who individually have the ability to expose a firm with total consolidated assets of at least \$50 billion to possible losses that are substantial in relation to the firm's size, capital, or overall risk tolerance as persons whose compensation should be subject to the requirements of the statute (designated risk takers), the proposed rule should encourage executives to consider more carefully those compensation

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arrangements that could potentially lead to activities that could expose the covered institution to significant risks. Properly incentivizing designated risk takers could limit the risk exposure of covered financial institutions.

The reporting provisions of the proposed rule are designed to elicit qualitative statements from the covered financial institution, including covered BDs and IAs, regarding, among other things, the specific reasons the covered financial institution believes the structure of its incentive-based compensation plan does not provide covered persons incentives to engage in behavior that is likely to cause the covered financial institution to suffer a material financial loss and does not provide covered persons with excessive compensation. The proposed rule is designed to elicit a meaningful discussion of the firm's incentive-based compensation arrangements. In all cases, covered BDs and IAs should report to the Commission the comprehensive descriptions relating to each of the required disclosures described below.

## 2. Costs

The Commission is aware that requiring companies to file reports on the structure of their incentive-based compensation arrangements could impose costs on covered financial institutions. For example, by requiring covered financial institutions to report the information in the proposed rule, it is possible that this could serve as a disincentive for covered financial institutions to revisit or otherwise revise their incentive-based compensation plans, because doing so would create additional regulatory burdens for the covered financial institution. Further, while the Commission intends to keep the reported information confidential to the full extent it is permitted to do so under the Freedom of Information Act ("FOIA"), the Commission understands that firms may nonetheless have concerns about potential disclosure of information

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that could be competitively sensitive, as incentive-based compensation plans and arrangements are. The Commission believes that not including information regarding the individual compensation levels of covered persons may mitigate some confidentiality concerns.

Accordingly, the Commission is aware of these potential costs and seeks comment on them generally, as well as on any specific methods that could be used to minimize these costs and concerns.

The Commission is also aware that the proposed rule would generate compliance-related costs associated with, among other things, collecting the necessary information and preparing the reports, as well as hiring outside professionals, such as attorneys, compensation or benefits consultants, accountants and/or actuaries. In the charts below, the Commission estimates the internal and external costs associated with the proposed reporting requirements. In order to arrive at the internal cost estimates, the Commission multiplied the hourly burden estimates provided in the PRA Section by the estimated hourly rate for a securities attorney.<sup>104</sup> The Commission is using the same external cost estimates for the reporting requirement that it used in the PRA Section of this proposed rule. The Commission seeks comment on all these cost estimates.

Internal Costs

|  | <u>Covered bank<br/>BDs and IAs<br/>(\$50B +)</u> | <u>Covered bank<br/>BDs and IAs<br/>(\$1B-\$50B)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$50B +)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$1B-\$50B)</u> |
|--|---|--|--|---|
|  |   |  |  |   |

<sup>104</sup> The Commission estimates \$354 per hour for a securities attorney, based on SIFMA's *Management & Professional Earnings in the Securities Industry 2010*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

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|                          |                          |                            |                          |                            |
|--------------------------|--------------------------|----------------------------|--------------------------|----------------------------|
| <u>Initial Reporting</u> | \$900,000 <sup>105</sup> | \$3 million <sup>106</sup> | \$175,000 <sup>107</sup> | \$3 million <sup>108</sup> |
| <u>Ongoing Reporting</u> | \$900,000 <sup>109</sup> | \$3 million <sup>110</sup> | \$175,000 <sup>111</sup> | \$3 million <sup>112</sup> |

External Costs

|                          | <u>Covered bank BDs and IAs (\$50B +)</u> | <u>Covered bank BDs and IAs (\$1B-\$50B)</u> | <u>Covered non-bank BDs and IAs (\$50B +)</u> | <u>Covered non-bank BDs and IAs (\$1B-\$50B)</u> |
|--------------------------|---|--|---|--|
| <u>Initial Reporting</u> | \$1 million <sup>113</sup>                | \$3.4 million <sup>114</sup>                 | \$200,000 <sup>115</sup>                      | \$3.4 million <sup>116</sup>                     |
| <u>Ongoing</u>           | \$1 million <sup>117</sup>                | \$3.4 million <sup>118</sup>                 | \$200,000 <sup>119</sup>                      | \$3.4 million <sup>120</sup>                     |

<sup>105</sup> 2,500 hours x \$354/hour = \$885,000

<sup>106</sup> 8,500 hours x \$354/hour = \$3,009,000

<sup>107</sup> 500 hours x \$354 = \$177,000

<sup>108</sup> 8,500 hours x \$354/hour = \$3,009,000

<sup>109</sup> 2,500 hours x \$354/hour = \$885,000

<sup>110</sup> 8,500 hours x \$354/hour = \$3,009,000

<sup>111</sup> 500 hours x \$354 = \$177,000

<sup>112</sup> 8,500 hours x \$354/hour = \$3,009,000

<sup>113</sup> 2,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$987,500

<sup>114</sup> 8,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$3,357,500

<sup>115</sup> 500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$197,500

<sup>116</sup> 8,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$3,357,500

<sup>117</sup> 2,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$987,500

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|                  |  |  |  |  |
|------------------|--|--|--|--|
| <u>Reporting</u> |  |  |  |  |
|------------------|--|--|--|--|

