McGUIREWOODS

July 22, 2016

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Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, DC 20551
Docket No. R-1536
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Docket ID OCC-2011-0001
RIN 1557-AD39

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File Number S7-07-16

Re: Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements, June 10, 2016

Dear Sir or Madam:

McGuireWoods, LLP hereby submits this letter in response to the request for public comments by the Board of Governors of the Federal Reserve System (the "Federal Reserve"), Federal Deposit Insurance Corporation (the "FDIC"), National Credit Union Association (the "NCUA"), Office of the Comptroller of the Currency (the "OCC"), Federal Housing Finance

Agency (the "FHFA"), and Securities and Exchange Commission (the "SEC"), which are collectively referred to as the "Agencies," to the Notice of Proposed Rulemaking (the "Proposed Rules") on Section 956 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"), which was published in the Federal Register on June 10, 2016.[1] Our comments specifically address the impact of the Proposed Rules on incentive-based compensation arrangements provided by large and diversified financial institutions to their employees.[2]

Executive Summary

In today's global market, financial services companies are more than just depository institutions. Financial institutions deliver financial solutions to individuals, businesses, investors, and the communities they serve. Crowdfunding, peer-to-peer lenders, mobile payments, digital currency, robo-advisers, and other developments are changing the way in which financial solutions are being delivered. In light of such fast-developing financial innovations, the human capital and technological needs of financial institutions are shifting and growing rapidly. We believe that the Proposed Rules, as written, are overly prescriptive and excessive and fail to provide financial institutions with the flexibility that they need to compete with other industries for talent. To meet this evolving landscape, financial institutions must not only compete for talented employees against other financial institutions, but also against, for example, technology companies such as Google and Apple.

Incentive-based compensation plans are an important tool in helping any organization attract and retain talented employees. Compensation arrangements are tailored to the specific business needs and unique attributes of an organization. It has long been acknowledged by the Agencies, such as the Federal Reserve, that there are potential hazards that can be created with rigid, one-size-fits-all supervisory limits or formulas. Thus, rules that regulate compensation arrangements should be developed in a manner that provides financial institutions with the necessary flexibility to address the ongoing business goals and objectives of shareholders and stakeholders. As federal regulators work to develop compensation rules for the industry, they should be mindful that compensation arrangements are constantly evolving, and thus financial institutions must be allowed to design plans that appropriately balance risks and rewards. Above all, any final rule must reflect current best practices and provide room for further innovation.

The Proposed Rules fossilize current compensation practices and inhibit the evolution of compensation arrangements. Financial institutions must be able to develop incentive-based compensation plans that are innovative. No two financial institutions are the same—each organization and its employees have unique activities, products, goals, and structures. As a result, compensation arrangements vary significantly, and should be allowed to continue to vary to meet the specific needs of each financial institution and its stakeholders. In contrast, the overly prescriptive and one-size-fits all nature of the Proposed Rules may lead financial institutions—as well as their shareholders and other stakeholders—to incorrectly conclude that the standards the Agencies set in the Proposed Rules should be deemed adequate under all

[1] 81 Fed. Reg. 37,670 (June 10, 2016). Unless otherwise specified, the citations herein are to the Proposed Rules as set forth by the Federal Reserve.
[2] For your convenience, we have included a Table of Contents attached as Appendix A.

circumstances, now and in the future, without regard to a financial institution's unique attributes or needs. We believe that, as time has shown, principles-based rules, such as those set forth by the Federal Reserve and the Financial Stability Board (the "FSB"), have allowed incentive-based compensation programs to evolve in a manner that is most appropriate for all stakeholders. Thus, we strongly encourage the Agencies to re-examine the Proposed Rules and take a more principles-based approach to these rules.

Section 956 of the Dodd-Frank Act was intended to better align incentive-based compensation program design with the risk tolerances of a financial institution. The Proposed Rules, however, do not provide any evidence of a nexus between the restrictions proposed and the risk-taking activities of the individuals and institutions identified by the rules. Rather, the Agencies' use of asset size to identify covered institutions that may pose the most significant risks to the safety and soundness of our financial system is based on unsupported assumptions that an institution's size will always dictate the design of its compensation practices and that larger firms are more likely to have compensation arrangements that encourage inappropriate risk-taking.

