CENTER FOR CAPITAL MARKETS COMPETITIVENESS

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May 31, 2011

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

Re: Docket No. R-1410; RIN No. 7100-AD69; Incentive-Based Compensation Arrangements

Dear Ms. Johnson:

The U.S. Chamber of Commerce is the world's largest business federation, representing more than 3 million businesses and organizations of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. To achieve this objective it is an important priority of the CCMC to advance an effective and transparent incentive-based compensation structure. The CCMC welcomes this opportunity to comment on the Proposed Rules on Incentive-Based Compensation Arrangements ("proposed rules") proposed by the Board of Governors of the Federal Reserve System ("Board").

The CCMC believes that strong corporate governance is a cornerstone of fundamental business practices and capital formation needed for economic growth and job creation. In evaluating rules and legislative proposals regarding corporate governance and executive compensation, the CCMC uses the following principles:

- **Corporate governance policies must promote long-term shareholder value and profitability but should not constrain reasonable risk-taking and innovation.**

- **Long-term strategic planning should be the foundation of managerial decision-making.**

- **Corporate executives' compensation should be premised on a balance of individual accomplishment, corporate performance, adherence to risk management and compliance with laws and regulations, with a focus on shareholder value.**

- **Management needs to be robust and transparent in communicating with shareholders.**

The proposed rules are issued pursuant to Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). Using the forgoing principles to evaluate the proposed rules, the CCMC has several serious concerns including:

- One-Size-Fits-All Approach;
- Retention and Acquisition of Talent;
- Need for a Cost Benefit Analysis;
- "Excessive Compensation" and "Inappropriate Risk";
- Calculation of "Total Consolidated Assets";
- "Covered Financial Institution";
- Defining "Incentive-Based Compensation";
- Reporting Requirements, and;
- The Role of the Director and Shareholder.

Accordingly, in compliance with Section 956, the CCMC recommends that the Board continue with guidance, rather than rules, following a period of evaluation and correction to address these defects in the proposed rules.

A detailed discussion of our concerns is provided below.

A. Background

Section 956 of the Act requires the OCC, Board, FDIC, OTS, NCUA, SEC, and FHFA (together "the Agencies") to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions. Specifically, Section 956 requires that the Agencies prohibit incentive-based payment arrangements, or any feature of any such arrangement, at a covered financial institution that the Agencies determine encourages inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. Under the Act, a covered financial institution also must disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements sufficient to determine whether the structure provides "excessive compensation, fees, or benefits" or "could lead to material financial loss" to the institution.

B. Discussion of Concerns Regarding the Proposed Rules

I. One-Size-Fits-All Approach

This joint agency rulemaking attempts to impose a one-size-fits-all approach to financial regulation.[1] Given that various forms of financial market participants each operate in a unique fashion, it is inappropriate to regulate them as if they were all the same. It is unrealistic to expect one set of rules to be equally applicable to all types of financial institutions that would be swept under these proposed rules.

Because the issues involved are complex, far-reaching, and introduce a number of unknowns into the compensation decision making process, we believe it would be appropriate to convene a series of working groups comprised of investors and institutions representing each of the industries affected by these proposed rules to gain a fuller understanding of the true impact that these rules would have on the ability of covered institutions in each covered industry to raise capital and compete

[1] It would seem on its face that the Banking Guidance provides a basis of regulatory compliance with Section 956. That being said, it would seem prudent to first evaluate and test the impacts of the Banking Guidance before moving forward with an expansion of compensation policies by the financial regulators.

globally. We further recommend that such working groups address each of the issues discussed below.

Informed by the recommendations of these working groups, the Board should carefully consider revisiting the mandates of Section 956 as guidelines rather than rules. The Board may very well determine that guidelines are preferable if the working groups recommend significantly different approaches for the different industries involved. It also may need to consider whether a second comment period is necessary to explore any issues raised by the working groups that have not been sufficiently considered during the current comment process.

II. Retention and Acquisition of Talent

Human capital is the operating infrastructure of a financial institution. The quality of the workforce and ability to attract talent are long-term indicators of financial institutions' ability to be successful and secure profitability. Appropriate compensation practices that allow employees to engage in reasonable risk taking and long-term decision making are of great importance. Narrow compensation policies and practices will drive away talent and degrade the foundation and long-term viability of a firm.

Actions have consequences and the competition for talent is fierce. Employees can be lured away by direct competitors, global firms, or different industries. Such an exodus of skill, intelligence and experience can quickly denude a financial institution of its talent base and impact its prospects.

Accordingly, while the proposed rules suggest an appropriate balance between risk taking and compensation, there has not been enough of a discussion or development of guidance to address the competition of talent or the impacts of a brain drain from a financial institution. An exit of talent can be as devastating as excessive risk, yet the proposed rules largely remain silent on the issue.

III. Need for a Cost Benefit Analysis

A true cost-benefit analysis should be undertaken to determine the benefits and the true costs to businesses in complying with the proposed rules. In order to determine the true costs, other facts, in addition to administrative costs, should be considered including the competitive burden that the rules will impose on covered institutions relative to their domestic and foreign competitors that will not be covered by similar rules. A cost-benefit analysis should also compare the use of guidance, instead of rules. Finally, if it is determined that the costs will exceed $100 million, then the proposed rule would be an economic significant rulemaking and the Board should submit the proposed rule to an Office of Information and Regulatory Affairs (OIRA) regulatory review process.