**B. Prohibition on Certain Incentive-Based Compensation Arrangements**

The proposed rule states that a covered financial institution may not establish or maintain any incentive-based compensation arrangement, or any feature of any such arrangement, that encourages a covered person to expose the institution to inappropriate risks by providing that person with excessive compensation. Under the proposed rule, compensation would be considered excessive when amounts paid are unreasonable or disproportionate to the services performed by a covered person. In determining whether incentive-based compensation is unreasonable or disproportionate to the services performed, the covered BDs and IAs would consider those factors set forth in the Section 39(c) of the FDIA.<sup>121</sup>

<sup>118</sup> 8,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$3,357,500

<sup>119</sup> 500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$197,500

<sup>120</sup> 8,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$3,357,500

<sup>121</sup> Under Section 248.205(a)(2) of the proposed rule, an incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

- (i) The combined value of all cash and non-cash benefits provided to the covered person;
- (ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
- (iii) The financial condition of the covered financial institution;
- (iv) Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution’s operations and assets;
- (v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;
- (vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

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To address the prohibition against arrangements that potentially encourage inappropriate risks that could lead to a material financial loss at the covered financial institution, the Agencies propose to deem incentive-based compensation arrangements for all covered persons to encourage inappropriate risks that could lead to material financial loss at the institution unless the arrangement or feature: (i) balances risk and financial results, for example, by using deferral of payments, risk adjustment of awards, longer performance periods, or reduced sensitivity to short-term performance; (ii) is compatible with effective controls and risk management; and (iii) is supported by strong oversight by a covered BD's or IA's board of directors. These principles are substantially identical to the principles published in the Guidance.<sup>122</sup>

The proposed rule would require additional measures for certain covered persons working for covered financial institutions with total consolidated assets of \$50 billion or more. For executive officers and heads of major business lines of such firms, at least 50% of their incentive-based compensation would be required to be deferred on a pro-rata basis over a period of at least three years. Such executive officers' and business line heads' deferred incentive-based compensation would be required to be adjusted downward to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period (the "look-back").

The Agencies also propose for a covered financial institution with \$50 billion or more in assets that for certain classes of covered person whose activities, by their nature, expose the covered financial institution to a risk of significant loss (designated risk takers), that such firm's

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(vii) Any other factors the Commission determines to be relevant.

<sup>122</sup> See Guidance on Sound Incentive Compensation Policies, 75 FR 36395 (June 25, 2010) (jointly adopted by the OCC, the FRB, the FDIC and OTS).

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board of directors, or a committee thereof, perform individual review of each such person's incentive-based compensation against certain factors and that each such person's incentive-based compensation be approved by the board of directors, or committee thereof.

1. Benefits

The Commission believes that the proposed prohibitions related to the incentive-based compensation arrangements would help ensure that covered financial institutions avoid incentive-based compensation arrangements that would threaten the safety and soundness of the covered financial institution or otherwise have serious adverse effects on economic conditions or financial stability of covered BDs and IAs. In order to address the adverse effects that incentive-based compensation arrangements may have on covered financial institutions' financial condition, the proposed rules would mandate the application of the principles described in the Guidance (provide incentives that appropriately balance risk and reward, compatibility with effective controls and risk-management, and the support of strong corporate governance) to all covered financial institutions, including covered BDs and IAs. The Commission believes that applying these principles to covered BDs and IAs should promote sound incentive-based compensation practices and discourage incentive-based compensation arrangements that contributed to the recent financial crisis.

The proposed elements defining when an incentive-based compensation arrangement provides excessive compensation or could result in a material financial loss would benefit covered financial institutions by identifying specific factors to determine whether certain arrangements are prohibited. Abiding by the standards reflected in Section 39(c) of the FDIA and the principles described in the Guidance, which already apply to banking institutions, should

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help to promote the safety and soundness of the covered BD or IA and by extension protect investors and promote the public interest. The proposed rule also should give firms the discretion to reward the most productive employees because the definition of “excessive compensation” should be sufficiently broad so as to permit covered financial institutions the flexibility to reward productive employees.

Moreover, by not prescribing mandatory deferral for covered BDs and IAs with assets under \$50 billion, but rather by requiring non-specific standards for these arrangements (i.e., that they balance risk and return, are compatible with effective controls and risk management, etc.), the proposed rule would provide smaller covered BDs and IAs with significant flexibility to tailor their compensation packages to their covered persons. The proposed rule would permit covered BDs and IAs with assets below \$50 billion to determine their respective incentive-based compensation arrangements within the parameters of meeting certain goals (i.e., that the payments balance risk and return, are compatible with effective risk controls and risk management) set forth in the proposed rule.

The Commission believes that the proposed rule should curb excessive risk taking, which should lead to more effective capital allocation. The rule should discourage compensation incentives that encouraged capital flow into investments that were unprofitable on the whole. Hereafter, the flow of capital into less risky investments should result in capital being put to more effective use. More efficient capital allocation, in turn, should improve the quality of the firms’ financial services and products, as firms employ capital to its most productive use. Since higher quality service and products are ordinarily associated with increased competition, it is possible that competition among covered BDs and IAs would be more robust.

