American Bankers Association
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May 31, 2011

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: OTS-2011-0004

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549
Attention: File Number S7-12-11

Re: Proposed Rule; 76 Federal Register 21170; April 14, 2011; Joint Notice and Request for Comment; **OCC:** Docket ID OCC-2011-0001; **FRB:** Docket No. R-1410 and RIN No. 7100-AD69; **FDIC:** RIN 3064-AD56; **OTS:** OTS-2011-0004; **SEC:** File Number S7-12-11

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the proposed rule on Incentive-Based Compensation Arrangements[2] as issued by the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), National

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. The majority of ABA's members are banks with less than $165 million in assets. Learn more at www.aba.com.
[2] 76 *Fed. Reg.* 21170 (April 14, 2011).

Credit Union Administration (NCUA), Securities and Exchange Commission (SEC), and Federal Housing Finance Agency (FHFA) (collectively, the agencies). The proposed rule would implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA).[3]

ABA members have expressed no concerns with many parts of the agencies' proposal. However, ABA urges the agencies to consider including in the final rule on Incentive-Based Compensation Arrangements the several changes suggested below to the agencies' proposed rule. We believe these suggested changes would still allow the agencies to obtain the meaningful information that they need in a manner that satisfies the statutory requirements while avoiding much unnecessary regulatory burden.

- Effective date: ABA recommends that the effective date be twelve, rather than the proposed six, months after the publication of the final rule in the Federal Register. ABA also recommends that the rule be phased in over a longer period of time for covered financial institutions with assets of $1 billion to $10 billion.

- Definitions: ABA recommends several revisions to definitions, including board of directors, covered financial institution, covered person, and executive officer.

- Mandatory deferrals for executive officers of larger covered financial institutions: ABA recommends that the final rule should not mandate or prescribe deferral arrangements, nor fixed deferral vesting periods.

- Special review and approval for other designated individuals (other than executive officers) by larger covered financial institutions: ABA recommends that identification of such individuals; approval and maintaining documentation of the approval of incentive-based compensation for such covered persons; and the balancing of financial rewards and risks related to the identified person's activities should be done by a bank's management, not the board, or a committee thereof. ABA recommends that for each of these functions, the board's or committee's responsibilities should be focused on oversight of these functions, including reviewing and approving management's actions.

- Reports to regulators: ABA recommends that a more principles-based approach annual certification by the board, or a committee thereof, be provided by the parent institution, in lieu of submitting an annual report to regulators disclosing the structure of incentive-based compensation arrangements.

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[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 (July 21, 2010). *See* section 956, Enhanced Compensation Structure Reporting.

Discussion

ABA supports the following item:

Policies and Procedures.
ABA supports the proposal that would require the policies and procedures to subject any incentive-based compensation arrangement, or component thereof, to a corporate governance framework that provides for ongoing oversight by the board of directors or a committee of the board of directors.

ABA concerns with the following items with respect to all covered financial institutions:

General Regulatory Approach.
As a general premise, ABA recommends a principles-based approach in the final rule for incentive-based compensation arrangements, rather than prescriptive rules.

Effective Date.
The Overview of the Proposed Rule states:

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

ABA recommends that the effective date be twelve, rather than the proposed six, months after the publication of the final rule in the Federal Register, with annual "certifications" in lieu of reports due within 90 days of the end of each covered financial institution's fiscal year.

ABA also recommends that the final rule not be retroactive for grants of incentive compensation. If the awarded performance was prior to the effective date, the final rule should not impact the award, even though the award is paid after the effective date of the final rule.