In addition, the Proposed Rules' approach to identifying those who take significant risks is overly broad and not sufficiently connected to a person's ability to expose an institution to material financial risk. We believe that the Proposed Rules will result in identifying many employees whose activities do not generate risk and potentially omit employees who actually engage in risk-taking activities. Consider, for example, the impact of the Proposed Rules on financial advisors who manage assets for unrelated third parties and, as such, cannot encourage institutions to take inappropriate risks that could lead to material financial loss. The Proposed Rules could require that large numbers of financial advisors be classified as Significant Risk-Takers, not because of the risks posed by their business activities, but because of the relative amount and structure of their individual compensation. As explained more fully below, classifying financial advisors as Significant Risk-Takers would not meaningfully reduce risks to Covered Institutions, but would disrupt carefully calibrated and effective compensation regimes, divert resources away from more risk-intensive areas, and unnecessarily tilt the competitive landscape in favor of smaller, less regulated firms—ultimately to the detriment of the millions of Americans who rely on financial advisors for financial solutions. Thus, we believe that financial advisors and other employees who do not have sufficient ability to expose an institution to material financial risk should be excluded from the rules.

The Proposed Rules are anti-competitive because they do not provide for the same enhanced restrictions on the incentive-based compensation arrangements of smaller financial institutions engaged in the same risk-taking activity as larger financial institutions. The prescriptive downward adjustment, deferral, forfeiture, and clawback rules that are contemplated within the three-level structure of the Proposed Rules place certain institutions at a severe disadvantage when competing for talent. Because large and diversified financial institutions pose less risk than those that are smaller but highly concentrated, we believe these large and diversified organizations should not automatically be subject to the more onerous compensation restrictions contemplated by the Proposed Rules simply based on their asset size. Any restrictions on compensation should be imposed on Covered Institutions by using a role/activity-based structure that identifies those institutions and employees who create the most significant risk. Thus, the Agencies should continue utilizing the principles-based approach taken in the

Federal Banking Agencies' Guidance on Sound Incentive Compensation Policies (the "2010 Guidance") and contemplated by the 2011 proposed rules in order to appropriately limit coverage to those individuals and institutions that can expose a financial institution to material financial loss based on their actual roles and risk-taking responsibilities. Such an approach will ensure that financial institutions can compete against other firms and industries for the talented employees that they need to ensure the efficiency, safety, and stability of their financial institutions.

I. The Agencies Acknowledge that a Principles-Based Regulatory Framework Provides Flexibility Needed to Achieve the Statutory Goals of Dodd-Frank Section 956; however the Proposed Rules Take a Contrary Approach that is Prescriptive and One-Size-Fits-All.

Incentive-based compensation arrangements play a critical role in the successful management of financial institutions. At their best, they create a unique balance between managing risk and rewarding hard work. In developing optimal incentive-based compensation arrangements, financial institutions must develop plans that fit the needs of all the institution's shareholders *and* stakeholders, including not only employees, but also the individuals, businesses, investors, and communities they serve. Because each organization and its employees are unique, compensation arrangements vary significantly and are often tailored to the specific business needs and unique attributes of the organization. Thus, rules that regulate compensation arrangements should be developed in a manner that provides flexibility and recognizes that these arrangements are continually evolving both to address the on-going business goals and objectives of employers and to reflect current best-practices.[3]

Since the financial crisis, financial institutions and regulators around the globe have worked hard to develop rules to ensure that incentive-based compensation arrangements do not create excessive risks to the safety and soundness of our financial system. As pointed out in the preamble to the Proposed Rules (the "preamble"), U.S. banking regulators have undertaken a number of initiatives, including the 2010 Guidance; the Federal Reserve's *2010 Horizontal Review* of the largest 25 organizations (the "Horizontal Review") and the *2012 Large Business Organization Review*. In addition, the FSB's *Principles for Sound Compensation Practices* and the associated *Implementation Standards* provide enhanced oversight of incentive-based compensation arrangements. We urge the Agencies to not only look at the rules that already have been developed, but also to the approaches taken in developing those regimes. We are deeply concerned that the Proposed Rules ignore the work that has been done to date and create an overly prescriptive additional regime for financial institutions to comply with that is burdensome and inflexible.

In order to provide the desired oversight of compensation practices and give financial institutions the flexibility they need, rules that oversee incentive-based compensation arrangements are most effective when they are principles-based. This approach was taken by the Federal Banking Agencies when they adopted the 2010 Guidance governing incentive-based compensation programs, which applies to all banking organizations regardless of asset size. The 2010 Guidance uses a principles-based approach to ensure that incentive-based compensation arrangements appropriately tie rewards to longer-term performance and do not undermine the safety and soundness of banking organizations or create undue risks to the financial system. We agree with the 2010 Guidance's approach and believe that principles-based rules would better serve the Agencies' goal of reducing the chance that incentive-based compensation arrangements may encourage inappropriate risk-taking.

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[3] *See* 75 Fed. Reg. at 36,407, noting that "effective and balanced incentive compensation practices are likely to evolve significantly in the coming years."

