July 22, 2016

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Re: Incentive-Based Compensation Arrangements (Release No. 34-77776; IA-4383; File No. S7-07-16)

Dear Ladies and Gentleman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned re-proposed rules ("Re-Proposal") issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

Insurance Corporation, the National Credit Union Administration, the Federal Housing Finance Agency, and the Securities and Exchange Commission (collectively, "Agencies").

The Re-Proposal would implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[2] which requires the Agencies to issue regulations prohibiting incentive-based compensation arrangements that encourage inappropriate risks at large financial institutions. Under Section 956, those regulations must also require covered financial institutions to disclose information about their incentive-based compensation arrangements to the appropriate agency. While the Re-Proposal represents a significant improvement in several respects over the original proposal, it nevertheless suffers from numerous material weaknesses that must be addressed in the final rule.

BACKGROUND

Executive compensation policies that encouraged short-sighted and high-risk corporate behavior were undoubtedly major contributors to the financial crisis of 2008. The report of the House Financial Services Committee on the "Corporate and Financial Institution Compensation Fairness Act of 2009," which was a precursor to the executive compensation provisions in the Dodd-Frank Act, observed that as the financial crisis has unfolded, "a broad consensus has developed that executive and financial institution compensation structures relate directly to both the safety and soundness of individual financial institutions and the health of the broader financial system."[3]

Another analysis of the financial crisis described the harmful impact of poorly designed compensation systems in these terms:

> Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.[4]

The release accompanying the Re-Proposal ("Release")[5] confirms that flawed incentive-based compensation policies can pose a threat not only to the long term health of individual financial institutions, but also to the long-term health of the U.S. economy.[6] It also highlights the reality that such compensation arrangements are a concern among major financial institutions worldwide, not only in the U.S. For example, the Release cites a 2009 survey from the Institute of International Finance showing that 98 percent of respondents

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2 Public Law No. 111-203, 124 Stat. 1376 (July 21, 2010).
3 H.R. REP. NO. 111-236, 111th Cong., 1st Sess., at 6 (2009).
4 *The Financial Crisis Inquiry Report*, Financial Crisis Inquiry Commission, at xix (Jan. 2011).
5 81 Fed. Reg. 37670 (2016).
6 Release at 37674.

"recognized the contribution of incentive-based compensation practices to the financial crisis."[7]

Even before the crisis, regulators had begun to promulgate rules substantially improving the disclosure regime for executive compensation.[8] After the crisis, calls for more fundamental reform in the area of executive compensation were widespread, and they culminated in Title IX, Subtitle E of the Dodd-Frank Act.

In the Dodd-Frank Act, Congress passed a broad series of measures aimed at correcting the structural flaws in our traditional approach to executive compensation. Those measures include shareholder votes on executive compensation, new listing standards to ensure that compensation committees and their consultants at public companies are independent from management, mandatory disclosure of executive compensation in relation to corporate performance, and recovery of erroneously awarded compensation.[9]

Section 956 of the Dodd-Frank Act is one of the most important components of the new regulatory framework governing executive compensation. It requires the imposition of new disclosure requirements and prohibitions relating to incentive-based compensation arrangements offered by banks, broker-dealers, and other financial institutions. Specifically, Section 956—

- Requires each covered financial institution to disclose to its appropriate federal regulator the structure of all incentive-based compensation arrangements offered by the institution to determine whether the compensation structure:
    - provides any executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits; or
    - could lead to material financial loss to the institution; and
- Prohibits any type of incentive-based compensation arrangement that the appropriate regulator determines encourages inappropriate risks by covered financial institutions:
    - by providing an employee with excessive compensation, fees, or benefits; or
    - that could lead to material financial loss to the institution.

The Agencies issued an original proposal to implement Section 956 in 2011. However, as explained in the Release, since 2011, incentive-based compensation practices have evolved in the financial services industry, U.S. bank regulators have gained supervisory experience applying compensation-related rules, and foreign jurisdictions have adopted

7 *Id.*

8 Executive Compensation and Related Person Disclosure, SEC Release No. 33-8732A (Aug. 29, 2006) (Final Rule), 71 Fed. Reg. 53158 (Sept. 8, 2006).

