Section 76.75 requires that each MVPD employment unit shall establish, maintain and carry out a program to assure equal opportunity in every aspect of a cable entity's policy and practice.

Section 76.79 requires that every MVPD employment unit maintain, for public inspection, a file containing copies of all annual employment reports and related documents.

Section 76.1702 requires that every MVPD place certain information concerning its EEO program in the public inspection file.

Federal Communications Commission.

Marlene H. Dortch,

Secretary.

[FR Doc. E9–25814 Filed 10–26–09; 8:45 am]

BILLING CODE: 6712–01–S

FEDERAL RESERVE SYSTEM

Formations of, Acquisitions by, and Mergers of Bank Holding Companies

The companies listed in this notice have applied to the Board for approval, pursuant to the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*) (BHC Act), Regulation Y (12 CFR Part 225), and all other applicable statutes and regulations to become a bank holding company and/or to acquire the assets or the ownership of, control of, or the power to vote shares of a bank or bank holding company and all of the banks and nonbanking companies owned by the bank holding company, including the companies listed below.

The applications listed below, as well as other related filings required by the Board, are available for immediate inspection at the Federal Reserve Bank indicated. The applications also will be available for inspection at the offices of the Board of Governors. Interested persons may express their views in writing on the standards enumerated in the BHC Act (12 U.S.C. 1842(c)). If the proposal also involves the acquisition of a nonbanking company, the review also includes whether the acquisition of the nonbanking company complies with the standards in section 4 of the BHC Act (12 U.S.C. 1843). Unless otherwise noted, nonbanking activities will be conducted throughout the United States. Additional information on all bank holding companies may be obtained from the National Information Center website at *www.ffiec.gov/nic/*.

Unless otherwise noted, comments regarding each of these applications must be received at the Reserve Bank indicated or the offices of the Board of Governors not later than November 20, 2009.

A. Federal Reserve Bank of Atlanta (Steve Foley, Vice President) 1000 Peachtree Street, N.E., Atlanta, Georgia 30309:

1. TWO ROA, LLC, Huntsville, Alabama; to become a bank holding company by acquiring 51 percent of the voting shares of RB Bancorporation, and Reliance Bank, both of Athens, Alabama.

Board of Governors of the Federal Reserve System, October 22, 2009.

Margaret McCloskey Shanks,

Associate Secretary of the Board.

[FR Doc. E9–25771 Filed 10–26–09; 8:45 am]

BILLING CODE 6210–01–S

FEDERAL RESERVE SYSTEM

Sunshine Act Meeting

AGENCY HOLDING THE MEETING: Board of Governors of the Federal Reserve System.

TIME AND DATE: 12 p.m., Monday, November 2, 2009.

PLACE: Marriner S. Eccles Federal Reserve Board Building, 20th and C Streets, N.W., Washington, D.C. 20551.

STATUS: Closed.

MATTERS TO BE CONSIDERED:

1. Personnel actions (appointments, promotions, assignments, reassignments, and salary actions) involving individual Federal Reserve System employees.

2. Any items carried forward from a previously announced meeting.

FOR FURTHER INFORMATION CONTACT: Michelle Smith, Director, or Dave Skidmore, Assistant to the Board, Office of Board Members at 202–452–2955.

SUPPLEMENTARY INFORMATION: You may call 202–452–3206 beginning at approximately 5 p.m. two business days before the meeting for a recorded announcement of bank and bank holding company applications scheduled for the meeting; or you may contact the Board's Web site at *http://www.federalreserve.gov* for an electronic announcement that not only lists applications, but also indicates procedural and other information about the meeting.

Board of Governors of the Federal Reserve System, October 23, 2009.

Robert deV. Frierson,

Deputy Secretary of the Board.

[FR Doc. E9–25946 Filed 10–23–09; 4:15 pm]

BILLING CODE 6210–01–S

FEDERAL RESERVE SYSTEM

[Docket No. OP–1374]

Proposed Guidance on Sound Incentive Compensation Policies

AGENCY: Board of Governors of the Federal Reserve System (Board).

ACTION: Proposed guidance with request for public comment.

SUMMARY: The Board is requesting comment on proposed guidance (the ''guidance'') designed to help ensure that incentive compensation policies at banking organizations do not encourage excessive risk-taking and are consistent with the safety and soundness of the organization. The Federal Reserve also is commencing two supervisory initiatives to spur progress by the banking industry in the development and implementation of sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the banking industry. The Federal Reserve expects all banking organizations to evaluate their incentive compensation arrangements and related risk management, control, and corporate governance processes and immediately address deficiencies in these arrangements or processes that are inconsistent with safety and soundness.

DATES: Comments must be submitted on or before November 27, 2009.

ADDRESSES: The Board will review all of the comments submitted. Please consider submitting your comments by e-mail or fax since paper mail in the Washington DC area and at the Board is subject to delay. You may submit comments, identified by Docket No. OP–1374, by any of the following methods:

- *Agency Web Site: http://www.federalreserve.gov*. Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm*.
- *Federal eRulemaking Portal: http://www.regulations.gov*. Follow the instructions for submitting comments.
- *E-mail: regs.comments@federalreserve.gov*. Include the docket number 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, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site 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 in electronic or paper form in Room MP–500 of the Board's Martin Building (20th and C Streets, NW.,) between 9 a.m. and 5 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT:

Barbara J. Bouchard, Associate Director, (202) 452–3072, William F. Treacy, Adviser, (202) 452–3859, Robert Motyka, Senior Project Manager, (202) 452–5231, Division of Banking Supervision and Regulation; Mark S. Carey, Adviser, (202) 452–2784, Division of International Finance; or Kieran J. Fallon, Assistant General Counsel, (202) 452–5270, or Michael W. Waldron, Counsel, (202) 452–2798, Legal Division. For users of Telecommunications Device for the Deaf (''TDD'') only, contact (202) 263–4869.

SUPPLEMENTARY INFORMATION:

I. Background

Incentive compensation practices in the financial services industry were one of many factors contributing to the financial crisis that began in 2007. Banking organizations too often rewarded employees for increasing the firm's short-term revenue or profit without adequate recognition of the risks the employees' activities posed for the firm. Importantly, problematic compensation practices were not limited to the most senior executives at financial firms. Compensation practices can incent employees at various levels of a banking organization, either individually or as a group, to undertake imprudent risks that can significantly and adversely affect the risk profile of the firm.