The Federal Reserve has previously acknowledged "the potential hazards or unintended consequences that would be associated with rigid, one-size-fits-all supervisory limits or formulas."[4] We believe these prescriptive rules will, as discussed throughout this letter, prevent further refinement and development of compensation best practices and lead to unintended consequences.[5] If prescriptive and detailed rules had been released ten or fifteen years earlier, for example, they likely would have been drafted under the assumption that a much larger portion of incentive-based compensation was (and should be) granted in the form of stock options, as these were the favored form of equity compensation at the time. Many diversified institutions however, have since shifted away from the use of options. This shift was made both to address the preference of shareholders and regulators and based on the institutions' practical experience, which led them to the conclusion that options were not actually the most effective vehicle to appropriately incentivize individuals in the current environment. We are concerned that the prescriptive nature of the Proposed Rules fossilizes current compensation practices and prevents innovation that appropriately balances risks and rewards and allows financial institutions to adjust their compensation practices. In another ten or fifteen years, laddered stock options or contingent convertible bonds, for example, may be considered more appropriate compensation tools than performance or restricted stock units.

Moreover, the overly prescriptive and one-size-fits all nature of the Proposed Rules may lead financial institutions—as well as their shareholders and other stakeholders—to incorrectly conclude that the minimum standards set by the regulators should be deemed sufficient under all circumstances. This may have the unintended effect of actually *reducing* the restrictions on compensation for some top-level senior executives at large and diversified financial institutions. We do not believe this is the Agencies' intended outcome. For example:

> Bank Y currently defers 75 percent of Chief Executive Officer Johnson's compensation based on its own risk assessment. The deferral requirements of the Proposed Rules may lead Bank Y and its shareholders to believe that a 60 percent deferral is sufficient for CEO Johnson when in fact, the higher deferral percentage may be more appropriate given Bank Y's risk tolerances and CEO Johnson's specific role and responsibilities.

Thus, we strongly encourage the Agencies to provide a more principles-based approach to these rules in order to allow financial institutions the flexibility they need to develop optimal plans and avoid unintended consequences.

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[4] See *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations, October 2011, Board of Governors of the Federal Reserve System*, http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf.

[5] For example, the SEC notes that "[t]here could be situations, however, where bonus deferral could actually lead to an increase in risk-taking incentives." 81 Fed. Reg. at 37,785.

II. The Three-Level Structure is Arbitrary, Overly Broad, and Anti-Competitive.

A. Asset size is not an appropriate measure of risk.

The Proposed Rules' reliance on asset size alone to identify Covered Institutions and determine their respective regulatory requirements is a misguided approach to ensuring incentive-based compensation practices actually promote the long-term health of a financial institution. Although the failure of a larger institution would likely place the financial system at greater risk, the structure of large and diversified financial institutions inherently places them at a decreased risk of failure. For the reasons outlined below, the potential effect on the financial system of the failure of a larger institution should not cause the Agencies to jump to the conclusion that asset size is an appropriate measure of risk. First, the Agencies' use of asset size to identify Covered Institutions subject to the enhanced restrictions is based on an unsupported assumption that an institution's size somehow dictates its compensation practices and that larger firms are more likely to have compensation arrangements that encourage inappropriate risk-taking.

Second, the use of asset size alone to determine applicability of the rules is inconsistent with how the Agencies identify other Covered Institutions elsewhere in the Proposed Rules. For example, the FHFA proposes to treat Federal Home Loan Banks ("FHLBs") as Covered Institutions, recognizing that

> ***asset size is not a meaningful indicator of risk*** [emphasis added]. The Federal Home Loan Banks all operate in a similar enough manner that treating them differently based on asset size is not justifiable. Because of the scalability of the Federal Home Loan Bank business model, it is possible for a Federal Home Loan Bank to pass back and forth over the asset-size threshold without any meaningful change in risk profile.[6]

In the proposed treatment of FHLBs, federal regulators explicitly acknowledge that asset size alone may not be an appropriate metric for determining coverage, noting its weak correlation with an institution's risk profile.

The Agencies again recognize that asset size may not be an accurate barometer of risk in their discussion of Level 3 Covered Institutions, affirming the validity of using risk profile as an additional criterion in determining coverage. Under Section 236.6 of the Proposed Rules, the Agencies would have the authority to require a Level 3 Covered Institution to comply with

> some or all of the more rigorous requirements applicable to Level 1 and Level 2 covered institutions … if the appropriate Federal regulator determined that the covered institution's complexity of operations or compensation practices are consistent with those of a Level 1 or Level 2 covered institution, ***based on the covered institution's activities, complexity of operations, risk profile or compensation practices*** [emphasis added].[7]

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[6] 81 Fed. Reg. at 37,688.
[7] *Id.* at 37,715.