9 Dodd-Frank Act §§ 951-957.

codes, regulations, and guidance relating to incentive-based compensation.[10] In light of these developments, and the comments received on the original proposal, the Agencies developed the Re-Proposal.

The Re-Proposal includes some beneficial new provisions. For example, they would broaden the scope of the initial proposal beyond just senior executive officers to include "significant risk-takers" who "are in a position to put large covered institutions at risk of material financial loss."[11] They would also would add a clawback provision to provide for the recovery of incentive-based compensation under certain circumstances, and they would prohibit hedging by covered institutions on behalf of their covered employees against decreases in the value of a person's incentive-based compensation.

However, notwithstanding these changes, the Re-Proposal unfortunately suffers from substantial gaps and weaknesses, as detailed below:

- The types of conduct that trigger clawbacks should be expanded beyond culpable behavior. In addition, covered institutions should be required to exercise their clawback remedies, not simply allowed to do so.
- The deferral periods should be extended and pro rata vesting should be abandoned in favor of cliff vesting.
- Stock options should be banned as a form of incentive-based compensation, including as a form deferred incentive-based compensation.
- The prohibition on hedging should cover individuals, not only the institutions acting on their behalf.

COMMENTS

I. **CLAWBACKS: The types of conduct that trigger clawbacks should be expanded beyond culpable behavior. In addition, covered institutions should be required to exercise their clawback remedies, not simply allowed to do so.**

A. *The triggers for clawbacks should not be limited to misconduct.*

The clawback provision in the Re-Proposal is flawed in two important respects. First, it is too narrow, as it applies only in the event of "misconduct" or other types of culpable behavior. The Re-Proposal would provide for institutions to recover incentive-based compensation if the institution determines that the executive officer or significant risk-taker engaged in:

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10 Release at 37673.
11 Release at 37692.

(1) **Misconduct** that resulted in significant financial or reputational harm to the covered institution;
(2) **Fraud**; or
(3) **Intentional misrepresentation** of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation.[12]

All three of these elements incorporate some measure of fault. But this narrow approach is inconsistent with the purposes of Section 956, the approach reflected in other statutes, and even the increasingly common practices among financial institutions.

A fundamental goal of Section 956 is to discourage excessively risky behaviors at large financial institutions whether or not those behaviors rise to the level of illegal, fraudulent, or otherwise blameworthy "misconduct." Nothing in Section 956 on its face or in its intended purposes suggests that it was aimed only at that narrow band of blameworthy behavior. Thus, limiting clawback provisions to instances of such conduct conflicts with the basic purpose of the statute.

Other regulatory measures are not so limited. For example, under Section 954 of the Dodd-Frank Act, the SEC's rules must require issuers to recover excessive incentive-based compensation resulting from noncompliance with financial reporting requirements, without regard to culpability. Common practices in the industry also depart from this narrow approach. The Release notes that "clawback provisions are increasingly common at the largest financial institutions."[13] It goes on to explain the types of factors that serve as triggers:

> "Over the past several years, many financial institutions have further refined such mechanisms. Most often, clawbacks allow banking institutions to recoup incentive-based compensation in cases of financial restatement, misconduct, **or poor financial outcomes.** A number of covered institutions have gone beyond these minimum parameters to include situations where **poor risk management** has led to financial or reputational damage to the firm."[14]

The highlighted language from this review of prevailing trends confirms that the predominant focus of common clawback provisions is on conduct that leads to "poor financial outcomes" or "financial damage," irrespective of whether it constitutes what is normally meant by "misconduct." The norms or trends in a regulated industry should never serve as the primary determinant of regulatory standards, but at the very least, regulatory standards should at least be as strong or stronger than prevailing industry practices. In this case, that means expanding the scope of the clawback provision beyond misconduct.

Finally, repeatedly in the Release, the Agencies themselves explain the rationale for the Re-Proposal broadly in terms of addressing both "inappropriate risk-taking" **and**

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12 Release at 37731-32 (emphasis added).
13 Release at 37732.
14 *Id.* (emphasis added).