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By requiring that the incentive-based compensation arrangements of covered BDs and IAs with more than \$50 billion in total assets defer at least 50% of the compensation of covered executives and chiefs of major business lines for at least three years, and requiring firms to adjust any amount deferred to reflect actual losses or other measures of performance that are realized or become better known only during the deferral period, the proposed rule should help align the interests of those covered persons with the greatest ability to influence the risk profile of the covered financial institution with the interests of the covered financial institution. The deferral requirement for executive officers and chiefs of major business lines at the largest covered financial institutions reflects the previously acknowledged benefit for deferral of certain high-level employees whose activities present broad, and potentially lengthy, risk exposure to an institution, and whose activities do not lend themselves as easily to risk quantification and assessment through ex ante or other predictive risk adjustment measures. Requiring deferral for this discrete group of individuals at particularly large institutions, where up-front or ex ante risk adjustment measures are less likely to be effective, is a useful risk adjustment tool. It permits time for risks not previously discerned or quantifiable to ultimately materialize and permits adjustment of unreleased deferral payments on the basis of observed consequences as opposed to mere predicted results. The Commission believes that the heightened standards for the largest covered BDs and IAs is particularly appropriate because decisions made at the largest covered BDs and IAs can greatly impact the fair and orderly operation of the financial markets. These deferral restrictions should weaken the incentive for executive officers and chiefs of major business lines to make decisions that create short term gain at the expense of increased long term risk. The Commission also expects that by example, an express deferral requirement for

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executive officers and heads of major business lines would have a broader beneficial impact on the structure of compensation used throughout a company.<sup>123</sup> The required look-back mechanism included in the proposed rule is a means by which the covered financial institution may reduce previously awarded compensation over the deferred period of time. Thus, the required look-back adds to the power of deferring compensation in that previously awarded compensation may actually not be awarded if the firm finds that such compensation does not reflect actual losses or other measures better realized during the deferral period.

As with the deferral requirement and the look-back mechanism, the Commission preliminarily believes that these provisions of the proposed rule relating to designated risk takers would help to strengthen board oversight of covered persons' incentive-based compensation. The Commission believes that promoting strong corporate governance oversight of a covered BD's or IA's incentive-based compensation arrangements would promote sound practices and foster a high quality process regarding incentive-based compensation decisions at a covered financial institution. Moreover, the additional oversight of designated risk takers' incentive-based compensation should help to provide proper incentives to these persons and thus limit the risk exposure of covered BDs and IAs. In addition, requiring the board of directors, or a committee of the board, to identify designated risk takers other than executive officers and to approve their incentive-based compensation should help to improve the board's understanding of the risk profile of certain firm activities or divisions that have the ability to expose the institution

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Certain recent studies provide empirical evidence consistent with deferred compensation helping reduce the probability of corporate default. See e.g. Wei and Yermack (2010). In one study, the authors conclude that bank CEOs with large amounts of inside debt in the form of pensions and deferred compensation exposed their firms to less risk and obtained greater performance during the recent financial crisis. ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1519252](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1519252)).

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to possible substantial losses. It would also encourage the board to spend more time considering the compensation arrangements of important employees who are not executives but who have the ability to materially impact the risk profile of the firm. The proposed rule also provides covered financial institutions the flexibility to determine who the relevant potential excessive risk takers are.

2. Costs

a. All Covered BDs and IAs

The Commission also anticipates that the proposed rule may entail certain costs. For example, in a case where a firm elects to defer an excessive portion of covered persons' compensation, such deferral may reduce effort expended by covered persons and the willingness of covered persons to take even measured risks. The Commission understands that it is necessary for covered financial institutions to take a certain amount of risk in order to operate their businesses. Accordingly, the Commission desires to carefully balance the need for covered financial institutions to take risk against the possibility that if the wrong regulatory balance is struck, covered persons may have the incentive to actually take less risk than is optimal in order to ensure that, on a personal level, the covered employee has sufficient cash flow. In the event that employees are induced to take less than optimal risk, then there might be a negative effect on the efficiency of capital allocation. The Commission preliminarily believes that the proposed rule strikes an appropriate balance in this regard but requests comment generally on this issue.

Based on its experience in the area, staff conversations with covered BDs and filings by publicly-traded covered BDs, IAs and certain parent companies, the Commission believes that the elements of the prohibition applicable to all covered BDs and IAs related to excessive

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compensation and material financial loss to the firms already generally represent the practices of many covered BDs and IAs. Therefore, the Commission believes that covered BDs and IAs generally already consider factors consistent with those referenced in Section 39(c) of the FDIA and the principles in the Guidance in designing and administering their incentive-based compensation programs. Nonetheless, the Commission recognizes that some covered BDs and IAs may not conform to incentive-based compensation standards consistent with Section 39(c) of the FDIA and the principles in the Guidance.

In addition, the Commission acknowledges the possibility that the proposed rules may reduce the incentive for certain covered persons to switch jobs because would-be new employers that are covered financial institutions would be bound to offer such covered persons compensation packages that comply with the proposed rules. If a lack of turnover results, it might adversely impact competitiveness among firms, but it may also promote institutional stability within firms. The Commission believes the proposed rule strikes an appropriate balance in this regard, but requests comment generally on this issue.