In the two cases above, the Agencies clearly recognize the significance of an institution's risk profile rather than asset size alone when determining coverage and thus, should revise their three-level methodology to reflect that understanding. The FSB and the U.S. Financial Stability Oversight Council (the "FSOC") have also reconsidered the use of asset size to assess the risk profile of certain financial institutions. In 2016, these regulatory bodies agreed to shift their focus away from an entity's asset size and look more closely at specific activities that could generate risk. Both the FSB and FSOC acknowledged that risk to financial stability can stem from issues related to: (1) liquidity, (2) leverage, (3) operational functions, (4) securities lending activities and (5) resolvability and transition planning.[8] In view of these recent developments in the understanding of risk, we urge the Agencies to revise the methodology used in their approach to identifying Covered Institutions to focus on overall risk profiles rather than asset size.

B. The three-level structure is anti-competitive and should be replaced with a regulatory approach applicable to all Covered Institutions that avoids placing certain institutions at a severe disadvantage when competing for talent.

The Proposed Rules' tiered approach to regulating incentive-based compensation granted to employees of Covered Institutions poses a severe competitive disadvantage for U.S.-based Covered Institutions ("U.S. Covered Institutions"). Covered Institutions rely heavily on human capital in order to succeed and compete globally for talent. Placing arbitrary restrictions on U.S. Covered Institutions based solely on their asset size and the fact they are U.S.-based creates an uneven playing field and puts them at a severe disadvantage.

The Proposed Rules divide Covered Institutions into three levels based on their average total consolidated assets, as reported on their four most recent regulatory reports. Level 1 and Level 2 Covered Institutions are subject to enhanced regulation in the form of downward adjustment, minimum deferral, forfeiture, and clawback requirements, along with restrictions on incentives based solely on relative performance metrics (e.g., total shareholder return – a commonly utilized performance measure) and volume-driven awards. Level 1 Covered Institutions face even more onerous and prescriptive deferral requirements than Level 2 Covered Institutions, with respect to both the required amount of deferral and the time period that the compensation must be subject to deferral and forfeiture. In addition, a greater percentage and number of employees at a Level 1 Covered Institution are subject to such deferral and forfeiture requirements. In particular, the percentage of a Level 1 Covered Institution's employees who may be considered "significant risk takers" ("SRTs") under the compensation test is 250 percent greater than the corresponding percentage for a Level 2 Covered Institution (i.e., top five percent of covered employees versus top two percent of covered employees).[9]

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[8] Financial Stability Board's "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" http://www.fsb.org/2016/06/fsb-publishes-proposed-policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/; Financial Stability Oversight Council's "Update on Review of Asset Management Products and Activities" https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf.

[9] *See* Section 236.2(hh)(1), 81 Fed. Reg. at 37,808.

This disparity is magnified when comparing the absolute number of employees considered SRTs at a Level 1 versus a Level 2 Covered Institution as Level 1 Covered Institutions likely have larger retail bases and more employees. For example:

> Level One Bank, a large and diversified Level 1 Covered Institution with 200,000 or more total employees could have well over 10,000 SRTs under the Proposed Rules, whereas Level Two Bank, a Level 2 Covered Institution that is less diversified and employs 10,000 people may only have 200 SRTs. There is no basis for assuming that Level Two Bank inherently employs fewer individuals engaged in risk-taking activities that could lead to material financial losses than Level One Bank based solely on the difference in asset size.
>
> Moreover, Level Two Bank may principally be engaged in investment banking and trading activities and hold $200 billion in assets. In the event that Level Two Bank were to expand the scope of its business via opening commercial and retail banking operations, such that its assets increased to $300 billion, the application of the enhanced incentive-based compensation restrictions may only serve to discourage it from developing such independent, diversified lines of business rather than to actually reduce risk-related activities.
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> Level 3 Covered Institutions, on the other hand, are generally subject to principles-based prohibitions on excessive incentive-based compensation arrangements and certain corporate governance and recordkeeping requirements.

This three-level approach to regulating incentive-based compensation arrangements inherently places larger and more diversified Covered Institutions at a competitive disadvantage in their ability to attract and retain talented employees who are critical to the success of their organization. In our experience, Covered Institutions compete from largely the same pool of talent, irrespective of their asset size. Thus, individuals often have the choice of working for institutions that span the three-level spectrum, as well as unregulated institutions. By subjecting institutions that have larger assets to more onerous restrictions on compensation, which would cover a greater number of employees (as the example above demonstrates), the Proposed Rules may inadvertently deprive larger Covered Institutions of talented employees. More talented individuals may instead choose to work at institutions where their compensation is not subject to the enhanced requirements of the Proposed Rules.