"misconduct," two distinct forms of behavior.[15] Yet, without explanation, the Re-Proposal establishes the more narrow band of misconduct as the trigger for clawbacks.

For all of these reasons, the Agencies must amend the Re-Proposal to expand the triggers for clawbacks beyond scenarios involving misconduct.

B. Application of the clawback remedy should be mandatory, not discretionary.

The second major problem is that the while the Re-Proposal would require the *inclusion* of a clawback provision in incentive-based compensation arrangements, it would not actually require that covered institutions *exercise* the clawback provision.[16] That decision would remain entirely in the discretion of the institution, and the Re-Proposal would not even prescribe the process that the institution should follow to recover vested incentive-based compensation under the clawback provision.

Leaving the use of clawbacks completely to the discretion of the regulated industry, without even specifying required procedures or guidelines, severely weakens the clawback provision in the Re-Proposal. Without question, the result will be cases where executives are able to retain incentive-based compensation even though it led to a material financial loss for the firm. It is easy to imagine circumstances where the Board yields to the myriad of intra-corporate political pressures that a high level executive or top-producing risk-taker could apply to fend off the discretionary application of a clawback provision and to protect his or her incentive-based compensation. Such outcomes are precisely the ones that the Re-Proposal should be designed to prevent.

As an apparent justification for this lax approach, the Release explains that "facts, circumstances, and all relevant information should determine whether and to what extent it is reasonable for a Level 1 or Level 2 covered institution to seek recovery of any or all vested incentive-based compensation."[17] But this is simply a truism, not a convincing rationale for leaving the exercise of a core reform in the hands of the regulated institutions. A mandatory clawback clause could take several forms, all of which would address the Agencies' stated concern about facts and circumstances. For example, the Agencies could require use of the clawback mechanism and then (1) couple that requirement with a list of factors the firm must consider; (2) require the adoption of policies and procedures that establish guidelines for use of the clawback provision; or (3) simply issue separate guidance regarding application of the clawback provision. But abandoning a mandatory provision altogether is unacceptable.

It is especially difficult to reconcile the hands-off approach in the Re-Proposal with the severity of the three criteria for application of the clawback provision in the first instance. Clearly, if an executive officer or significant risk-taker engages in fraud, intentional misrepresentation, or misconduct—the predicates for clawback set forth in the Re-

15 *E.g.* Release at 37720.
16 Release at 37732.
17 Release at 37732.

Proposal—then it would be unquestionably appropriate to mandate the application of a clawback provision.

And as with the standards of conduct that trigger clawbacks, other statutory provisions exemplify the mandatory approach to the exercise of the clawback remedy. For example, under Section 304 of the Sarbanes-Oxley Act and Section 954 of the Dodd-Frank Act, the recovery of incentive-based compensation is mandatory whenever an issuer is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements.

In light of all of these considerations, the Agencies must require application of the clawback provision if the triggers, as amended in accordance with part I.A. above, are met.

II. VESTING PERIODS: The deferral periods should be extended and pro rata vesting should be abandoned in favor of cliff vesting.

A. *The vesting periods are too short.*

One of the core provisions in the Re-Proposal is the time period over which executive officers and significant risk-takers must defer their incentive-based compensation. Under the Re-Proposal, those time periods vary depending on the size of the institution, the position of the actor (senior executive officer or significant risk-taker), and the type of compensation plan. But even at the largest institutions, and even in cases where the most senior executive officer is responsible, the Re-Proposal only provides for a minimum mandatory deferral period of four years.

These deferral periods are too short in light of both theory and practice. The Release aptly describes the need in principal for significant deferral periods to achieve the risk-mitigating purposes embodied in Section 956:

> "The deferral period allows for amounts of incentive-based compensation to be adjusted for actual losses to the covered institution or for other aspects of performance that become clear during the deferral period before those amounts vest or are paid.... Deferral periods that are sufficiently long to allow for a substantial portion of the risks from the covered person's activities to manifest **are likely to be most effective** in ensuring that risks and rewards are adequately balanced."[18]

Elsewhere, the Release notes that "this approach may be particularly relevant, for example, where performance is difficult to measure because performance results and risks take time to observe," as is often the case in financial transactions such as loans.[19]