Supervisory attention and action is necessary to address the potential for incentive compensation arrangements to encourage employees to take excessive risks on behalf of their organization. Shareholders of a banking organization cannot directly control the day-to-day operations of the firm—especially a large and complex firm—and must rely on the firm's management to do so, subject to direction and oversight by shareholder-elected boards of directors. Incentive compensation arrangements are one way that firms can encourage managers and other employees to take actions that are consistent with the interests of shareholders by appropriately rewarding behavior that increases the organization's revenue, profits, or other measures of performance. However, flawed compensation programs can incentivize employees to take additional risk beyond the firm's tolerance for, or ability to manage, risk in order to increase the employees' personal compensation. Shareholders have an interest in ensuring that incentive compensation arrangements do not encourage employees to take risks beyond the risk tolerance of shareholders.

Aligning the interests of shareholders and employees, however, is not always sufficient to protect the safety and soundness of a banking organization. Because of the protections offered by the federal safety net, shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Thus, a review of incentive compensation arrangements and related corporate governance practices to ensure that they are effective from the standpoint of shareholders is not sufficient to ensure they adequately protect the safety and soundness of the organization.

In addition, supervisors can provide a common prudential foundation for incentive compensation arrangements across banking organizations and promote the overall movement of the industry toward better practices. Even if the owners or managers of an individual firm do not like the way compensation is structured at their firm, they may be unwilling to make unilateral changes because doing so might mean losing valuable employees and business to other firms. Supervisory action can play a critical role in addressing this ''first mover'' problem that may make it difficult for individual firms to act alone in addressing misaligned incentives. Through their actions, supervisors can help to better align the interests of managers and other employees with the long-term health of the organization, and also reduce firms' concerns that making prudent modifications to their incentive compensation arrangements might have adverse competitive consequences.

II. Federal Reserve Guidance

The Federal Reserve has developed the attached guidance to help protect the safety and soundness of banking organizations and promote the prompt improvement of incentive compensation practices throughout the banking industry.[1] The guidance is based on three key principles that are designed to ensure that incentive compensation arrangements at a banking organization do not encourage employees to take excessive risks. These principles provide that incentive compensation arrangements at a banking organization should—

- Provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk;
- Be compatible with effective controls and risk management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles, and the types of policies, procedures, and systems that banking organizations should have to help ensure compliance with these principles, are discussed in more detail in the attached proposed guidance. These principles and the guidance are consistent with the Principles for Sound Compensation Practices adopted by the Financial Stability Board (FSB) in April 2009, as well as the Implementation Standards for those principles issued by the FSB in September 2009.

Because incentive compensation arrangements for executive and non-executive employees may pose safety and soundness risks if not properly structured, the proposed guidance applies to senior executives as well as other employees who, either individually or as part of a group, may expose the relevant banking organization to material amounts of risk. In addition, implementation of the guidance by a banking organization should be appropriate in light of the scope and complexity of the organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Thus, for example, the reviews, policies, procedures, and systems implemented by a small banking organization that uses incentive compensation arrangements on a limited basis will be substantially less extensive, formalized, and detailed than those at large, complex banking organization that uses incentive compensation arrangements extensively.

The Board invites comment on all aspects of the guidance. In particular, are the three core principles described in the guidance appropriate and sufficient to help ensure that incentive compensation arrangements do not threaten the safety and soundness of banking organizations? Should

[1] As used in the guidance, the term ''banking organization'' includes U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the United States.

additional or different principles be included to achieve this goal? To what extent are the current incentive compensation arrangements of banking organizations consistent with the principles set forth in the guidance and are there material legal, regulatory, or other impediments to the prompt implementation of incentive compensation arrangements and related processes that would be consistent with these principles?

In addition, some have suggested that one or more formulaic limits be adopted for some or all banking organizations, and, in particular, have suggested consideration of an approach in which at least 60 percent of all incentive compensation received by senior executives of all large, complex banking organizations be deferred and at least 50 percent of incentive compensation be paid in the form of stock, options, or other equity-linked instruments. Would such formulaic limits on determining and paying incentive compensation likely promote the long-term safety and soundness of banking organizations generally if applied to certain types or classes of executive or non-executive employees across all or certain types of banking organizations? If so, what are those classes of executives, employees and institutions, and what formulaic limits would be most effective? Moreover, would market forces or practices in the broader financial services industry, such as the use of ''golden parachute'' or ''golden handshake'' arrangements to retain or attract employees, present challenges for banking organizations in developing and maintaining balanced incentive compensation arrangements? If so, what types of statutory, regulatory, or private-sector actions might help mitigate these challenges?

Further, the Board seeks comment on whether the proposed guidance would impose undue burdens on, or have unintended consequences for, banking organizations and, particularly, regional and small organizations, and whether there are ways such potential burdens or consequences could be addressed in a manner consistent with safety and soundness. Also, are there types of incentive compensation plans, such as firm-wide profit sharing plans that provide for distributions in a manner that is not materially linked to the performance of specific employees or groups of employees, that could and should be exempted from, or treated differently under, the guidance because they are unlikely to affect the risk-taking incentives of all, or a significant number of, employees? If so, what are the features of these plans and the types of employees for which they are unlikely to affect risk-taking behavior?

III. Federal Reserve Supervisory Initiatives

The Federal Reserve expects all banking organizations to evaluate their incentive compensation arrangements and related risk management, control, and corporate governance processes and immediately address deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in the guidance, do not encourage excessive risk-taking, and do not pose a threat to the safety and soundness of the organization.

The Federal Reserve is committed to moving the banking industry forward to incorporate the principles described in the guidance into incentive compensation practices. Accordingly, in addition to proposing guidance, the Federal Reserve is commencing the following two supervisory initiatives to spur and monitor the industry's progress towards the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry:

- A special horizontal review of incentive compensation practices at large complex banking organizations (LCBOs); and
- A review of incentive compensation practices at other banking organizations as part of the risk-focused examination process for these organizations.

LCBOs warrant special supervisory attention because they are significant users of incentive compensation arrangements and because the adverse effects of flawed approaches at these institutions are more likely to have adverse effects on the broader financial system.[2] As part of the horizontal review of these firms, each LCBO will be expected to provide the Federal Reserve information and documentation that clearly describes the organization's current incentive compensation practices and its plans (including timetables) for improving these practices.