In order to address the additional burden on community banks, ABA also recommends that the rule be phased in over a longer period of time for covered financial institutions with assets of $1 billion to $10 billion. An additional six months for complying with the reporting or certification provision of the final rule would help ease the increasing compliance burden on community banks. These banks already are under enormous pressures, whether from the challenges posed by the economic downturn, complying with existing regulations (many of which were recently adopted), or preparing for new regulations to implement the known changes that will be brought about by DFA. None of these banks presents systemic risk. Moreover, these banks already are complying with the recently-adopted Interagency Guidance on Sound Incentive Compensation

Policies (Banking Agency Guidance).[4] Many have yet the additional "suspenders" of the TARP Standards for Compensation and Corporate Governance[5] to go with the "belt" of the Banking Agency Guidance. Layering on yet another set of rules that address the same issues is simply unnecessary. If such duplication is required under the DFA, there is no reason to do so quickly. Absent a known problem in a given bank, there is no need to require all of these banks to take on yet more burden in a short timeframe when supervisory objectives could be achieved through a more gradual phase-in. A precipitous implementation would force the banks to compete for a finite amount of external resources that can help them comply and will divert attention away from other matters that affect more directly a given bank's safety and soundness and its service to its community.

Definitions.

Board of Directors.
The proposed rule defines "Board of Directors as the governing body of any covered financial institution performing functions similar to a board of directors. …"

ABA recommends amending the definition of "Board of Directors" by adding the following sentence: "In the case of one or more covered financial institutions that are direct or indirect subsidiaries of a parent covered financial institution, 'Board of Directors' shall mean the governing body of the parent covered financial institution."

Institutions affected by the proposed rule may have multiple covered financial institutions, with separate or overlapping boards of directors. We urge the agencies to streamline and simplify potentially overlapping and overly burdensome new duties for boards of directors when there are subsidiary covered financial institutions within a corporate entity. Our recommended revision to the definition that incorporates the governing body of the parent covered financial institution would centralize the responsibilities with the board of the parent covered financial institution.

Covered Financial Institution**.**
The Federal Reserve Board (Board) definition of "Covered Financial Institution" captures subsidiaries of the institution. This could lead to overlapping rules throughout the corporate structure for each subsidiary that is regulated by one of the listed agencies. ABA members have significant concerns about the overlapping agencies' jurisdiction, supervisory regulation, and disclosures that would result from the proposed rule, as well as the resulting confusion and redundancy that this would cause for covered institutions that are regulated by the Board and have subsidiaries that are regulated by other listed agencies.

ABA recommends regulation and certification at the parent/holding company level, rather than requiring institution-by-institution regulation and reporting. ABA recommends that this be accomplished by:

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[4] Guidance on Sound Incentive Compensation Policies, 75 *Fed. Reg.* 36395 (June 25, 2010), adopted by the Federal banking agencies, meaning the OCC, Board, FDIC, and OTS.
[5] TARP Standards for Compensation and Corporate Governance; Interim Final Rule, 74 *Fed. Reg.* 28394 (June 15, 2009).

(1) rolling up the application of the regulation for each affected covered financial institution into a single set of regulation and certification of compliance with the section 956 requirements at the parent/holding company level to one of the listed agencies in the proposed rule; and

(2) carving-out from separate regulation and reporting covered financial institutions that would be rolled up into a single certification of compliance with the section 956 requirements at the parent/holding company level to one of the listed agencies.

Covered Person.
ABA recommends that the definition of "Covered Person" in the proposed rule be revised to tie in a risk-based aspect to this defined term. This would be consistent with the intent of section 956 and would avoid needless burden.

One way to do this would be to define "covered person" consistent with the Banking Agency Guidance.[6] This would apply an appropriate risk-based standard consistent with prior regulatory guidance for the purpose of determining risk takers whose compensation arrangements would be subject to further review and approval under the proposed rules.

Executive Officer.
The agencies' proposed definition of "executive officer" refers to a person who holds listed titles or performs the function of these positions, or the head of a major business line. Specifically, the agencies' proposed definition is as follows:

> The Proposed Rule defines "executive officer" of a covered financial institution as a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following positions: President, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief

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[6] The Banking Agency Guidance, at 36407, states "[t]his 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 organization to material amounts of risk (*e.g.* traders with large position limits relative to the organization'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 organization to material amounts of risk, even if no individual employee is likely to expose the organization 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 hereafter as 'covered employees' or 'employees'."
(Note: the first bullet further provides in a footnote "[s]enior executives include, at a minimum, 'executive officers' within the meaning of the Federal Reserve's Regulation O … and, for publicly traded companies, 'named officers' within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation …. Saving associations should also refer to OTS's rule on loans by savings associations to their executive officers, directors, and principal shareholders….")

investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

ABA recommends that the definition of "executive officer" of a covered financial institution be aligned with the Securities Exchange Act of 1934 (Exchange Act) definition, which focuses on persons designated by public companies who have significant <u>policy making functions</u>. The use of such formal designations of executive officers promotes certainty and consistency in the identification of executive officers for purposes of the proposed rule, both for the covered financial institution and the regulators.