The Commission seeks comment on whether the proposed prohibitions applicable to covered BDs and IAs (which include only those broker-dealers and investment advisers with assets of more than \$1 billion) may disadvantage covered financial institutions as compared to financial institutions not covered under the proposed rules because covered financial institutions would be required to assume costs in designing, implementing, monitoring and maintaining a regulatory program reasonably designed to address the requirements of the proposed rules, whereas broker-dealers and investment advisers with total consolidated assets less than \$1 billion would not be subject to such costs. The Commission also seeks comment on whether it is

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possible that covered BDs and IAs would have more difficulty recruiting qualified individuals to work for their firms if such individuals fear that added scrutiny of their incentive-based compensation may lead to lower aggregate pay.

b. Covered BDs and IAs with Assets of \$50 Billion or More

In addition to the costs imposed upon all covered BDs and IAs, described above, the proposed rule would impose additional costs on firms with assets of \$50 billion or more. The Commission anticipates that it is possible that covered BDs and IAs with assets of \$50 billion or more may have to pay more in base salary to compensate their executive officers and heads of a major business line for the uncertainty associated with the ultimate receipt of deferred compensation. However, it is also possible that increases in salaries would be offset by decreases in deferred incentive-based compensation. The Commission requests comment on whether covered BDs and IAs should expect to incur the cost of increased salaries that may result from the implementation of required deferred compensation and look-back policies for certain covered persons.

As stated above, the Commission also recognizes that the firms with assets of at least \$50 billion may have more difficulty recruiting individuals for those positions than a firm not subject to the deferral requirement. In addition, such firms may have difficulty recruiting individuals who object to having their compensation specifically approved and monitored by the covered BD's or IA's board of directors or committee thereof. To the extent that this adversely affects the quality of employees that firms of that size are able to attract, it may negatively affect the business of larger covered financial institutions.

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To the extent that the proposal relies on an assumption that a covered person understands the risks inherent in a particular business decision but chooses to disregard them because the covered person would not bear the costs associated with those risks being realized, the proposal may not be effective at promoting a more accurate or realistic assessment of a business decision as to which neither the executive officer nor the covered financial institution grasps the inherent risk. To the extent, however, that the proposal relies on an assumption that covered persons do not always fully understand the risks inherent in particular business decisions and have had inadequate incentives to ensure that they comprehend these risks, the proposal would be more effective. It is not clear what, if any, other regulatory steps could be taken to promote a better comprehension of risk, and mandatory deferral as provided in the proposed rule would at least provide some required measure of risk adjustment in cases where such risks are understood by executive officers at large covered financial institutions. If, however, the risks that covered persons take are very long term (i.e., beyond 5 years), the proposed compensation deferral might not prove to be effective at deferring covered persons' taking on inappropriate risk for the firm.

As stated above, the Commission also believes there would be compliance-related costs associated with the proposed rule. Based upon experience of the Commission staff, the Commission understands that although mandatory deferral of a significant percentage of firms' incentive-based compensation to executive officers and chiefs of major business lines is the existing practice among many covered BDs and IAs, it would represent a new practice for some firms. Even for firms with existing deferral practices, there would be costs to conform their deferral practices to the requirements of proposed Section 248.205(b)(3). For example, based on staff's discussions with the industry, its review of information in public filings, and its

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experience in the area, the Commission believes that the practice of adjusting deferred amounts of compensation to reflect actual losses or other measures that are realized or become known during the deferral period (administering a look-back) exists in comparatively fewer firms than does the practice of deferral itself. The Commission also believes that many firms may provide deferral or vesting periods of less than the 3 years under the proposed rule. The Commission believes, based upon its experience and the filings submitted by publicly-traded covered BDs, IAs and certain public companies, that some, but not all boards or board committees of covered BDs and IAs with assets of at least \$50 billion already have a role in approving the compensation for highly-paid individuals, including most people that would be defined as designated risk takers under the proposed rule. Accordingly, the Commission anticipates that covered BDs and IAs would experience costs in implementing the deferral, look-back and designated risk takers components of the requirements for firms with assets of \$50 billion or more.

The requirement under proposed Section 248.205(b)(3)(ii)(B) to require the board of directors (or committee of the board) of covered financial institutions that have total consolidated assets of \$50 billion or more to approve and document the identification of those covered persons that 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 would create new burden for such larger covered financial institutions. Based on staff experience and conversations with larger covered BDs and the filings submitted by publicly-traded covered IAs and certain parent companies, the Commission does not believe that the boards of larger covered BDs and IAs generally identify and approve the compensation of such designated risk takers.

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The Commission believes that the most significant ongoing cost that covered BDs and IAs would assume to comply with proposed Section 248.205(b)(3)(ii)(B) is the cost of having appropriate senior personnel administer the deferred compensation, look-back and designated risk takers provisions. As with all matters related to incentive-based compensation, covered BDs and IAs would be required to administer their incentive-based compensation arrangements in a manner that is compatible with effective controls and risk management and is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors. The Commission anticipates that firms would use an appropriate mix of senior risk management personnel along with the firms' board of directors, or committee thereof, to administer the identification of designated risk takers and approval of their compensation, as required under the proposed rule.

Larger covered financial institutions with total consolidated assets of at least \$50 billion may experience a disadvantage relative to smaller financial institutions on account of the proposed required deferral for executive officers and board-level review of the incentive-based compensation of designated risk takers. In addition to the added costs that such larger financial institutions would incur to implement the deferral and board-level review of designated risk takers' compensation, the Commission believes that some executive officers may have disincentives from working for a covered financial institution whereby their compensation would be required to be deferred or in firms where their incentive-based compensation is subject to board-level scrutiny.