The horizontal review of LCBOs will be led by Board staff, working with relevant Reserve Bank supervisors, and will draw on a multidisciplinary group comprised of staff with expertise in banking supervision, risk management, economics, finance, law, accounting, and other areas as appropriate. This multidisciplinary team also will have access to information and analysis developed as part of the reviews of other banking organizations, and will serve as a resource for supervisory staff across the System on incentive compensation matters.

The Federal Reserve will work closely with each LCBO to ensure that its plans are likely to result in the establishment and maintenance of incentive compensation arrangements that do not encourage excessive risk-taking. The Federal Reserve also will supervise these organizations to ensure that these plans are fully implemented in a timely manner.

In the second initiative, the Federal Reserve will review incentive compensation arrangements at non-LCBO banking organizations as part of risk management reviews during the regular, risk-focused examination process. As with other aspects of the examination process, these reviews will be tailored to reflect the scope and complexity of the organization's activities, as well as the prevalence and scope of the organization's incentive compensation arrangements.[3]

For LCBOs and other organizations, supervisory findings will be included in the relevant report of examination or inspection, communicated to the organization, and incorporated, as appropriate, into the organization's supervisory ratings. The Federal Reserve in appropriate circumstances may take enforcement action against a banking organization if its incentive compensation arrangements or related risk management, control, or governance processes pose a risk to the safety and soundness of the organization and the organization is not taking prompt and

[2] An important aspect of the Federal Reserve's consolidated supervision programs for bank holding companies and the combined U.S. operations of foreign banking organizations is the assessment and evaluation of practices across groups of organizations with similar characteristics and risk profiles. LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their regulatory structures, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one key financial market. *See* SR letter 08–9, Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organization (Oct. 16, 2008).

[3] Similarly, for foreign banking organizations, the management of U.S. operations will be assessed with regard to the consistency of incentive compensation arrangements and related processes with the principles set forth in this guidance, taking into account the size and complexity of U.S. operations. *See* SR letter 08–9, Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations (Oct. 16, 2008).

effective measures to correct the deficiencies. Where appropriate, such an action may require an organization to develop a corrective action plan that is acceptable to the Federal Reserve to rectify deficiencies in its incentive compensation arrangements or related processes.

Additional information concerning these supervisory initiatives is provided in the guidance. Effective and balanced incentive compensation practices are likely to evolve significantly in the coming years, spurred by the efforts of banking organizations, supervisors, and other stakeholders. The Federal Reserve will review and update the guidance as appropriate to incorporate best practices that emerge from these efforts. In addition, in order to monitor and encourage improvements, Federal Reserve staff will prepare a report on trends and developments in compensation practices at banking organizations after the conclusion of 2010.

IV. Other Matters

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR Part 1320 Appendix A.1), the Board reviewed the proposed guidance under the authority delegated to the Board by the Office of Management and Budget (OMB). The Board has determined that certain aspects of the proposed guidance may constitute a collection of information. In particular, these aspects are the provisions that state a banking organization should (i) have policies and procedures that identify and describe the role(s) of the personnel and units authorized to be involved in incentive compensation arrangements, identify the source of significant risk-related inputs, establish appropriate controls governing these inputs to help ensure their integrity, and identify the individual(s) and unit(s) whose approval is necessary for the establishment or modification of incentive compensation arrangements; (ii) create and maintain sufficient documentation to permit an audit of the organization's processes for incentive compensation arrangements; (iii) have any material exceptions or adjustments to the incentive compensation arrangements established for senior executives approved and documented by its board of directors; and (iv) have its board of directors receive and review, on an annual or more frequent basis, an assessment by management of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness. The Federal Reserve estimates that the above-described information collections included in the proposed guidance would take respondents, on average, 40 hours each year. Any changes to the Federal Reserve's regulatory reporting forms that may be made in the future to collect information related to incentive compensation arrangements would be addressed in a separate Federal Register notice. The Board may not conduct or sponsor, and an organization is not required to respond to, an information collection unless the information collection displays a currently valid OMB control number.

For purposes of the PRA, this information collection will be titled Recordkeeping Provisions Associated with the Incentive Compensation Guidance. The agency form number for the collection is FR 4027. The agency control number for this new collection will be assigned by OMB.

This information collection is authorized pursuant to sections 11(a), 11(i), 25, and 25A of the Federal Reserve Act (12 U.S.C. 248(a), 248(i), 602, and 611), section 5 of the Bank Holding Company Act (12 U.S.C. 1844), and section 7(c) of the International Banking Act (12 U.S.C. 3105(c)). The Board expects to review the policies and procedures for incentive compensation arrangements as part of the Board's supervisory process. To the extent the Board collects information during an examination of a banking organization, confidential treatment may be afforded to the records under exemption 8 of the Freedom of Information Act (FOIA), 5 U.S.C. 552(b)(8).

The frequency of information collection is estimated to be annual. Respondents are banking organizations as defined in the guidance, which total 6,889. The estimated annual reporting hours are 275,560.

Comments on the collection of information should be sent to Michelle Shore, Federal Reserve Board Clearance Officer, Division of Research and Statistics, Mail Stop 95–A, Board of Governors of the Federal Reserve System, Washington, DC 20551, with copies of such comments sent to the Office of Management and Budget, Paperwork Reduction Project (Docket No. OP–1374), Washington, DC 20503.

Comments are invited on:

(1) Whether the proposed collection of information is necessary for the proper performance of the Federal Reserve's functions; including whether the information has practical utility;

(2) The accuracy of the Federal Reserve's estimate of the burden of the proposed information collection, including the cost of compliance;

(3) Ways to enhance the quality, utility, and clarity of the information to be collected; and

(4) Ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology.

While the guidance is not being adopted as a rule, the Board also has considered the potential impact of the proposed guidance on small banking organizations in accordance with the Regulatory Flexibility Act (5 U.S.C. 603(b)). For the reasons discussed in the ''Supplementary Information'' above, the Board believes that issuance of the proposed guidance is needed to help ensure that incentive compensation arrangements do not pose a threat to the safety and soundness of banking organizations, including small banking organizations.