SEC Rule 3b-7 of the Exchange Act (which applies to public companies reporting on Form 10-K) defines "executive officer" as follows:

> §240.3b-7 Definition of "executive officer".
>
> The term *executive officer,* when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.

We believe this definition adequately covers the universe of individuals who are acting in an executive officer capacity. To avoid the needless burden that inevitably would follow from having to comply with two similar, but distinct, definitions, ABA recommends that the definition of "executive officer" be revised to read:

> (f) Executive officer of a covered financial institution means a person who has been designated as an "executive officer" as that term is defined in 17 C.F.R. §240.3b-7 (Rule 3b-7) of the Securities Exchange Act of 1934.
>
> In the absence of any such designation, "executive officer" of a covered financial institution means a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.

ABA concerns relating to larger covered financial institutions:

<u>*Mandatory deferrals for executive officers of larger covered financial institutions*</u>.
The proposal's prescriptive approach of mandating deferral provisions for larger institutions is problematic. ABA recommends that the final rule should not mandate or prescribe deferral arrangements, nor fixed deferral vesting periods. Mandatory deferral provisions are not required by section 956. Indeed, a reason for this may be because there are alternative ways to address material financial loss concerns, including holding periods and clawbacks. The decision to use a

deferral of incentive compensation tool to manage risk should be left to the board of directors of the covered institution as part of its corporate governance.

It would be a mistake to include mandatory deferral provisions in the final rule. Steps could be taken to mitigate only to some degree the negative effects of their inclusion and serious practical problems related to such provisions. For example, regulators would need to address several important issues that would become critical as the result of mandatory deferral provisions. Many large financial institutions presently implement mandatory deferral requirements in both their short-term and annual incentive design structures and maintain mandatory deferral requirements through corporate stock ownership guidelines and stock retention periods. Accordingly, any final rule that included mandatory deferral provisions would need to clarify that any performance measurement period, vesting requirement, mandatory retention period or other period in which an award or incentive amount remains not fully vested or freely transferable, or subject to forfeiture would meet the requisite mandated deferral requirements.

Deferral period for Executive Officers.
The agencies would need to clarify that a deferral period would begin at the time of the grant of incentive compensation.

The agencies' request specific comment on several issues relating to the proposed mandatory deferral requirement for larger covered financial institutions. ABA recommends the following in response to one of the agencies' specific questions, once again emphasizing that it would be wiser not to include mandatory referral requirements in the final rule.

Are there additional considerations, such as tax or accounting considerations, that may affect the ability of larger covered financial institutions to comply with the proposed deferral requirement or that the Agencies should consider in designing this provision in the rule?[7]

Tax Considerations.

Any such final rule would need to make clear that employers do not have to take steps that could result in deferred compensation failing to comply with Section 409A or Section 457A of the Internal Revenue Code (which could result in accelerated tax and potentially a 20% additional tax on employees). Similarly, the final rule would need to make clear that employers do not have to take steps that could result in compensation failing to be considered "performance-based compensation" under Section 162(m) (which could result in an institution's inability to deduct the amount paid to certain employees as compensation expense).

The proposed rule creates issues for structuring incentive compensation arrangements for nonqualified deferred compensation plans under Section 409A of the Internal Revenue Code of 1986, as amended (the Code). Specifically, the mandatory deferral requirement and the

[7] *See* note 2, at 21181.

performance-based adjustment requirement applicable to covered financial institutions with $50 billion or more in total consolidated assets create potential problems with respect to revising existing arrangements and structuring new arrangements.