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In order to help the Commission better understand all the costs associated with this aspect of the proposed rule, the Commission requests comment on them generally. The Commission is also soliciting comment on the following specific issues:

- Do commenters believe that requiring a minimum deferral period of three years for at least 50% of the compensation for executive officers and chiefs of major business lines at large covered financial institutions would place such financial institutions at an unjustified disadvantage in the hiring of and retaining qualified personnel as compared to smaller covered financial institutions? If commenters believe that this is the case, what would commenters do to modify the proposed rule while reasonably ensuring that there is useful and meaningful risk adjustment of incentive-based compensation for executives at large covered financial institutions? Do commenters believe that requiring a different minimum deferral period or minimum deferred percentage would promote better incentive-based compensation practices? Should the required minimum deferral provisions be extended to smaller covered financial institutions?
- Do commenters believe that there is a substantial risk that covered financial institutions would reconfigure their operations, structure, or assets in such a manner so as to circumvent being classified as a large covered financial institution?
- Do commenters believe that mandating deferral as a risk adjustment tool for executive officers at large covered financial institutions would inhibit the development of other potentially more effective risk adjustment tools? Are there other risk adjustment tools that are more effective than deferral, and why are those tools more effective?

**C. Required Policies and Procedures and Documentation of the Compensation of Certain Covered Persons**

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The proposal would require covered financial institutions to adopt policies and procedures reasonably designed to ensure and monitor compliance with 12 U.S.C. 5641 commensurate with the size and complexity of the organization and the scope and nature of its use of incentive-based compensation. As described in further detail above, the proposed rule would require that the policies and procedures, at a minimum, be consistent with the disclosure requirements and prohibitions in other parts of the proposed rule, ensure that risk management or oversight personnel have a role in designing and assessing incentive-based compensation arrangements, provide for independent monitoring of the incentive-based compensation awards, risks taken and actual outcomes, require that a covered financial institution's board receive data and an analysis to enable the board to assess whether the incentive-based compensation arrangements are consistent with 12 U.S.C. 5641, and require sufficient documentation of the covered financial institution's incentive-based compensation arrangements to enable the Commission to determine the covered BDs' or IAs' compliance with 12 U.S.C. 5641. In addition, the proposal would require that the covered BDs' and IAs' policies and procedures include certain features for when a firm uses deferral in connection with an incentive-based compensation arrangement, and that the policies and procedures subject incentive-based compensation arrangements to an appropriate corporate governance framework.

In addition, for covered BDs and IAs with assets of at least \$50 billion, proposed Section 248.205(b)(3)(ii)(B) would require a firm's board of directors, or a committee thereof, to identify those covered persons (other than executive officers) that 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. These covered persons may include, for example, traders with large

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position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution. The Agencies propose that the compensation decisions applicable to such persons must be approved by the firm's board of directors or a committee of the board and that the covered BD or IA document the compensation decisions made by the board or its committee.

### **1. Benefits**

The Commission believes that requiring covered financial institutions to adopt and enforce the policies and procedures described above would foster the Agencies' understanding of the covered financial institutions' incentive-based compensation practices and would promote compliance and accountability regarding the practices that the Agencies propose to prohibit. The rule is designed to ensure that covered BDs and IAs establish adequate procedures and controls to ensure compliance with 12 U.S.C 5641. The Commission preliminarily believes that the policies and procedures section of the proposed rule would help to ensure that boards receive data to monitor incentive-based compensation arrangements. Further, the Commission believes that, at a minimum, the proposed rule should help to ensure that incentive-based compensation arrangements would be designed with more careful consideration of its effects on risk. The Commission also believes that the proposed rule would provide greater board of director and risk management / risk oversight personnel supervision of incentive-based compensation arrangements and practices at the covered financial institution because boards would receive data and analysis from management to support a finding that the incentive-based compensation arrangements are consistent with 12 U.S.C. 5641. Moreover, risk-management / risk-oversight personnel would help to design and assess the effectiveness of the covered BD's or IA's

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incentive-based compensation arrangement. The Commission believes that these provisions of the proposed rule would help to strengthen the supervision of covered persons' incentive-based compensation arrangements by the board of directors. The proposed rule would help increase the importance of the compensation-setting function at covered financial institutions, including covered BDs and IAs. The Commission preliminarily believes that this increased internal importance would result in a higher quality process regarding incentive-based compensation decisions at a covered financial institution. For example, the proposed rule would help to ensure that information is received by the relevant decision makers and other persons acting in an internal supervisory role within the covered financial institution. This development should strengthen the supervision of the board with respect to incentive-based compensation arrangements.

The recordkeeping requirement in proposed in Section 248.206(b)(5) should ensure that Commission staff members are able to properly examine covered BDs' and IAs' incentive-based compensation practices in the context of an examination. The proposal also would require that a covered BD or IA have policies and procedures that provide that compensation payments are reduced to reflect adverse risk outcomes or high levels of risk taken. This should help ensure that the compensation contracts are accurately followed and diminish the adverse effect of deferred compensation that proves to be unwarranted once the risks associated with the covered person's activities are realized over time.