In addition to the issues associated with using asset size as a proxy for risk, the potential for competitive disadvantage inherent in the tiered regulatory approach is compounded by the Proposed Rules' methodology for determining the average total consolidated assets, which only measures propriety, U.S.-based assets. This approach may cause the Proposed Rules to favor Covered Institutions that are U.S. subsidiaries of globally significant financial institutions at the expense of U.S. Covered Institutions. For example, a Covered Institution that is a U.S. subsidiary of a large U.K. financial institution may have limited U.S.-based assets that are below

the Level 1, 2, or 3 threshold. As a result, the U.S.-subsidiary of a U.K. financial institution may be subject to significantly less restrictive incentive-based compensation measures and would have a competitive advantage over its U.S.-based competitors in its ability to attract and retain talented employees, even though both organizations are considered globally significant to the financial markets.

Likewise, the Proposed Rules' methodology for calculating average total consolidated assets will give other financial firms, such as hedge funds and stand-alone investment advisers or broker-dealers, an advantage in recruiting talent when competing in the same space. For example:

> BHC, a bank holding company that operates significant U.S. retail banking, commercial banking, investment banking, broker-dealer, and investment advisory services would likely be categorized as a Level 1 or Level 2 Covered Institution. However, BHC will compete for talent not only with similar firms, but also with stand-alone firms that only provide broker-dealer or investment advisory services and will likely be Level 3 Covered Institutions, if covered at all. Therefore, the stand-alone firms would be able to offer significantly less restrictive and more attractive incentive-based compensation programs to their employees as compared to BHC. This remains true even if the employee of BHC and the employee of a stand-alone firm are performing the exact same function with the exact same risk profile and even if the employee of BHC actually has a lower risk profile.

As this example illustrates, the Proposed Rules could have the effect of enticing existing employees of diversified bank holding companies to leave for stand-alone firms and impede efforts of diversified bank holding companies to attract new and vital talent to fill these abandoned positions. A migration to stand-alone firms will serve to increase the population of individuals over which the Agencies have no oversight, despite the fact that some of these individuals would have been deemed to have the ability to subject their previous employer to *significant* risk.

We believe that the Proposed Rules need to create a level playing field amongst all Covered Institutions. Because they are more onerous on larger and more diversified institutions, the Proposed Rules create an anti-competitive environment. The Proposed Rules may also inadvertently create more risk for larger and more diversified Covered Institutions by limiting their ability to attract and retain top-rate talent for their organizations. As a result, the Proposed Rules could encourage a "brain-drain" from large and diversified Covered Institutions and increase the risks these institutions face. Alternatively, the Proposed Rules could force large and diversified Covered Institutions to overpay in order to attract and retain the same talent as entities subject to less restrictive compensation regulations. This would also increase the Covered Institution's risk profile and could prevent the Covered Institution from adequately adjusting to economic downturns (e.g., if Level 1 Covered Institutions have to dramatically increase base salaries to compete for talent, their compensation programs may be less sensitive to company performance and less effective in motivating appropriate behavior). Moreover, the

Proposed Rules could create a need for institutions to move towards a more fixed compensation structure, which may put more stress on an institution in an economic downturn. Such stress may force an institution to lay off employees rather than incentivize them by aligning their compensation with the institution's long-term stability and growth during difficult times.

In view of these considerations, we recommend the Agencies replace the proposed three-level regulatory framework with a uniform approach to regulating incentive-based compensation applicable to all Covered Institutions to ensure a level playing field for all financial services organizations.

C. If a tiered regime is retained, there should only be two levels: (1) principles-based rules applicable to Covered Institutions with $1 billion to $50 billion in assets and (2) enhanced restrictions applicable to (a) Covered Institutions with $50 billion or more in assets and (b) Covered Institutions who are G-SIBs, G-SIFIs, or G-SIIs, regardless of asset size.

In the alternative, the Agencies should consider a two-level approach that is similar to the 2011 proposed rules on incentive-based compensation arrangements.[10] Under the two-level approach, Level 1 would capture institutions with assets of greater than $50 billion, and Level 2 would capture institutions with assets between $1 billion and $50 billion. We believe that a two-level structure will significantly reduce the possibility that certain Covered Institutions may receive a competitive advantage simply due to their organizational structure and U.S.-based assets.