Existing Arrangements

Assume that payments under a covered financial institution's annual cash incentive compensation arrangement are structured to comply with Section 409A of the Code. Once the time and form of payment of an amount of compensation is established, Section 409A of the Code imposes substantial restrictions on the ability subsequently to change the time and form of payment. The restrictions under Section 409A of the Code would effectively prohibit changing a lump-sum cash payment in the year following the performance year in order to accommodate the mandatory deferral requirements for annual plans already in effect as of the effective date of the final rule.

Therefore, the final rule would need to contain transitional guidance to accommodate or exempt arrangements in effect prior to the effective date of the final rule.

Structuring New Arrangements

The mandatory deferral requirement and the performance adjustment requirement also present concerns with respect to structuring new incentive compensation arrangements.

Complexities arise in structuring the arrangement to comply with the requirement that the deferred amount be adjusted "to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period." The final rule would need to address whether the adjustment requirement is intended to result in the forfeiture of payments that would otherwise be payable during the deferral period or if another "adjustment" is contemplated.

The distinction between a forfeiture of compensation and a change in the time and form of payment is an important one, since changes to the time and form of payment are severely restricted by Section 409A of the Code.

The final rule would also need to address whether larger covered financial institutions are permitted to accelerate payment based on the occurrence of certain events, such as involuntary terminations without cause or change in control transactions.

Accounting Considerations.

Covered financial institutions should not be required to implement any deferral or adjustment in a manner that would result in liability (as opposed to equity) accounting for equity awards. Under U. S. accounting standards, an award that meets certain requirements is treated as a compensation expense based on the fair value of the award on the date the award is "granted." If an employer retains too much discretion in an equity award to reduce the award or forfeit it entirely, the award will not be considered to have been granted for accounting purposes and will be subject to accounting as a liability. As a liability, subsequent changes to the fair value of the equity award would be marked to market through earnings (which could provide unnecessary volatility to capital).

Special Review and Approval Requirement for Other Designated Individuals (Relating to Larger Covered Financial Institutions).

Identification of covered persons (other than executive officers).
The proposed rule would require that a larger covered financial institution's board of directors, or a committee thereof, identify covered persons (other than executive officers) that individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance.

ABA recommends that identification of such individuals should be done by a bank's management, not the board or a committee thereof. The board's (or board committee's) responsibilities should be focused on oversight, including reviewing and approving the identification of such covered persons (other than executive officers).

ABA members are concerned that the proposal removes this identification process from management, which is better positioned to identify the covered individuals. A board should not be distracted by tasks that are more appropriately fulfilled by management. Blurring the line risks causing a board to lose the focus on the major issues of corporate governance and business strategy, exposes directors to additional liability, and makes the role of director that much less desirable.

Approval and maintaining documentation of the approval, of incentive-based compensation for such covered persons.
The proposed rule also requires the board of directors, or a committee thereof, to approve, and maintain documentation of the approval of, the incentive-based compensation arrangement for such identified individuals.

ABA recommends that the Board of Directors, or a committee thereof, should similarly provide an oversight role to achieve the objectives of the proposal rather than being responsible for approving the incentive-based compensation arrangement for each individual who is an identified covered person. Management is better able to approve and document the approval of the incentive-based compensation arrangements for the identified covered individuals.

ABA also recommends that the board, or a committee thereof, should approve the overall incentive-based compensation plan structure for such covered persons, rather than the individual incentive-based compensation arrangement or amounts for each identified covered person.

It would be very burdensome for board members, or a committee thereof, of a large complex financial institution to be required to approve and maintain documentation of the approval of the incentive-based compensation arrangement for each individual who is an identified covered person. These functions are more appropriately fulfilled by management. ABA recommends that the role of the board or a committee should be more aligned to the board's or committee's oversight role as part of its corporate governance responsibilities.

Balancing financial rewards and the range and time horizon of risks related to the identified covered person's activities.