## 2. Costs

As described more fully in the PRA Section, the Commission believes that covered individual bank BDs and IAs would be subject to significantly less initial and ongoing costs than

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non-bank BDs and IAs because bank BDs and IAs are already subject to the Guidance. The Commission is also aware that the proposed rule would generate compliance-related costs associated with, among other things, collecting the necessary information and preparing the reports, as well as hiring outside professionals, such as attorneys, compensation or benefits consultants, accountants and/or actuaries. In the chart below, the Commission estimates the internal costs associated with the proposed recordkeeping requirements. In order to arrive at these internal cost estimates, the Commission multiplied the hourly burden estimates provided in the PRA Section by the estimated hourly rate for a securities attorney.<sup>124</sup> The Commission is using the same external cost estimates for the recordkeeping requirement that it used in the PRA Section of this proposed rule. The Commission seeks comment on all these cost estimates.

Total Internal Recordkeeping Cost

|                      | <u>Covered bank<br/>BDs and IAs<br/>(\$50B +)</u> | <u>Covered bank<br/>BDs and IAs<br/>(\$1B-\$50B)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$50B +)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$1B-\$50B)</u> |
|----------------------|---|--|--|---|
| <u>Initial</u>       | \$900,000 <sup>125</sup>                          | \$1.2 million <sup>126</sup>                         | \$1.1 million <sup>127</sup>                           | \$16 million <sup>128</sup>                               |
| <u>Recordkeeping</u> |   |  |  |   |
| <u>Ongoing</u>       | \$400,000 <sup>129</sup>                          | \$400,000 <sup>130</sup>                             | \$150,000 <sup>131</sup>                               | \$1.5 million <sup>132</sup>                              |

<sup>124</sup> The Commission estimates \$354 per hour for a securities attorney, based on SIFMA's Management & Professional Earnings in the Securities Industry 2010, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

<sup>125</sup> 2,500 hours x \$354 = \$885,000

<sup>126</sup> 3,400 hours x \$354 = \$1,203,600

<sup>127</sup> 3,000 hours x \$354 = \$1,062,000

<sup>128</sup> 46,000 hours x \$354 = \$16,284,000

<sup>129</sup> 1,000 hours x \$354 = \$354,000

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|                      |  |  |  |  |
|----------------------|--|--|--|--|
| <u>Recordkeeping</u> |  |  |  |  |
|----------------------|--|--|--|--|

Total External Recordkeeping Cost

|                                  | <u>Covered bank<br/>BDs and IAs<br/>(\$50B +)</u> | <u>Covered bank<br/>BDs and IAs<br/>(\$1B-\$50)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$50B +)</u> | <u>Covered non-<br/>bank BDs and<br/>IAs (\$1B-\$50B)</u> |
|----------------------------------|---|---|--|---|
| <u>Initial<br/>Recordkeeping</u> | \$1 million <sup>133</sup>                        | \$1.3 million <sup>134</sup>                        | \$1.2 million <sup>135</sup>                           | \$18 million <sup>136</sup>                               |
| <u>Ongoing<br/>Recordkeeping</u> | \$400,000 <sup>137</sup>                          | \$400,000 <sup>138</sup>                            | \$150,000 <sup>139</sup>                               | \$1.7 million <sup>140</sup>                              |

**SOLICITATION OF COMMENT**

<sup>130</sup> 1,000 hours x \$354 = \$354,000

<sup>131</sup> 400 hours x \$354 = \$141,600

<sup>132</sup> 4,300 hours x \$354 = \$1,522,200

<sup>133</sup> 2,500 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$987,500.

<sup>134</sup> 3,400 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$1,343,000

<sup>135</sup> 3,000 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$1,185,000.

<sup>136</sup> 46,000 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$18,170,000

<sup>137</sup> 1,000 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$395,000

<sup>138</sup> 1,000 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$395,000

<sup>139</sup> 400 hours X [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$158,000

<sup>140</sup> 4,300 hours x [(25% x \$400/hour) + (25% x \$600/hour) + (25% x \$330/hour) + (25% x \$250/hour)] = \$1,698,500

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In enacting this section of the Dodd-Frank Act, Congress has made the judgment that regulation entailing potential burdens and impacts of the type discussed below is justified so as to prevent covered financial institutions from utilizing incentive-based compensation arrangements that could threaten the health of financial institutions or have serious effects on economic conditions or financial stability.<sup>141</sup> The Commission generally solicits comment on all the costs, benefits, and analyses set forth in this economic analysis. The Commission also specifically requests comment on the following issues:

- The Commission requests comments on the anticipated impact of the proposal on the competitiveness of covered financial institutions as compared to broker-dealers and investment advisers that do not meet the definition of covered financial institution as well as the impact of the proposal on the competitiveness of covered BDs and IAs with assets of at least \$50 billion as compared to covered BDs and IAs with assets between \$1 billion and \$50 billion.
- Could the proposed rule be modified so as to implement the mandate of 12 U.S.C. 5641 in a manner that improves the efficiency of covered financial institution and imposes less of a burden on competition? If so, what specific changes would commenters suggest? Would the impact be improved with a different deferral threshold (currently 50% of incentive-based compensation) or deferral period (currently no faster than pro rata over 3 years)? Is there a better way to design or apply the “look-back” period?
- The Commission solicits public comment on the degree to which commenters believe that the proposal would encourage covered employees to take optimal risk and/or

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<sup>141</sup> See Joint Explanatory Statement of the committee of Conference Accompanying H.R. 4173, H.R. Rep. No. 111-517, at 873.