As part of this two-level structure, we believe the Agencies should designate all Covered Institutions identified by the FSB as Global Systemically Important Banks ("G-SIBs"), Global Systemically Important Insurers ("G-SIIs"), and Global Systemically Important Financial Institutions ("G-SIFIs") as Level 1 entities. We believe the FSB's G-SIB, G-SII, and G-SIFI lists are more appropriate for determining Level 1 entities because the FSB takes into account an analysis of risk and systemic importance in determining whether or not an entity is a G-SIB, G-SII or G-SIFI. In each case, assets should be measured on a consolidated basis, including assets held by non-U.S. entities within the organization.

D. The Proposed Rules' inclusion of non-U.S. and minority-owned subsidiaries is overly broad and anti-competitive.

1. *Subsidiaries operating outside the U.S. should be excluded from the definition of Covered Institutions because their operations are sufficiently regulated under local law.*

Under the Proposed Rules, it appears that non-U.S. subsidiaries of Covered Institutions could be covered in the event their average total consolidated assets equal or exceed $1 billion. The Agencies recognized in the preamble that many non-U.S. jurisdictions already have adopted regulatory regimes governing compensation practices of financial institutions, which provide for

[10] *See generally* 75 Fed. Reg. at 36,440 (The 2011 Proposed Rules generally distinguish between financial institutions and large banking organizations).

comprehensive oversight of compensation practices. For example, the European Union's (the "E.U.") *Capital Requirements Directive IV* ("CRD IV") governing compensation arrangements of financial institutions operating within the E.U. generally limits the ability to award guaranteed variable remunerations, caps the ratio of fixed and variable components of compensation, and requires deferrals of incentive compensation and clawback rights of certain individuals.[11] Importantly, non-U.S. subsidiaries of U.S.-based financial institutions in the E.U. are currently subject to these CRD IV requirements.

The Agencies should provide for an exemption from the rules for all non-U.S. based entities within a Covered Institution's consolidated group to the extent that such entity does not sponsor any incentive-based compensation programs in which U.S.-based employees participate. This exemption would ensure that non-U.S. entities that may be parents or subsidiaries of a U.S. Covered Institution are not subject to multiple sets of compensation regulations, which may be overlapping, contradictory or otherwise create compliance confusion. For example, the U.K. remuneration rules published jointly by the Prudential Regulatory Authority and the Financial Conduct Authority generally require seven-year deferrals for "senior managers," five-year deferrals for "risk managers," and three-year deferrals for all other "material risk-takers" (each as defined in the remuneration rules). In contrast, the Proposed Rules would generally require a four-year deferral period for "qualifying incentive-based compensation" arrangements and a two-year deferral period for "long-term incentive plans." Therefore, an individual may be subject to a longer deferral period if employed by a subsidiary of a U.S. Covered Institution, but would be subject to a shorter deferral period if they worked for an E.U.-based financial institution or vice versa. In addition, certain carve-outs to the CRD IV "material risk taker" definition could result in an E.U.-based employee being exempt from CRD IV deferral requirements, but still subject to the Proposed Rules if they work for an E.U.-regulated subsidiary of a Covered Institution. Such a framework would put U.S. Covered Institutions at a significant competitive disadvantage vis-à-vis their E.U.-based counterparts with whom they compete for talent in non-U.S. labor markets.

A Covered Institution that is subject to both sets of rules may not be able to effectively structure its incentive-based compensation arrangements in a manner that satisfies its obligations under each. The events that could trigger clawbacks under CRD IV differ from those under the Proposed Rules. Thus, if a Covered Institution was subject to both sets of rules, and the Proposed Rules required a clawback, but the CRD IV rules did not, the Covered Institution may not be able to comply with its clawback obligations under the Proposed Rules because local law would not recognize such clawback rights. In Germany, for example, courts will usually decide on a case-by-case basis if forfeiture and clawback clauses are invalid. In France, the French High Court has previously invalidated contractual provisions requiring clawback following an employee's resignation. This could lead to uncertainty, conflicting requirements, and increased costs for Covered Institutions if clawbacks must be defended in court on a case-by-case basis.

Moreover, the CRD IV regime has its own requirements related to the composition of variable compensation. Specifically, at least 50 percent of any variable pay must consist of shares or equivalent ownership interests (or, for non-listed institutions, share-linked, or

[11] *See* Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, 2013 O.J. (L 176) 338.

equivalent non-cash instruments) or certain classes of other instruments that fulfill specific requirements. If a Covered Institution has to comply with these CRD IV composition requirements and the Proposed Rules' requirement that deferrals consist of substantial amounts of both cash and equity-like instruments, it is possible that deferring adequate portions of all necessary components would lead to a total percentage of greater than 100 percent. In other words, it would be impossible.