It is estimated that the proposed guidance, if adopted in final form, would apply to 3002 small banking organizations (defined as banking organizations with $175 million or less in total assets). *See* 13 CFR 121.201. The Board has focused the guidance on those employees who have the ability, either individually or as part of a group, to expose a banking organization to material amounts of risk. In addition, the Board has sought to tailor the guidance and its supervisory initiatives to account for the differences between large and small banking organizations and has provided that, in conducting reviews of small banking organizations as part of the regular examination process, the Federal Reserve will take into account the scope and complexity of the organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. In light of the foregoing, the Board does not believe that the proposed guidance, if adopted in final form, would have a significant economic impact on a substantial number of small entities. As noted above, the Board specifically seeks comment on whether the proposed guidance 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 safety and soundness.

V. Proposed Guidance

The text of the proposed guidance is as follows:

I. Introduction

Incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis. Banking organizations too often rewarded employees for increasing the firm's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the firm. These practices exacerbated the risks and losses at a number of banking organizations and resulted in the misalignment of the interests of employees with the long-term well being and safety and soundness of their organizations.

This document provides guidance on sound compensation practices to banking organizations supervised by the Federal Reserve.[1] Alignment of the incentives provided to employees with the interests of shareholders of the organization often also furthers safety and soundness. However, aligning those interests is not always sufficient to address safety and soundness concerns. Because of the presence of the federal safety net, shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Accordingly, the Federal Reserve expects banking organizations to maintain incentive compensation practices that are consistent with safety and soundness, even when these practices go beyond those needed to align shareholder and employee interests.

To be consistent with safety and soundness, incentive compensation arrangements at a banking organization should:

- Provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk;
- Be compatible with effective controls and risk management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles, and the types of policies, procedures, and systems that banking organizations should have to help ensure compliance with these principles, are discussed in Part II of this guidance.

The Federal Reserve expects all banking organizations to evaluate their incentive compensation arrangements for executive and non-executive employees who, either individually or as part of a group, have the ability to expose the firm to material amounts of risk and the risk management, control, and corporate governance processes related to these arrangements. Banking organizations should immediately address deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in this guidance and do not encourage excessive risk-taking or pose a threat to the safety and soundness of the organization.[2]

Designing and implementing compensation arrangements that properly incent employees to pursue the organization's long-term well being and that do not encourage excessive risk-taking is a complex task and one that requires the commitment of adequate resources. The Federal Reserve recognizes that incentive compensation arrangements often seek to serve several important and worthy objectives.[3] It is important that incentive compensation arrangements be properly structured for all employees at a banking organization, including non-executive employees, who have the ability, either individually or as a group, to take material risks. The analysis and methods for making incentive compensation arrangements take appropriate account of risk also should be tailored to the business model, risk tolerance, size, and complexity of each firm. Thus, achieving and sustaining adherence to sound practices will present challenges.

While the issues are complex, the Federal Reserve is committed to moving banking organizations forward to incorporate the principles described in this guidance into incentive compensation practices. To help accomplish this, the Federal Reserve is commencing two supervisory initiatives:

- A special horizontal review of incentive compensation practices at large, complex banking organizations; and
- A review of incentive compensation practices at other banking organizations as part of the regular risk-focused examination process for these organizations.

These initiatives, which are described in greater detail in Part III of this guidance, are designed to spur and monitor progress toward safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.

The Federal Reserve expects to commence promptly the horizontal review of large, complex banking organizations (LCBOs). As part of this review, each LCBO will be expected to provide the Federal Reserve with, among other things, the organization's plans, including relevant timetables, for improving the risk-sensitivity of its incentive compensation arrangements and related risk management, controls, and corporate governance practices. The Federal Reserve will work with these organizations as necessary through the supervisory process to ensure that they produce plans that will promptly result in incentive compensation arrangements that are consistent with safety and soundness, and will supervise the organizations to ensure that these plans are fully implemented in an expeditious manner.

To promote consistency and to leverage the resources available at the Federal Reserve, the horizontal review of LCBOs will be led by Board staff, working with Reserve Bank supervisors responsible for LCBOs. This coordinating group will be comprised of staff with expertise in banking supervision, risk management, economics, finance, law, accounting, and other areas as appropriate. This multidisciplinary team also will have access to information and analysis developed as part of the reviews of other banking organizations and will serve as a resource for supervisory staff across the System on incentive compensation matters.

As part of the supervisory process for all banking organizations, the Federal Reserve will assess the potential for incentive compensation arrangements to encourage excessive risk-taking, the actions an organization has taken or proposes to take to correct deficiencies, and the adequacy of the organization's compensation-related risk management, control, and corporate governance processes. Reviews at regional and community banking organizations will be conducted as part of the evaluation

[1] As used in this guidance, the term ''banking organizations'' includes U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company in the United States.

[2] In this guidance, the term ''incentive compensation'' refers to that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (*e.g.,* a level of sales, revenue, or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is tied to, continued employment (*e.g.,* salary).

[3] For example, incentive compensation arrangements may be used to help attract skilled staff, promote better firm and employee performance, promote employee retention, provide retirement security to employees, or provide a closer tie between compensation expenses and revenue on a firm-wide basis.

the firm's risk management, internal controls, and corporate governance during the regular examination process.[4] These reviews will be tailored to reflect the scope and complexity of the organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. In this regard, the compensation-related policies, procedures, and systems at a small banking organization that uses incentive compensation arrangements on a limited basis will be substantially less extensive, formalized, and detailed than those of an LCBO that uses incentive compensation arrangements extensively.

Supervisory findings for all types of organizations will be included in the relevant report of examination or inspection and communicated to the organization.[5] In addition, these findings will be incorporated, as appropriate, into the organization's rating component(s) and subcomponent(s) relating to risk management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.[6]

In appropriate circumstances, the Federal Reserve may take enforcement action against a banking organization if its incentive compensation arrangements or related risk management, control, or governance processes pose a risk to the safety and soundness of the organization and the organization is not taking prompt and effective measures to correct the deficiencies. For example, the Federal Reserve may take an enforcement action it considers appropriate against an LCBO if the organization fails to develop, submit, or adhere to an effective plan designed to ensure that the organization's incentive compensation arrangements do not encourage excessive risk-taking and are consistent with principles of safety and soundness. As provided under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), an enforcement action may, among other things, require an organization to develop a corrective action plan that is acceptable to the Federal Reserve to rectify deficiencies in its incentive compensation arrangements or related processes. Where warranted, the Federal Reserve may require the organization to take affirmative action to correct or remedy deficiencies related to the organization's incentive compensation practices until its corrective action plan is implemented.