IV. "Excessive Compensation" and "Inappropriate Risk"

A. "Excessive Compensation"

Competition for Talent. Covered financial institutions face intense competition for talent. Employees can be lured away by direct competitors, global firms, or different industries. Accordingly, a flight of talent from covered financial institutions to other industries or institutions that are not subject to these rules may create a brain drain that can be destructive to the covered institutions. Such an exodus of skill, intelligence, and experience can quickly erode an institution's talent base and impede its ability to compete.

This competitive environment must be factored into any analysis of covered financial institutions' incentive compensation arrangements. A covered financial institution may appropriately put in place incentive compensation arrangements that differ from those of comparable covered financial institutions because it believes that such differing arrangements are necessary to attract and retain the best talent in a competitive environment. Accordingly, we request that the Board also consider competition for talent as a factor that appropriately affects whether a compensation arrangement is "excessive," particularly in light of the fact that covered institutions must compete with one another as well as with firms that are not "covered financial institutions" subject to these proposed rules.

Comparable Compensation Practices at Comparable Institutions. In determining whether an incentive-based arrangement provides "excessive compensation," the proposed rules provide a number of enumerated factors for the Board to consider, including "comparable compensation practices at comparable covered financial institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets." The fact that compensation practices fall within the range of compensation practices at comparable institutions strongly suggests that such compensation practices are not excessive. At the same time, compensation practices that differ from those of comparable covered financial institutions should not be presumed to be excessive, because compensation is company specific. In such cases, additional analysis may be required to determine why an institution's compensation practices appear to diverge from those of comparable institutions.

The Financial Condition of the Covered Financial Institution. In determining whether an incentive-based arrangement provides "excessive compensation," the proposed rules provide that "the financial condition of the covered financial institution" is a factor for the Board to consider. With respect to this factor, we note that high performing employees of high performing institutions would naturally be expected to share in the institutions' success, provided that adequate measures are taken to manage pay riskiness. Additionally, institutions that have experienced financial difficulty may need flexibility to set compensation arrangements that attract and retain personnel who will be key to improving performance, provided that adequate measures are taken to manage pay riskiness.

B. *"Inappropriate Risk"*

The prohibition against incentive-based compensation arrangements that encourage "inappropriate risk" provides that an arrangement will not be in compliance unless it: (i) balances risk and financial rewards, for example by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods; (ii) is compatible with effective controls and risk management; and (iii) is supported by strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof.

Risk-taking is at the core of the free enterprise system, and is the essential factor distinguishing it from other types of financial systems. We agree that there is a distinction to be made between appropriate and inappropriate risk-taking, but the distinction is a facts and circumstances one that calls for a good degree of experience and judgment as applied to individual cases. Whether appropriate or inappropriate, there is no escaping the reality that risk can result in losses as well as in gains.

While the proposal provides several pages describing each of the above mentioned standards of "inappropriate risk" in greater length, these lengthier descriptions are in some respects circular and provide little practical insight to guide institutions' efforts to achieve compliance with this prohibition. For example, "inappropriate risks" are described as those that "may encourage inappropriate risks that could lead to material financial loss" or "may encourage excessive risk-taking." As is implicit in the rules' use of "inappropriate," not all risks would lead to a violation. All financial institutions take risks, including some that may expose the firm to a material financial loss. Accordingly, it will be crucial for these firms to be able to clearly distinguish between "appropriate" and "inappropriate" risks in order to comply with the proposed rules.

Under the "Compatibility with Effective Controls and Risk Management" heading, it is noted that covered financial institutions must ensure that risk-management personnel "have an appropriate role in the institution's processes for designing incentive-based compensation arrangements, monitoring their use, and assessing whether they achieve balance." We believe that a full understanding of the risks associated with a particular institution's activities requires intimate familiarity with the particular institution, and believe the Board should allow a reasonable amount of deference to the well-informed judgment of personnel who are familiar with the institution, including what role, if any, would productively be played by risk-management personnel. The determination of the "appropriate" role of risk-management personnel in designing incentive-based compensation arrangements, monitoring their use, and assessing whether they achieve balance, should be left to the institutions' reasonable judgment.

V. <u>Calculation of Total Consolidated Assets</u>

The proposed rules apply to covered financial institutions that have total consolidated assets of $1 billion or more, with additional requirements for covered financial institutions that have total consolidated assets of $50 billion or more.

Indexing for Inflation. We believe that the $1 billion and $50 billion asset thresholds should be indexed for inflation so that, in the future, only those institutions whose assets, in real terms, are equivalent to $1 billion and $50 billion today will be swept into the coverage of these rules. This would help ensure that the asset thresholds remain constant in real terms in the future and that smaller institutions, which are currently intended to be outside the scope of this rule, are not unintentionally brought within its scope in the future merely because of inflation.