18 Release at 37720 (emphasis added).
19 Release at 37716.

Together, these observations make clear that the longer the deferral period, the more accurate the assessment of the risks that an executive or significant risk-taker may have created for the institution and that take time to incubate. Academic research bears this out. Empirical studies indicate that longer deferral periods correlate with better firm value and performance, lower risk exposure, and less frequent manipulation of earnings.[20]

Thus, to better serve the underlying purposes of Section 956, the Re-Proposal should be revised to extend the minimum deferral period. Six years would be more consistent with the average life span of the business cycle in the U.S., which is estimated to be 5.7 years.[21] Some other regulators have imposed deferral periods of as much as seven years for senior managers.[22] The Release itself comes close to endorsing a "business cycle" metric, stating that the three-to-four year minimum deferral period was chosen because, coupled with the typical one-year performance period, it would allow institutions four to five years, "or the **majority of a traditional business cycle**," to identify outcomes associated with the activities of a senior executive officer or significant risk-taker.[23]

However, the Release offers no convincing explanation for the decision to tailor the minimum deferral period to only a fraction of a business cycle. The Release simply notes, without elaboration or citation to data, that "deferral periods that are inordinately long may reduce the effectiveness of incentive-based compensation arrangements because employees more heavily discount the potential impact of such arrangements."[24]

In fact, based on all of the considerations set forth above, establishing a deferral period at least as long as a full business cycle would be more appropriate and effective.

B. *The vesting formula should be limited to cliff, not pro rata, vesting.*

The Re-Proposal provides that deferred compensation may vest in annual increments, but no faster than on a pro rata basis. The Release portrays this arrangement as one that would help prevent covered institutions from "defeating the purpose of the deferral requirement by allowing vesting of most of the required deferral amount immediately after the award date."[25] But this approach fails to meet its stated goal, and it actually defeats the very purpose of deferring compensation.

Under the pro rata scenario, a quarter of the deferred incentive-based compensation promised to a senior executive officer at the largest institutions would vest with each passing year, adding to the already vested, non-deferred compensation. This renders the overall length of the vesting period largely a fiction, since what matters most is the annually vested increment, not the full vesting period.

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20 Release at 37721 n. 151.
21 Release at 37721 n. 154.
22 The Prudential Regulation Authority in the United Kingdom has stipulated that the minimum deferral period shall be seven years for senior managers and five years for risk managers. Release at 37722.
23 Release at 37721 (emphasis added).
24 Release at 37721.
25 Release at 37718.

In addition, the result conflicts with the underlying purpose of a significant deferral period. The longer the deferral period, the more accurate the assessment of the risks actually facing an institution. In other words, the most precise understanding of the amount of incentive-based compensation that an executive or significant risk taker should actually receive comes at or near the end of the vesting period. But at that point, under the pro rata approach, all or nearly all of the incentive-based compensation will have vested. In short, when the institution is best-equipped to assess the executive's contribution to excessive or inappropriate risks, the compensation is already vested.

The solution is clear and simple. The Re-Proposal must be amended to require cliff vesting, whereby the entire amount of the deferred compensation vests only at the conclusion of the deferral period. This approach is especially important if the vesting period is not extended to cover at least a full business cycle, as argued in Section II.A. above.

III. <u>STOCK OPTIONS: Stock options should be banned as a form of incentive-based compensation, including as a form of deferred incentive-based compensation.</u>

The Re-Proposal would allow incentive-based compensation to include an unlimited number of stock options. The only restriction it would impose is a cap of 15% on the amount of **deferred** incentive-based compensation that could take the form of options. However, this approach conflicts with the language and purposes of Section 956, academic studies, and prevailing trends. Accordingly, the Re-Proposal should be revised to eliminate options altogether as a permitted from of incentive-based compensation, deferred or otherwise.