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discourage covered employees from taking inappropriate levels of risk. If commenters believe the proposal would lead to covered employees undertaking less than optimal risk (e.g., make decisions that are too conservative for the firm), then please elaborate why that is the case.

- If commenters believe a different approach is warranted, do commenters believe that a different approach would be equally effective at helping to ensure, particularly at large covered financial institutions, that incentive-based compensation arrangements do not result in excessive compensation or a material financial loss to the covered financial institution? What alternative would commenters propose and why do commenters believe that it would be as effective, or more effective?
- Does the proposed rule promote greater internal discipline and controls by covered financial institutions with respect to incentive-based compensation arrangements? Similarly, does the proposed rule help to promote that discipline upon a greater number of persons at the covered financial institution, including not only the executive officers (or comparable persons) at a covered financial institution, but also those persons whose activities subject the covered financial institution to significant risk?

## **I. SEC CONSIDERATION OF IMPACT ON THE ECONOMY**

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"<sup>142</sup> the Commission must advise OMB whether a proposed regulation constitutes a major rule. Under SBREFA, a rule is "major" if it has resulted in, or is likely to result in:

- an annual effect on the economy of \$100 million or more

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<sup>142</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

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- a major increase in costs or prices for consumers or individual industries; or
- a significant adverse effect on competition, investment, or innovation.

If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review. The Commission requests comment on the potential impact of each of the proposed rules and rule amendments on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

#### **LIST OF SUBJECTS**

12 CFR Part 42

12 CFR Part 236

Compensation, Banks, Bank Holding Companies, Reporting and recordkeeping requirements.

12 CFR Part 372

12 CFR Part 563h

Compensation, Holding companies, Reporting and recordkeeping requirements, Savings associations.

12 CFR Parts 741 and 751 [NCUA]

Compensation, Credit Unions, Reporting and recording requirements

17 CFR Part 248

Incentive-based Compensation Arrangements

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## Securities and Exchange Commission

We are proposing the amendments contained in this document under the authority set forth in Section 956 of the Dodd-Frank Act.

### List of Subjects

#### 17 CFR Part 248

Reporting and recordkeeping requirements; Securities.

For the reasons set forth in the preamble, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations to read as follows:

#### **PART 248 – REGULATION S-P, REGULATION S-AM, AND INCENTIVE-BASED COMPENSATION ARRANGEMENTS**

\* \* \* \* \*

#### **Subpart C – Incentive-based Compensation Arrangements**

[1] The authority for Part 248 is amended to read as follows:

Authority: 15 U.S.C. 78q, 78q—1, 78w, 78mm, 80a—30, 80a—37, 80b—4, 80b—11, 1681s—3 and note, 1681w(a)(1), 6801-6809, and 6825, and 12 U.S.C. 5641.

\* \* \* \* \*

[2] Add §248.201 through §248.207 to read as follows:

- 248.201 Authority.
- 248.202 Scope and purpose.
- 248.203 Definitions.
- 248.204 Required reports to regulators.
- 248.205 Prohibitions.

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248.206 Policies and procedures.

248.207 Evasion.

\* \* \* \* \*

**§248.201 Authority.**

This subpart is issued pursuant to section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5641).

**§248.202 Scope and purpose.**

This subpart applies to a covered financial institution that has total consolidated assets of \$1 billion or more and offers incentive-based compensation arrangements to covered persons. Nothing in this subpart in any way limits the authority of the Commission under other provisions of applicable law and regulations.

**§248.203 Definitions.**

For purposes of this subpart, the following definitions apply unless otherwise specified:

(a) Board of directors means the governing body of any covered financial institution performing functions similar to a board of directors.

(b) Compensation means all direct and indirect payments, fees or benefits, 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 financial institution, including, but not limited to, payments or benefits pursuant to an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement.

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(c) Covered financial institution means: 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)) that has total consolidated assets of \$1 billion or more.

(d) Covered person means any executive officer, employee, director, or principal shareholder of a covered financial institution.

(e) Director of a covered financial institution means a member of the board of directors of the covered financial institution, or of a board or committee performing a similar function to a board of directors.

(f) Executive officer of a covered financial institution means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

(g) Incentive-based compensation means any variable compensation that serves as an incentive for performance.

(h) Principal shareholder means an individual 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 financial institution.

(i) Total consolidated assets means:

(1) For a broker or dealer registered under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) total assets reported in the firm's most recent year-end audited

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Consolidated Statement of Financial Condition filed pursuant to Rule 17a-5 under the Securities Exchange Act of 1934; and

(2) For 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)) the adviser's total assets shown on the balance sheet for the adviser's most recent fiscal year end.

**§248.204 Required reports to the Commission.**

(a) In general. A covered financial institution must submit a report annually to, and in the format directed by, the Commission, that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the covered financial institution.

(b) Individual compensation. A covered financial institution is not required to report the actual compensation of particular covered persons as part of the report required by paragraph (a) of this section.