In the event the Agencies wish to extend application of the rule to non-U.S. parents or subsidiaries of Covered Institutions, the Agencies should at a minimum consider providing an exemption for such non-U.S. entities that are subject to non-U.S. regimes determined to be substantially compliant with the FSB's *Principles for Sound Compensation Practices* and the associated *Implementation Standards*. Similarly to the Proposed Rules, these standards were developed to align compensation with prudent risk-taking and focus on independent board oversight of compensation practices, linkages of variable compensation with overall company performance, compensation structure, and risk alignment (including deferral, vesting, and clawback arrangements), limitations on guaranteed bonuses, enhanced public disclosures and transparency of compensation, and enhanced supervisory oversight of compensation.[12] Moreover, the Federal Reserve, OCC, FDIC, and Office of Thrift Supervision ("OTS") already have endorsed and referenced these principles in the 2010 Guidance.[13] Any non-U.S.-based entity subject to such a non-U.S. compensation compliance regime would therefore already be required to comply with these heightened compensation restrictions. Thus, additional regulation would not only be unnecessary, but could also impose contradictory regulatory requirements upon such entities.

2. *The definition of control should be increased to more than 50 percent of any class of voting securities of the Covered Institution to ensure a parent is only responsible for a subsidiary if it has the legal authority necessary to implement the requirements of the Proposed Rule.*

The Proposed Rules generally define the term "subsidiary" as a company that is owned or controlled directly or indirectly by another company.[14] Control exists if (1) the Covered Institution directly or indirectly or acting through one or more persons owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the bank or company, (2) the Covered Institution controls in any manner the election of a majority of the board of directors of the bank or company, or (3) the applicable Agency determines after notice and opportunity for hearing, that the Covered Institution directly or indirectly exercises a controlling influence over the management or policies of the bank or company.[15]

We believe that the Agencies should revise the first prong of the definition of control to require a parent own or control or have the power to vote, directly or indirectly or acting through one or more persons, a majority of any class of voting securities of the bank or company. The

[12] *See* FSB Principles for Sound Compensation Practices (Apr. 2, 2009); FSB Principles for Sound Compensation Practices: Implementation Standards (Sept. 25, 2009).
[13] *See generally*, Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. at 36,395.
[14] *See* Section 236.2(ii), 81 Fed. Reg. at 37,809.
[15] *See* Section 236.2(g), 81 Fed. Reg. at 37,813.

proposed 25 percent threshold could result in a Covered Institution being held responsible for the compliance of a bank or other entity when it does not have the legal authority to direct the activities of such organization. A Covered Institution that owns 25 percent of another Covered Institution, for example, may have no ability to shape, implement, or approve incentive-based compensation arrangements sponsored by that other Covered Institution due to its minority ownership interest.

Utilizing a majority ownership requirement would ensure that Covered Institutions actually have the ability to effectuate the compensation reforms contemplated by the Proposed Rules. It would also bring the Proposed Rules closer to alignment with existing standards for control in other regulations governing compensation. For example, both Section 409A of the *Internal Revenue Code of 1986*, as amended (the "Code") (regulating nonqualified deferred compensation), as well as Code Section 414 and Section 4001 of the *Employee Retirement Income Security Act of 1974*, as amended ("ERISA") (both regulating tax-qualified retirement plans), generally aggregate organizations based on an ownership interest of 80 percent or more. This level of ownership is designed to ensure that entities are aggregated based on actual control for purposes of these rules. As these examples demonstrate, the Proposed Rules' 25 percent standard is far lower than the standard commonly found in other regimes regulating compensation. We recommend the Agencies modify the definition of control by increasing the ownership interest requirement to more than 50 percent of any class of voting securities of the Covered Institution to ensure a parent is only responsible for a subsidiary if it has the legal authority needed to implement the requirements of the Proposed Rule.

III. The Definitions for Covered Persons, Senior Executive Officers ("SEOs"), and Significant Risk-Takers ("SRTs") are Overly Broad and Result in Unnecessary Complexity and Potential Coverage of Individuals with No Ability to Expose a Covered Institution to Material Risk.

A. The definitions for Covered Person, SEO, and SRT should be replaced with the role-based material risk-taker framework that already has been validated by the Agencies.

We are concerned that the Proposed Rules' approach to identifying Covered Persons, SEOs, and SRTs is overly broad and not sufficiently connected to a person's ability to expose a Covered Institution to material risk.