Exclude Deferred Compensation and Bonuses Payable. Deferral of some compensation is required for firms above the $50 billion threshold, and is a factor of pay riskiness for covered institutions below the $50 billion threshold. Assets set aside as deferred compensation and bonuses payable should be excluded from firms' assets because the inclusion of these assets—which have been earned or accrued by employees but not yet paid—for purposes of calculating the firm's total consolidated assets both overstate the firm's assets and provide a disincentive for firms to voluntarily defer employee compensation.

VI. Covered Financial Institution

Many institutions are complex, multi-level organizations comprised of numerous subsidiaries and affiliates, some of which may meet the definition of a covered financial institution while others do not. It is essential that the definition of "covered financial institution" is clear and unambiguous in the final rule. We believe that the covered financial institution should be defined as the entity identified in Section 956(e)-(f), and should not be expanded to include affiliated companies such as subsidiaries and parent companies that do not themselves qualify as covered financial institutions.

We further believe that any covered financial institution (a "parent CFI") should be permitted to comply with these rules on its own behalf and on behalf of any subsidiary that is itself a covered financial institution (a "subsidiary CFI") by adopting procedures and by making reports to the parent CFI's primary regulator that cover both the parent CFI and any subsidiary CFIs. Institutions should be permitted the flexibility – but not required – to comply separately. Some institutions may decide that it would be more appropriate to treat subsidiary CFIs as separate and distinct CFIs, with separate policies and procedures and separate reporting obligations to a different regulator. Others may prefer to take a more holistic approach with respect to their policies and reports.

VII. Defining Incentive-Based Compensation

The proposed rules define "incentive-based compensation" to mean any variable compensation that serves as an incentive for performance. The notice further indicates that the definition is broad and principles-based in order to address the objectives of Section 956 in a manner that provides for flexibility as forms of compensation evolve.

The notice also indicates that certain types of compensation would not fall within the scope of the definition, including salary, payments for achieving or maintaining professional certification, company 401(k) contributions, and dividends paid and appreciation realized on stock or other equity instruments that are owned outright by a covered person and not subject to any vesting or deferral arrangement.

To the extent that equity subject to vesting is treated as "incentive compensation," the rules should be clarified so that equity subject to vesting is treated as and valued for "incentive-based compensation" purposes at the time of grant, and that dividends and appreciation of such equity between grant and vesting would be excluded, because it is the grant-date value that is considered when compensation decisions are made.

VIII. Reporting Requirements

The proposed rules would require that a covered financial institution submit a report annually to its appropriate regulator or supervisor in a format specified by its appropriate Federal regulator. Such report would be required to describe the structure of the covered financial institution's incentive-based compensation arrangements for covered persons. The Agencies note that they have intentionally chosen phrases like "clear narrative description" and "succinct description" to describe the disclosures being sought.

We applaud the Agencies' decision to keep the instructions broad and to clarify that reports should be "succinct." In light of the general trend towards increased disclosures rather than improved disclosures, it is appropriate that the proposed rules seek to elicit such information through broad requirements that enable covered financial institutions to tailor their reports to their own situations in a succinct manner.

In addition, we note that the proposed rules apply to incentive compensation arrangements "established or maintained" by the institution. We request that the Board clarify that the requirements of proposed §236.5 be applied prospectively, and not retroactively to compensation that has been previously awarded but not paid, or to compensation subject to existing employment agreements.

IX. The Role of the Director and Shareholder

It goes without saying that the Board's role in the safety and soundness of covered financial institutions is paramount. However, it must not be forgotten that directors and shareholders, where that structure exists, share a unique and vital responsibility in the management of a financial institution.

A one-size-fits-all approach may emasculate the ability of directors and shareholders to perform their legally obligated management duties. This is clearly the case if a formulistic approach where ever to be used. However, a heavy handed use of the proposed rules could have the same effect.

Shareholders and directors can, within the regulatory framework, choose the governance and compensation structures that work best for that financial institution. This will lead to a diversity of structures and practices that can best suit the financial institution. While this may provide institutions with a competitive edge, it also creates a dynamic capital markets system. A one-size-fits-all approach will destroy that diversity and inhibit the efficiency of our capital markets, adversely impacting the economy overall. Accordingly, in its reviews, the Board should work closely with directors and shareholders to evaluate and strengthen the managerial aspects of that relationship. The Board should be sensitive not to undercut the director-shareholder dialogue and tailor the proposed rules and its implementation to reinforce it.

Conclusion

The CCMC once again would like to thank the Board for the opportunity to comment on the proposed rules. Without question, financial institutions should avoid excesses that imperil the long-term viability of the firm. However, the CCMC has serious concerns regarding the nature of the one-size-fits-all approach of the proposed rules, as well as a failure to understand the impacts upon capital formation and markets efficiency. These rules will not only impact financial institutions, but also the credit that they provide to businesses and ultimately their investors.

While excess should be avoided, we must also remember that a free enterprise system needs to allow businesses to engage in appropriate risk taking. Carefully calibrated guidance would be better suited to recognize and manage the significant differences between market participants, allowing for the effective operation of capital markets. An improper set of rules and enforcement can create underperformance values that will harm economic growth and job creation.

Sincerely,

Tom Quaadman