Effective and balanced incentive compensation practices are likely to evolve significantly in the coming years, spurred by the efforts of banking organizations, supervisors, and other stakeholders. The Federal Reserve will review and update this guidance as appropriate to incorporate best practices that emerge from these efforts.

II. Principles of a Sound Incentive Compensation System

The incentive compensation arrangements and related policies and procedures of banking organizations should be consistent with principles of safety and soundness.[7] This guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively take account of potential risks and risk outcomes.[8] Because incentive compensation arrangements for executive and non-executive personnel who have the ability to expose a banking organization to material amounts of risk may, if not properly structured, pose a threat to the organization's safety and soundness, this guidance applies to incentive compensation arrangements for:

- Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
- Individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk (*e.g.,* traders with large position limits relative to the firm's overall risk tolerance); and
- Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the firm to material amounts of risk, even if no individual employee is likely to expose the firm to material risk (*e.g.,* loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

For ease of reference, these executive and non-executive employees are collectively referred to as ''employees.'' Depending on the facts and circumstances of the individual organization, jobs and job families that are outside the scope of this guidance because they do not have the ability to expose the organization to material risks may include, for example, tellers, bookkeepers, couriers, or data processing personnel.

Principle 1: Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not provide employees incentives to take excessive risks on behalf of the banking organization.

Incentive compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the firm. 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 an employee who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to take more risk.

An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks, as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness. As an example, under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially. The employee whose activities create materially larger risks for the organization should receive less than the other employee, all else being equal.

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[4] Thus, for example, reviews at bank holding companies with total consolidated assets of $5 billion or less will be conducted in accordance with the risk-focused supervision program for these organizations. *See* SR letter 02–1, Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less (Jan. 9, 2002).

[5] *See* SR letter 08–1, Communication of Examination/Inspection Findings (Jan. 24, 2008).

[6] For example, supervisory findings for bank holding companies in the areas discussed in this guidance should be incorporated into the assessment of the appropriate subcomponent(s) for the BHC's ''Risk Management'' rating component in the RFI (Risk Management, Financial Condition, and Impact) rating. *See* SR letter 04–18, Bank Holding Company Rating System (Dec. 6, 2004).

[7] In the case of the U.S. operations of foreign banks, the organization's policies, including management, review, and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

[8] This guidance and the principles reflected herein are consistent with the Principles for Sound Compensation Practices issued by the Financial Stability Board (FSB) in April 2009, and with the FSB's Implementation Standards for those principles, issued in September 2009.

The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage excessive risk-taking. For example, if an employee's incentive compensation payments are closely tied to short-term revenue or profit of business generated by the employee, without any adjustments for the risks associated with the associated business, the potential for the arrangement to encourage excessive risk-taking may be quite strong. On the other hand, if an employee's incentive compensation payments are determined based on performance measures that are only distantly linked to the employee's activities (*e.g.,* for most employees, firm-wide profit), the potential for the arrangement to encourage the employee to take excessive risks on behalf of the organization may be weak.[9]

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes. If, for example, employees are paid substantially all of their potential incentive compensation even when risk or risk outcomes are materially worse than expected, employees have less incentive to avoid excessively risky activities.

• Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.

The activities of employees may create a wide range of risks for a banking organization, 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. For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (*e.g.,* the higher credit or compliance risk associated with subprime loans versus prime loans).[10] In addition, some risks may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized (''bad-tail risks''). While shareholders may have less incentive to guard against bad-tail risks because of their infrequency and the existence of the federal safety net, these risks warrant special attention from a safety-and-soundness perspective given the threat they pose to the organization's solvency and the federal safety net.

Banking organizations should consider the full range of current and potential risks associated with the activities of employees, including the cost and amount of capital and liquidity needed to support those risks, in developing balanced incentive compensation arrangements. Reliable quantitative measures of risk and risk outcomes (''quantitative measures''), where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced. However, reliable quantitative measures may not be available for all types of risk or for all activities, and their utility for use in compensation arrangements varies across business lines and employees. The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations should ignore such risks or outcomes for purposes of assessing whether an incentive compensation arrangement achieves balance. For example, while reliable quantitative measures may not exist for many bad-tail risks, it is important that such risks be considered given their potential effect on safety and soundness. As in other risk-management areas, banking organizations should rely on informed judgments to estimate risks and risk outcomes in the absence of reliable quantitative risk measures.[11]

Banking organizations, and particularly large, complex organizations, should consider using scenario analysis to help assess whether the features included in incentive compensation arrangements are likely to achieve balance over time. Scenario analysis of incentive compensation arrangements involves the evaluation of payments on a forward-looking basis based on a range of performance levels, risk outcomes, and the levels of risks taken. This type of analysis can help an organization assess whether incentive compensation payments to an employee are likely to be reduced appropriately as the risks to the organization from the employee's activities increase.

• An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.

If an incentive compensation arrangement may encourage employees to take excessive risks, the banking organization should modify the arrangement as needed to ensure that it is consistent with safety and soundness. Four methods currently are often used to make compensation more sensitive to risk. These methods are:

○ Risk Adjustment of Awards: The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities pose to the organization. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.

○ Deferral of Payment: The actual payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that become clear only during the deferral period.[12] Deferred payouts may be altered according to risk outcomes either formulaically or judgmentally, though extensive use of judgment might make it more difficult to execute deferral arrangements in a sufficiently predictable fashion to influence employee behavior. To be most effective, the deferral period should be

[9] Similarly, the size of an employee's incentive compensation payments in relation to the employee's total compensation package may affect the likelihood that the incentive compensation arrangement may induce the employee to take excessive risks. For example, where incentive compensation is a small portion of employees' total compensation—as is the case for many employees at regional and community banking organizations—such compensation is less likely to affect the employees' risk-taking behavior than when incentive compensation represents a large percentage, or even a majority, of the employees' total compensation.

[10] Importantly, the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure. For example, the ongoing reinvestment of funds by a cash management unit in commercial paper with a one-day maturity not only exposes the organization to one-day credit risk, but also exposes the organization to liquidity risk that may be realized only infrequently.

