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DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12CFR Part 42
Docket No. OCC-2011-0001
RIN 1557-AD39

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Part 236
Docket No. R-1410
RIN 7100-AD69

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 372
RIN 3064-AD56

DEPARTMENT OF THE TREASURY
Office of thrift Supervision
12 CFR Part 563h
Docket No. OTS-2011-0004
RIN 1550-AC49

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

U.S. SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 248
[Release No. 34-64140; File no. S7-12-11]

FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1232
RIN 2590-AA42

Re: Incentive-Based Compensation Arrangements

Ladies and Gentlemen:

We appreciate the opportunity to provide comments on the proposed rules applicable to the incentive-based compensation arrangements of all covered financial institutions ("Proposed Rule") that has been

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proposed by the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Office of Thrift Supervision, the National Credit Union Administration, the Securities and Exchange Commission, and the Federal Housing Finance Agency (collectively, the "Agencies"). We have read the Proposed Rule and, as requested by the Agencies, offer the following comments with respect to the potential accounting and tax implications for your consideration while finalizing the provisions of the Proposed Rule.

Excessive Compensation

The Proposed Rule would establish a general rule 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 …" (emphasis added). This may lead to unintended corporate governance consequences. Consider the following example:

> At the beginning of year 1, awards are made to executives under an incentive compensation program which sets a target level of earnings to be achieved over a 3-year period in order to earn the award. On the award date, the performance target is evaluated and a reasonable conclusion is reached that the program does not encourage inappropriate risks or result in excessive compensation. Sometime during year 2, it becomes apparent that the institution's earnings are not on track for the award to be earned.

The Proposed Rule appears to require a covered institution's governing body to evaluate whether the institution is so far behind achieving the performance target that continuing to maintain the incentive compensation arrangement encourages a covered person to expose the institution to an inappropriate risk as management attempts to make up lost ground before the end of year 3. If so, a governing body could be faced with deciding between a) eliminating the program and thereby eliminating a significant component of executive compensation before the program has run its full course; b) modifying the program to reduce the incentive targets and thereby potentially reward executives that fail to achieve the original performance objectives by making changes to a compensation arrangement (that shareholders may have previously indicated support for in a 'say on pay' vote) as well as lose the ability to report a tax deduction for awards granted to the most senior executives if the revised targets are met; or c) continue to maintain the program but be subject to potential regulatory scrutiny for failing to do a) or b). This concern could be alleviated if any assessment of whether an incentive compensation arrangement encourages excessive risks is required to be made only as of the date the incentive compensation arrangement is first awarded and not also over the award's performance period.

Deferral Periods

On page 41 of the Proposed Rule, the Agencies requested specific comment on all aspects of the required deferral, including tax or accounting considerations. Institutions with assets over $1 billion may decide to use deferral provisions to balance incentives and risk, but the Proposed Rule would require larger institutions to use a minimum three-year deferral period for at least 50 percent of a covered executive's incentive-based compensation. Many institutions have implemented executive compensation arrangements that require service, performance or market conditions to be met for an executive to vest in an award. The proposed rule is ambiguous about when the three-year deferral period begins for certain types of common awards that combine different types of vesting conditions. Depending on how the rule is interpreted, this could have significant accounting consequences for covered financial institutions.

Current U.S. accounting standards for share-based payments provide guidance about how to account for awards when delivery of the underlying shares is delayed beyond the vesting date. If share-based payment awards have only service-based conditions for vesting, the accounting is relatively straightforward. For example, a restricted stock unit award might require a four-year service period to vest, with the shares delivered three years after the vesting date. This three-year deferral period is frequently referred to as a "post-vesting restriction" because the shares are vested after four years and will be delivered based on the passage of time (the three-year post-vesting period) without regard to whether the employee continues to provide service during the deferral period. If a deferral period constitutes a post-vesting restriction, current U.S. accounting standards requires the compensation cost for the awards to be recognized over the service period from the grant date to the vesting date with no compensation cost allocated to the deferral period. However, the grant date fair value of the award is adjusted downward (using valuation techniques) to reflect that the deferred shares would be less valuable than shares that are delivered and owned outright once vested. Typically, the post-vesting restriction would result in a modest discount compared to the fair value of similar awards with no post-vesting restrictions.