The proposed rule prohibits the board, or a committee thereof, from approving an

> incentive-based compensation arrangement for an individual identified...unless the board (or committee) determines that the arrangement, …effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities, employing appropriate methods for ensuring risk sensitivity… [t]he board, or committee thereof, must evaluate the overall effectiveness of the balancing methods used…in reducing incentives for inappropriate risk taking by the identified covered person, as well as the ability of the methods used to make payments sensitive to the full range of risks presented by that covered person's activities….[8]

ABA recommends that the board, or a committee thereof, oversee and approve the decision-making process on these methods that would be used by management. Also, ABA recommends that the board, or committee thereof, should take appropriate steps to reach a conclusion that the overall incentive-based compensation program for such covered persons achieves the balance required by the agencies. Consistent with ABA's recommendations above, the board's (or committee's) responsibilities should be focused on oversight, including reviewing and approving actions more appropriately taken by management, which is better able to balance these requirements. This approach would be consistent with maintaining the board's focus on major issues of corporate governance.

The agencies request specific comment on several issues relating to the special review and approval requirement for other designated individuals. ABA recommends the following in response to one of the agencies' questions.

Is it sufficient that, as under the proposal, such covered persons are not subject to mandatory deferral but instead are separately identified by the institution's board and the board is required to approve the incentive-based compensation arrangement for the covered person after ensuring it is balanced and sensitive to risk?[9]

ABA recommends that such covered persons should not be subject to mandatory deferral. However, to be consistent with the recommendations made above, ABA recommends that management, rather than the board, or a committee thereof, should perform the above-mentioned duties, which would be subject to oversight, review, and approval by the board, or a committee thereof, consistent with general corporate governance responsibilities.

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[8] *Id.*
[9] *Id.*

Policies and procedures - prohibition on arrangements that could lead to material financial loss of the institution.

> The proposal rule would require a covered financial institution to develop and maintain policies and procedures designed to ensure that the covered financial institution's board of directors, or a committee thereof, receive data and analysis from management and other sources sufficient to allow it to assess whether the overall design and performance of the firm's incentive-based compensation arrangements are consistent with section 956 of the Act.

ABA recommends that the final rule conform this requirement to be consistent with ABA's recommendations noted above for an oversight and approval role of the board, or committee thereof, relating to the special review and approval requirement for other designated individuals.

Required Reports to Regulators.
Instead of submitting an annual report to its appropriate Federal regulator disclosing the structure of its incentive-based compensation arrangements as proposed, ABA recommends that a more principles-based approach annual certification by the board, or a committee thereof, be provided by the parent institution.

The proposed rule acknowledges the very sensitive nature of the material being requested in the annual report and indicates that "the [a]gencies generally will maintain the confidentiality of the information submitted to the [a]gencies, and the information will be nonpublic to the extent permitted by law."[10] However this provides no guarantee that the submitted material will in-fact remain confidential.

ABA's recommendation that the final rule provide that the covered financial institution may annually certify its compliance with the rule and file the certification with its primary Federal regulator (similar to the Compensation Committee Certification process that is required under TARP) would ensure the confidentiality of the required reporting. The covered financial institution will then be required to maintain the actual reporting items, in narrative form, as required under the proposed rule and allow the covered financial institution's regulator to review the material on-site at the financial institution. ABA recommends that the certification should be done by the board of directors, or a committee thereof; the certification should be filed at the parent company level; and the information would be retained at the parent company level (rolled-up) and be available for review/examination by the appropriate Federal regulator.

ABA raises an additional issue that is not included in the proposed rule:

Deferral period for executive officers.
Another problem with a mandatory deferral requirement is how it deals with unforeseeable but not uncommon issues such as the death or disability of an executive officer of larger covered financial institutions. With the imposition of such a rule, the agencies would need to create reasonable exceptions for situations such as death and disability of such "executive officers".

[10] *See* note 2, at 21177.

Since these practical situations which may occur during a mandatory deferral period were not addressed in the proposed rule, ABA draws the attention of the agencies to the need to provide clarification on these issues.

Conclusion

ABA appreciates the opportunity to comment on the proposed revisions included in the Notice and Request for Comment.

Please contact the undersigned at (202) 663-5331 or kmctighe@aba.com if you have any questions. Thank you for considering our comments and recommendations.

Sincerely,

K. P. McTighe

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