[11] Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, strong internal controls and ex post monitoring of incentive compensation payments relative to actual risk outcomes are particularly important to help ensure that the arrangements as implemented do not encourage excessive risk-taking.

[12] The deferral of payment method is sometimes referred to in the industry as a ''clawback.'' The term ''clawback'' also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur. Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7243), which applies to chief executive officers and chief financial officers of public banking organizations, is an example of this more specific type of ''clawback'' requirement.

sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.

○ Longer Performance Periods: The time period covered by the performance measures used in determining an employee'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 are realized or better known.

○ Reduced Sensitivity to Short-Term Performance: The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives.[13]

These methods for achieving balance are not exclusive, and additional methods or variations may exist or be developed. Moreover, each method has its own advantages and disadvantages. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for excessive 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), particularly if such risks are likely to be realized during the deferral period. Accordingly, in some cases two or more methods may be needed in combination for an incentive compensation arrangement to be balanced. The greater the potential incentives an arrangement creates for an employee to increase the risks borne by the organization, the stronger the effect should be of the methods applied to achieve balance.

Methods and practices for making compensation sensitive to risk-taking are likely to evolve rapidly during the next few years, driven in part by the efforts of supervisors and other stakeholders. A banking organization should monitor developments in the field and should incorporate new or emerging methods or practices that are likely to improve the organization's safety and soundness into its incentive compensation systems.

• The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.

Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. For example, the risks associated with the activities of one group of non-executive employees (*e.g.,* loan originators) may differ significantly from those of another group of non-executive employees (*e.g.,* spot foreign exchange traders). In addition, reliable quantitative measures of risk and risk outcomes are unlikely to be available for a banking organization as a whole, particularly a large complex organization. This can make it difficult for banking organizations to achieve balanced compensation arrangements for senior executives who have responsibility for managing risks on a firm-wide basis through use of the risk adjustment of award method.

Moreover, the payment of deferred incentive compensation in equity (such as restricted stock of the organization) or equity-based instruments (such as options to acquire the organization's stock) may be effective in restraining the risk-taking incentives of senior executives and other employees whose activities may have a material effect on the overall financial performance of the firm. However, equity-related deferred compensation may not be as effective in restraining the incentives of lower-level employees (particularly at large organizations) to take risks because such employees are unlikely to believe that their actions will materially affect the organization's stock price.

Banking organizations should take account of these differences when constructing balanced compensation arrangements. For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to provide at least some employees with incentives to take excessive risks.[14]

Incentive compensation arrangements for senior executives at LCBOs are likely to be better balanced if they involve 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, substantial use of multi-year performance periods, or both. Similarly, the compensation arrangements for senior executives at LCBOs are likely to be better balanced if a significant portion of the incentive compensation of these executives is paid in the form of equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the firm during the deferral period. The portion of the incentive compensation of other employees that is deferred or paid in the form of equity-based instruments should appropriately take into account the level, nature, and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the firm and its stock price.

• Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.

Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes, can provide the employee significant incentives to engage in undue risk-taking. Banking organizations should carefully review any such existing or proposed arrangements (sometimes called "golden parachutes") and the potential impact of such arrangements on the organization's safety and soundness. A banking organization should ensure that golden parachute arrangements do not encourage excessive risk-taking in light of the other features of the employee's incentive compensation arrangements.

Similarly, provisions that require an employee to forfeit deferred incentive compensation payments upon departure from the organization may weaken the

[13] Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above the target or may provide that awards will be granted only if a target is met or exceeded. Employees may be particularly motivated to take excessive risk in order to reach performance targets that are aggressive, but potentially achievable.

[14] For example, spreading payouts of incentive compensation awards over a three-year period may not be sufficient by itself to balance the compensation arrangements of employees who may expose the organization to substantial longer-term risks.

effectiveness of the deferral arrangement in achieving balance by removing the employee's financial exposure to the risk outcomes of the employee's activities at the firm. This weakening effect can be particularly significant for senior executives or other skilled individuals whose services are in high demand within the market. In such circumstances, the departing employee often may be able to negotiate a "golden handshake" arrangement with the employee's new firm, which compensates the employee for some or all of the estimated, non-risk-adjusted value of the deferred incentive compensation forfeited by the employee upon departure from the organization. While a banking organization may not be able to control the hiring practices of other firms, it should consider whether golden handshake arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees and, if so, whether changes to the organization's deferred compensation vesting policies or other aspects of its incentive compensation arrangements should be made to ensure that they do not encourage employees to take excessive risks while employed by the organization.

• Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.

In order for the risk-sensitive provisions of incentive compensation arrangements to affect employee risk-taking behavior, the organization's employees must understand that the amount of incentive compensation that they may receive will vary based on the risk associated with their activities. Accordingly, banking organizations should ensure that the employees covered by an incentive compensation arrangement are informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid. Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk-outcomes. An organization's communications should be tailored appropriately to reflect the sophistication of the relevant audience(s).

Principle 2: Compatibility With Effective Controls and Risk Management

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

• Banking organizations 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.

In order to increase their own compensation, employees may seek to evade the processes established by a banking organization to achieve balanced compensation arrangements. Similarly, an employee covered by an incentive compensation arrangement may seek to influence the risk measures or other information or judgments that are used to make the employee's pay sensitive to risk in ways designed to increase the employee's pay.

If successful, these actions may significantly weaken the effectiveness of an organization's incentive compensation arrangements in restricting excessive risk-taking. These actions can have a particularly damaging effect on the safety and soundness of the organization if they result in the weakening of risk measures, information, or judgments that the organization uses for other risk management, internal control, or financial purposes. In such cases, the employee's actions may weaken not only the balance of the organization's incentive compensation arrangements, but also the risk management, internal controls, and other functions that are supposed to act as a separate check on risk-taking.

To help prevent this damage from occurring, a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. For example, an organization's policies and procedures should (i) identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements; (ii) identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and (iii) identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements. Banking organizations also should create and maintain sufficient documentation to permit an audit of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements.

A banking organization should conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed. Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An organization's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements. The results should be reported to appropriate levels of management and, where appropriate, the organization's board of directors. Reviews conducted by regional or community banking organizations should be tailored to the management, internal control, compliance, and audit framework for the organization, as well as the scope and complexity of the organization's activities and its use of incentive compensation arrangements.

• Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk-taking.

Developing balanced compensation arrangements and monitoring arrangements to ensure they achieve balance over time requires an understanding of the risks (including compliance risks) and potential risk outcomes associated with the activities of the relevant employees. Accordingly, banking organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining excessive risk-taking.[15] Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to (i) reviewing the types of risks associated with the activities of employees covered by an incentive compensation arrangement; (ii) approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes

[15] Involvement of risk-management personnel in the design and monitoring of these arrangements also should help ensure that the organization's risk-management functions can properly understand and address the full range of risks facing the organization.

used in deferred-payout arrangements; and (iii) analyzing risk-taking and risk outcomes relative to incentive compensation payments.

Other functions within an organization, such as its control, human resources, or finance functions, also play an important role in helping ensure that incentive compensation arrangements are balanced. For example, these functions may contribute to the design and review of performance measures used in compensation arrangements or may supply data used as part of these measures.

• Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.

The risk management and control personnel involved in the design and oversight of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles, even when their efforts are challenged by employees seeking to increase their incentive compensation in ways that are inconsistent with sound risk management or internal controls. The compensation arrangements for employees in risk management and control functions thus should be sufficient to attract and retain qualified personnel with appropriate experience and expertise in these fields. In addition, to help preserve the independence of their perspectives, the incentive compensation received by risk management and control personnel staff should not be based predominately on the financial performance of the business units that they review. Rather, the performance measures used in the incentive compensation arrangements for these personnel should be based primarily on the achievement of the objectives of their functions (*e.g.,* risk-adjusted performance or adherence to internal controls).

• Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.

Banking organizations should track incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes. Results should be reported to appropriate levels of management, including where warranted, the board of directors. A banking organization should take the results of such monitoring into account in establishing or modifying incentive compensation arrangements and in overseeing associated controls. If, over time, incentive compensation paid by a banking organization does not appropriately reflect risk outcomes, the organization should review and revise its incentive compensation arrangements and related controls to ensure that the arrangements, as designed and implemented, are balanced and do not provide employees incentives to take excessive risks.

Principle 3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices.

• The board of directors of a banking organization should actively oversee incentive compensation arrangements.

The board of directors of an organization is ultimately responsible for ensuring that the organization's incentive compensation arrangements are appropriately balanced and do not jeopardize the safety and soundness of the organization. Accordingly, the board of directors should actively oversee the development and operation of a banking organization's incentive compensation systems and related control processes.[16] For example, the board of directors should review and approve the overall goals and purposes of the firm's incentive compensation system. The board should provide clear direction to management to ensure that its policies and procedures are carried out in a manner that achieves balance and is consistent with safety and soundness.

In addition, the board of directors should ensure that the compensation system—including performance measures and targets—for business units and individual employees that can expose the firm to large amounts of risk is designed and operated in a manner that will achieve balance. Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors should directly approve the incentive compensation arrangements for senior executives. The board should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and should carefully consider and monitor the effects of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization.

• The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.

The board of directors should regularly review the design and monitor the performance of the organization's incentive compensation systems. To allow for informed reviews, the board should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. For example, the board should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness. These reports should include an evaluation of whether or how incentive compensation practices may be encouraging excessive risk-taking. These reviews and reports should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the prevalence and scope of its incentive compensation arrangements.

In addition, at banking organizations that are significant users of incentive compensation arrangements, the board should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting excessive risk-taking. Boards of directors of these organizations also should consider periodically obtaining and reviewing scenario analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risks taken.

The board should closely monitor incentive compensation payments to senior executives and their sensitivity to risk outcomes. This monitoring should include the review of both backward-looking and forward-looking scenario analysis for senior executives separate from other employees. In addition, if the

[16] As used in this guidance, the term ''board of directors'' is used to refer to the members of the board of directors who have primary responsibility for overseeing the incentive compensation system. Depending on the manner in which the board is organized, the term may refer to the entire board of directors, a compensation committee of the board, or another committee of the board that has primary responsibility for overseeing the incentive compensation system.

compensation arrangement for a senior executive includes a clawback provision, then the review should include sufficient information to determine if the provision has been triggered.

The board of directors should seek to stay abreast of significant emerging changes in compensation plan mechanisms and incentives in the marketplace. However, the board should recognize that institutions, activities, and practices within the industry are not identical. Incentive compensation arrangements at one firm may not be suitable for use at another firm because of differences in the risks, controls, structure, and management among firms. The board of directors of each organization is responsible for ensuring that the incentive compensation arrangements for its organization do not encourage employees to take risks that are beyond the firm's ability to manage effectively, regardless of the practices employed by other firms.

• The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.

If a separate compensation committee is not already in place or required by other authorities,[17] the board of directors should consider establishing such a committee—reporting to the full board—that has primary responsibility for overseeing the organization's incentive compensation systems. A compensation committee should be composed solely or predominantly of non-executive directors. If the board does not have such a compensation committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems. At LCBOs and large regional banking organizations, and at other banking organizations where feasible, one or more of the board of directors should have a level of expertise and experience in risk management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities. The compensation committee should work closely with any board-level risk and audit committees where the substance of their activities overlap.

The board of directors should have the authority to, where appropriate, select, compensate, and use outside counsel, consultants, or other experts with expertise in incentive compensation and risk management.[18] In selecting and using outside parties, the board of directors should give due attention to potential conflicts of interest arising from other dealings of the parties with the firm or for other reasons. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence. While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.

• A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.

If a banking organization's incentive compensation arrangements provide employees incentives to take risks that are beyond the tolerance of the organization's shareholders, these risks are likely to also present a risk to the safety and soundness of the organization.[19] To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements and related risk management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take excessive risks.

The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements. The Securities and Exchange Commission (SEC), for example, has proposed to adopt certain disclosure requirements relating to incentive compensation practices for public companies.[20] The Federal Reserve will work with the SEC to improve the disclosures provided by public banking organizations in ways that promote the safety and soundness of these organizations. In addition, in connection with the special horizontal review process, the Federal Reserve will conduct a review of its regulatory reporting forms to determine what type(s) of summary-level quantitative information concerning incentive compensation arrangements, awards, and payments would be appropriate for the Federal Reserve to collect and make publicly available to help promote balanced incentive compensation arrangements.