If an award has multiple vesting conditions, the Proposed Rule does not clearly define when the deferral period begins. For example, it is not clear when the deferral period would commence if a covered institution granted an award with a condition that cumulative earnings must exceed a specified dollar amount over a two-year period (a performance condition) and then employees must provide service for three years beyond that period (a service condition). We suggest that the Proposed Rule clarify when the deferral period would commence when an award has multiple vesting conditions. Using this example, if the three-year deferral period commences at the end of the fifth year, current U.S. accounting standards requires the compensation cost to be measured at an amount that incorporates a three-year post vesting restriction (for a total of 8 years from the original grant date); the amount of compensation cost so determined would be recognized over the first five years. However, if the three-year deferral period commences at the end of the second year, the compensation cost still would be recognized over five years, but there would be no reduction in grant-date fair value for a post-vesting restriction because the shares would be delivered concurrent with the end of the required service period.

Clawbacks
Grant Dates - The Proposed Rule also would require covered institutions to retain the ability to clawback awards during the deferral period "… to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period." The way an institution implements this provision may impact the grant date for its share-based compensation arrangements. Current U.S. accounting standards require entities to measure compensation for equity-classified share-based compensation arrangements based on the fair value of the awards on the grant date with no adjustment for subsequent changes in fair value. A necessary condition for a grant date is a mutual understanding between the employer and employee about the significant terms and conditions of the award. To have a grant date for awards that would be subject to a deferral period after vesting or a clawback provision, it would be necessary to specify and communicate to the employee the terms and conditions of the deferral or clawback provisions including:

- The length of the deferral period;
- The rate at which units of the award will be released during the deferral period;

- The specific and objectively determinable criteria to be used to determine any clawback adjustments; and
- Other salient features of the award.

If the terms of an award of share-based compensation are not adequately described so that a mutual understanding between the employer and the employee exists or if the governing body of the institution designs the plan to retain significant discretion about when it might clawback an award, there would not be a grant date until the end of the deferral period. In this circumstance, the fair value of the award would be measured at the end of each period and any adjustment for the change in fair value (up or down) since the last measurement and additional service rendered would be recorded in earnings. The fair value of the award would be updated each period until the earlier of a grant date or the resolution of the clawback provision which would potentially introduce significant volatility to a covered institution's financial results.

<u>Modifications to Existing Compensation Arrangements</u> - Current U.S. accounting standards require modification accounting for *any* change to an award's terms. If the fair value of an award immediately after a modification is greater than the fair value of the award immediately prior to the modification, the difference is measured as incremental compensation cost and is recorded over the remaining service period. If the fair value immediately after a modification is equal or lower, then no change is recorded to the previously-measured compensation cost.

The Proposed Rule does not provide transition guidance for existing compensation arrangements. A modification to add a three-year deferral period with objectively determinable criteria to an existing award would generally be expected to reduce the fair value of the existing award, in which case the modification would have no accounting consequence. If subjective clawback provisions are added to the terms of an award, there may no longer be a grant date and the award would be accounted for based on its fair value each period until the end of the deferral period (similar to the treatment for which grant dates have not occurred, as described in the preceding section. However, when an equity-classified award is modified, the fair value of the award at the original grant date would be the minimum amount of compensation that should be recognized.

When share-based payment arrangements are modified, there also may be significant income tax consequences for a financial institution or its employees. Even when there are no accounting consequences for modifications, the tax effects could include the disallowance of the deductibility of an award, the disqualification of an award as an incentive stock option, or excise taxes being assessed to the holder of the award.

These concerns could be alleviated if the Agencies were to modify the Proposed Rule to provide that to the extent compliance with the Proposed Rule would result in substantial adverse tax or accounting consequences, the institution's governing body may limit its clawback authority to the extent necessary to avoid such consequences. We note that a similar provision was incorporated into the recommended standards for compensation policies that the Office of the Special Master for TARP Executive Compensation released in July 2010.

Definition of "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 arrangement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement." On page 23 of the Proposed Rule, the Agencies requested comment on this proposed definition. We suggest that the Agencies replace "stock option plan" with "share-based compensation" to be more comprehensive, as a stock option plan is only one form of share-based compensation.

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If you have any questions or comments regarding information included in this letter, please contact Glen Davison at (212) 909-5839, Tom Canfarotta at (212) 872-5863 or Jeffrey Jones at (212) 909-5490.

Very truly yours,

KPMG LLP