(c) Minimum standards. The information submitted by the covered financial institution pursuant to paragraph (a) of this section must include the following:

(6) A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;

(7) A succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements for covered persons;

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(8) If the covered financial institution has total consolidated assets of \$50 billion or more, an additional succinct description of incentive-based compensation policies and procedures specific to the covered financial institution's:

- (i) Executive officers; and
- (ii) Other covered persons who the board of directors, or a committee thereof, of the covered financial institution has identified and determined under §248.205(b)(3)(ii) of subpart C of this part individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the covered financial institution's size, capital, or overall risk tolerance;

(9) Any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report submitted under paragraph (a) of this section; and

(10) The specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage inappropriate risks by the covered financial institution by providing covered persons with:

- (i) Excessive compensation; or
- (ii) Incentive-based compensation that could lead to a material financial loss to the covered financial institution.

#### **§248.205 Prohibitions.**

(a) Excessive compensation prohibition.

(1) In general. A covered financial institution must not establish or maintain any

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type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.

(2) Standards. An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration:

- (i) The combined value of all cash and non-cash *benefits provided to the covered person*;
  - (ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
  - (iii) The financial condition of the covered financial institution;
  - (iv) Comparable compensation practices at comparable covered financial institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets;
  - (v) For postemployment benefits, the projected total cost and benefit to the covered financial institution;
  - (vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and
  - (vii) Any other factors the Commission determines to be relevant.
- (b) Material financial loss prohibition.

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(1) Generally. A covered financial institution 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 covered financial institution, by providing incentive-based compensation to covered persons, either individually or as part of a group of persons who are subject to the same or similar incentive-based compensation arrangements, that could lead to material financial loss to the covered financial institution.

(2) Requirements for all covered financial institutions. An incentive-based compensation arrangement established or maintained by a covered financial institution for one or more covered persons does not comply with paragraph (b)(1) of this section unless it:

(i) Balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods;

(ii) Is compatible with effective controls and risk management; and

(iii) Is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof.

(3) Specific requirements for covered financial institutions with \$50 billion or more in total consolidated assets.

(i) Deferral required for executive officers. As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, any incentive-based compensation arrangement for any executive officer established or maintained by a covered financial institution that has total consolidated assets of \$50 billion or more must provide for:

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(A) At least 50 percent of the annual incentive-based compensation of the executive officer to be deferred over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis; and

(B) The adjustment of the amount required to be deferred under paragraph (b)(3)(i)(A) of this section to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

(ii) Additional requirement for covered persons presenting particular loss exposure.

As part of appropriately balancing risk and financial rewards pursuant to paragraph (b)(2)(i) of this section, if a covered financial institution has total consolidated assets of \$50 billion or more—

(A) The board of directors, or a committee thereof, of the covered financial institution shall identify those covered persons (other than executive officers) who individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the covered financial institution's size, capital, or overall risk tolerance. These covered persons may include, for example, traders with large position limits relative to the covered financial institution's overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution;

(B) The incentive-based compensation arrangement for any covered person identified pursuant to paragraph (b)(3)(ii)(A) of this section must be approved by the board of directors, or a committee thereof, of the covered financial institution and such approval must be documented;

(C) The board of directors, or committee thereof, may not approve the incentive-based compensation arrangement for any covered person identified pursuant to paragraph

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(b)(3)(ii)(A) of this section unless the board or committee determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity such as deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; and

(D) In fulfilling its duties under paragraph (b)(3)(ii)(C) of this section, the board of directors or committee thereof must evaluate the overall effectiveness of the balancing methods used in the identified covered person's incentive-based compensation arrangements in reducing incentives for inappropriate risk taking by the identified covered person considering the methods' suitability for balancing the full range of risks presented by that covered person's activities, and the methods' ability to make payments sensitive to all the risks arising from the covered person's activities, including those that may be difficult to predict, measure or model.

**§248.206 *Policies and procedures.***

(a) In general. Any incentive-based compensation arrangement, or any feature of any such arrangement, is prohibited under section 248.205 of this subpart, unless adopted pursuant to policies and procedures developed and maintained by each covered financial institution and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements set forth in 12 U.S.C. 5641 and subpart C of this part and commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation.

(b) Standards. The policies and procedures must, at a minimum:

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- (1) Be consistent with the reporting requirements in section 248.204 of subpart C of this part and prohibitions in section 248.205 of subpart C of this part;
- (2) Ensure that risk-management, risk-oversight, and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;
- (3) Provide for the monitoring by a group or person independent of the covered person, where practicable in light of the covered financial institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive-based compensation payments for covered persons, or groups of covered persons, are reduced to reflect adverse risk outcomes or high levels of risk taken;
- (4) Provide for the covered financial institution's board of directors, or 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 covered financial institution's incentive-based compensation arrangements are consistent with 12 U.S.C. 5641;
- (5) Ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the Commission to determine the covered financial institution's compliance with 12 U.S.C. 5641 and subpart C of this part;
- (6) Consistent with section 248.205(b)(3) of subpart C, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-

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based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's covered persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and

(7) Subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee thereof, including the approval by the board of directors or a committee thereof of incentive-based compensation to executive officers.

**§ 248.207 Evasion.**

A covered financial institution is prohibited, for the purpose of evading the restrictions of this subpart, from doing indirectly or through or by any other person, any act or thing that it would be unlawful for such covered financial institution to do directly under this subpart.