• Large, complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.

At banking organizations with large numbers of risk-taking employees engaged in diverse activities, an ad hoc approach to developing balanced arrangements is unlikely to be reliable. Thus, an LCBO should use a systematic approach—supported by robust and formalized policies, procedures, and systems—to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. Such an approach should provide for the organization effectively to:

• Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include (i) senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines; (ii) individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk; and (iii) groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the firm to material amounts of risk;

• Identify the types and time horizons of risks to the organization from the activities of these employees;

• Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take excessive risks;

• Include measures, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced;

• Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and

• Monitor incentive compensation awards, payments, risks taken, and risk

[17] *See* NYSE Listed Company Manual Section 303A.05(a); Nasdaq Listing Rule 5605(d); Internal Revenue Code section 162(m) (26 U.S.C. 162(m)).

[18] It is recognized that the board of directors of an organization with less complex and extensive incentive compensation arrangements, such as many smaller regional and community banking organizations, may not find it necessary or appropriate to retain and use outside experts in this area.

[19] On the other hand, as noted previously, compensation arrangements that are in the interests of the shareholders of a banking organization are not necessarily consistent with safety and soundness. This is because the federal safety net bears some of the downside of risks taken by organizations with access, directly or through a subsidiary, to the safety net.

[20] *See* 74 FR 35076, July 17, 2009.

outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes. Regional and community banking organizations should develop and implement appropriate policies, procedures, and systems in a manner that is tailored to the size and complexity of the organization's activities, as well as the prevalence and scope of its incentive compensation arrangements.

III. Supervisory Initiatives

As noted earlier, the Federal Reserve is commencing two supervisory initiatives in order to spur and monitor the industry's progress toward the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry. In addition, the Federal Reserve will, on an on-going basis, assess banking organizations' incentive compensation arrangements for conformity with the principles of safety and soundness outlined in this guidance.

Large, complex banking organizations. LCBOs warrant the most intensive supervisory attention in the short run because they are significant users of incentive compensation arrangements and because the adverse effects of flawed approaches at these institutions are more likely to have adverse effects on the broader financial system. Accordingly, the Federal Reserve will conduct a formal horizontal review of incentive compensation arrangements at these organizations. The review is designed to achieve the following objectives:

1. Enhance supervisory understanding of the details of current practices, as well as the steps taken or proposed to be taken by organizations to improve the balance of incentive compensation arrangements;
2. Assess the strength of controls and whether actual payouts under incentive compensation arrangements are effectively monitored relative to actual risk outcomes;
3. Understand the role played by boards of directors, compensation committees, and risk-management functions in designing, approving, and monitoring incentive compensation systems; and
4. Identify emerging best practices through comparison of practices across organizations and business lines.

As part of this review, each LCBO will be expected to provide the Federal Reserve information and documentation that clearly describes (i) the structure of the organization's current incentive compensation arrangements, (ii) the existing processes used by the organization to oversee these arrangements and help ensure that they do not encourage employees to take excessive risks, and (iii) the organization's plans, including relevant timetables, for improving the risk-sensitivity of incentive compensation arrangements and related risk management, controls, and corporate governance practices.

The Federal Reserve will work closely with each LCBO to ensure that its plans are likely to result in the establishment and maintenance of incentive compensation arrangements that are consistent with safety and soundness and do not encourage excessive risk-taking. In addition, the Federal Reserve will closely monitor actions taken by the organization under the plan, including the organization's adherence to timetables set forth in its plan for improvements to be developed and implemented. As noted earlier, the Federal Reserve may take supervisory action as appropriate if the organization fails to develop, submit, or adhere to an effective plan designed to ensure that the organization's incentive compensation arrangements do not encourage excessive risk-taking and are consistent with principles of safety and soundness. Such action may include the establishment of appropriate limitations on the organization's incentive compensation awards or payments to help ensure that the organization's incentive compensation arrangements do not pose a threat to the safety and soundness of the organization.

Community and regional banking organizations with incentive compensation arrangements. Supervisory staff should review incentive compensation arrangements at non-LCBO banking organizations as part of the regular, risk-focused supervisory process.[21] These reviews should be conducted in connection with the review of the organization's risk management, internal controls and corporate governance, and should be tailored to reflect the scope and complexity of the organization's activities and prevalence and scope of its incentive compensation arrangements. Thus, for example, a small banking organization that uses incentive compensation arrangements on a limited basis is not expected to have as formalized, extensive, and detailed policies, procedures, and systems governing its incentive compensation arrangements as a LCBO that uses incentive compensation arrangements extensively. In addition, in considering the potential for incentive compensation arrangements, including commission-based programs, to encourage excessive risk-taking, examiners should take into account the strength of the organization's risk management and internal control framework in managing and controlling risks.

If examiners find incentive compensation practices that may be of concern, examiners should consult with the multidisciplinary group described previously. The Federal Reserve will incorporate the findings of these reviews into the organization's supervisory ratings and, where warranted, may take supervisory action against the organization to address deficiencies.

IV. Conclusion

Banking organizations are responsible for ensuring that their incentive compensation arrangements do not encourage excessive risk-taking and do not pose a threat to the safety and soundness of the organization. The Federal Reserve expects banking organizations to take prompt action to address deficiencies in their incentive compensation arrangements or related risk management, control, and governance processes.

The Federal Reserve expects to actively monitor the actions taken by banking organizations in this area and will promote further advances in designing and implementing balanced incentive compensation arrangements. Where appropriate, the Federal Reserve will take supervisory or enforcement action to ensure that material deficiencies that pose a threat to the safety and soundness of the organization are promptly addressed. The Federal Reserve also will update this guidance as appropriate to incorporate best practices as they develop over time.

This concludes the text of the proposed guidance.

By order of the Board of Governors of the Federal Reserve System, October 22, 2009.

Robert deV. Frierson,

Deputy Secretary of the Board.

[FR Doc. E9–25766 Filed 10–26–09; 8:45 am]

BILLING CODE 6210–01–P

[21] Thus, for example, reviews at bank holding companies with total consolidated assets of $5 billion or less will be conducted in accordance with the risk-focused supervision program for these organizations. *See* SR letter 02–1, Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less (Jan. 9, 2002).