Options by their nature are asymmetrical, as they offer large pay-offs when the price of the underlying asset rises, and little or no downside if the asset price falls. As a result, they can actually create incentives for covered persons "to take inappropriate risks in order to increase the covered institution's short-term share price, possibly without giving appropriate weight to long-term risks."[26] Academic literature supports the point. It shows a positive correlation between executive holdings of stock options and securities fraud and manipulation of earnings.[27] Notwithstanding these characteristics of options, the Re-Proposal would allow incentive-based compensation to include an unlimited number of stock options. Thus, it would allow a form of compensation that **incentivizes** risk to be embedded in compensation arrangements that, under Section 956, must be structured to **discourage** inappropriate risks.

That plainly conflicts with the intent of Section 956, and it arguably violates the plain language of the statute. Section 956(b) of the Dodd-Frank Act requires the Agencies to "prohibit any types of incentive-based payment arrangement, or any **feature** of any such arrangement, that the regulators determine encourage inappropriate risks by covered financial institutions." (Emphasis added).

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26 Release at 37727.

27 *Id.* n. 184.

While options do not appear by name in this language, the reference to "features" that encourage inappropriate risks would certainly seem to encompass options, in light of their asymmetric nature and the empirical evidence clearly correlating them with not only risky but fraudulent behavior.

It follows that the Re-Proposal must be revised to eliminate stock options as eligible **deferred** compensation. The Release acknowledges the need to limit the role of options as part of deferred compensation, but still allows options to comprise a significant portion—15%. It provides little justification for this approach, citing only the Agencies' general desire to "[allow] for some flexibility in the design and operation of incentive-based compensation arrangements."[28] And it fails to explain why that flexibility for the benefit of the covered institutions deserves priority over the risk-mitigation goals underlying Section 956. In fact, it does not deserve priority. The approach is especially weak given the larger context: Under the Re-Proposal, covered persons would still be able to received unlimited options as part of their incentive-based compensation package, so abolishing options solely as part of deferred compensation would do little to restrict the "flexibility" that the Agencies seek to preserve.

As with the other issues discussed above, the Agencies' approach is actually inconsistent with the prevailing trend, which "is moving away from its historical reliance on options as part of incentive-based compensation." According to the Release, a sample of disclosures from large covered institutions "shows minimal usage of stock options among CEOs and other named executive officers."[29] As a general matter, there is no justification for establishing regulatory standards that lag behind industry trends from the very day they are proposed, and that axiom certainly applies here.

IV. HEDGING: The prohibition on hedging should cover individuals, not only the institutions acting on their behalf.

The Re-Proposal would prevent covered institutions from purchasing hedging and similar instruments on behalf of covered persons to hedge or offset any decrease in the value of the covered person's incentive-based compensation.

This is certainly appropriate, but it does not go far enough. In addition, covered institutions must be required under the final rule to prohibit their senior executive officers and significant risk-takers from themselves hedging against the potential decrease in value of their incentive-based compensation.

The need for a prohibition against hedging is clear, as explained in the Release. "Personal hedging strategies may undermine the effect of risk-balancing mechanisms such as deferral, downward adjustment, and forfeiture, or may otherwise negatively affect the goals of these risk-balancing mechanisms and their overall efficacy in inhibiting inappropriate risk-taking."[30] What is not clear is why the Agencies were satisfied with a limited provision that only prohibits the institutions from hedging on behalf of the covered

28 Release at 37728.
29 *Id.*
30 Release at 37733.

person. The release accompanying the original proposal in 2011 actually acknowledges the possibility that covered persons who received incentive-based compensation in the form of equity "might wish to use **personal** hedging strategies as a way to assure the value of deferred equity compensation."[31] But the Agencies then offer no explanation as to why this concern was addressed through the half-measure set forth in the Re-Proposal, which would allow covered persons the freedom to engage in hedging.

This gap must be closed, or the risk-mitigating goals of Section 956 will be substantially undermined. The effectiveness of measures such as deferral periods, downward adjustments, and forfeitures will be largely blunted if senior executive officers and significant risk-takers can essentially guarantee themselves the rewards of incentive-based compensation regardless of the impact that their conduct may have on the value of that compensation.

CONCLUSION

We hope these comments are helpful as you develop the final version of the Re-Proposal.

Sincerely,

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[31] Release at 37734, citing 76 Fed. Reg. 21183 (emphasis added).