The Proposed Rules designate Covered Persons as any executive officer, employee, director, or principal shareholder who receives incentive-based compensation, irrespective of where within a large organization such individual performs such activities. Given the expansiveness of the Agencies' proposed definition of incentive-based compensation, a Covered Institution's Covered Persons would likely include all or almost all employees, regardless of the type of work performed by such individuals. Thus, we would expect that the vast majority of Covered Persons would have no risk-taking role and could not expose a Covered Institution to material financial loss. For example, a bonus program that provides for the award of $100 to $500 to administrative assistants as a reward for their exceptional performance would cause these individuals to be captured under the Proposed Rules. We do not believe this is necessary

or the intent of the Agencies. As discussed in greater detail below, utilizing such an expansive Covered Person definition is highly problematic due to the governance and recordkeeping requirements contemplated by the Proposed Rules.

In our view, both the SEO and SRT definitions should be limited to identify only individuals whose risk-taking or supervision of risk-takers could encourage a Covered Institution to take inappropriate risks due to the excessive compensation provided to such individuals or that could result in material losses for a Covered Institution.[16] Thus, the text of the statute suggests that the Agencies should focus only on individuals who participate in incentive-based compensation arrangements that could encourage a Covered Institution to take inappropriate risks. Individuals whose roles do not involve risk-taking on behalf of a Covered Institution are outside the purview of the statute and should not be subject to the Proposed Rules. As discussed in greater detail below, while the SEO definition focuses on job titles and individuals serving in similar roles, its application to large and diversified Covered Institutions would likely result in relatively low-level employees at subsidiary Covered Institutions being considered SEOs. Likewise, the SRT definition's focus on compensation received by employees of a Covered Institution would likely cover many employees whose activities do not generate risk and potentially omits employees who engage in risk-taking activities. As a result, risk management resources will invariably be misapplied under the proposed SEO and SRT framework.

1. *Covered Persons should be limited to role-based material risk-takers already identified by Covered Institutions in conjunction with the Federal Reserve Board and validated by the Agencies.*

We recommend the Agencies replace the Covered Person, SEO, and SRT definitions with the established "material risk taker" ("MRT") methodology developed as part of the interagency Horizontal Review process, which actually identifies the individuals and groups of individuals that could expose an organization to material risk.

During the Horizontal Review process, a risk assessment matrix was developed by regulated financial institutions to assess jobs relative to strategic, credit, market, liquidity, operation, compliance/legal, and reputational risk. Regulators from the Federal Reserve, OCC, OTS, and FDIC reviewed the various risk-taking activities of employees at financial institutions, analyzed the information, and worked collaboratively with these institutions to identify employees for whom incentive-based compensation arrangements may, if not properly structured, pose a threat to the organization's safety and soundness. Pursuant to this review, employees at financial institutions were grouped into three categories depending upon their risk-profile: *Category 1* - senior executives, *Category 2* - other individuals able to take or influence material risks, and *Category 3* - groups of similarly compensated individuals who, in the aggregate, can take or influence risk. As a result, many financial institutions already have performed a careful analysis, in conjunction with regulators, to determine which individuals within their organizations should be considered MRTs.

[16] *See Dodd-Frank Act*, Section 956(b).

This established and evaluated framework can seamlessly be applied to Covered Persons, SEOs, and SRTs by simply (i) defining Covered Persons as all MRTs, (ii) defining SEOs as all Category 1 MRTs, and (iii) defining SRTs as all Category 2 MRTs. There is no need for regulators to develop and attempt to enforce a new and convoluted regime when there is an existing regime they helped create and evaluate already in place. Therefore, we recommend the Agencies replace the Covered Person, SEO, and SRT definitions accordingly.

B. If the SEO definition in the Proposed Rules is retained, there should only be one set of SEOs for each consolidated organization, determined according to SEC Section 16 standards.

Under the Proposed Rules, the term SEO is defined as any Covered Person who holds the title or—without regard to title, salary, or compensation—performs the function of one or more enumerated positions at a Covered Institution for any period of time during the relevant performance period.[17] We believe that these positions (subject to our suggestions below) represent individuals who may be responsible for and have a control function over material risk-taking activities within a Covered Institution. We do not believe that additional positions, such as the chief technology officer, chief information security officer, or other similar titles should be considered SEOs, as these positions are not involved in risk-taking activities.

Individuals in these roles also possess skills that are both critically important to financial institutions, yet easily transferrable to other sectors of the economy (e.g., technology or other non-financial businesses). Subjecting these individuals to the enhanced compensation requirements would put Covered Institutions at a severe competitive disadvantage in their abilities to attract and retain talented employees to serve in these key roles, such as the first line of defense from constant cybersecurity threats. Accordingly, we believe that these positions should be explicitly excluded from the SEO definition and—as discussed in greater detail below—should not be considered SRTs.

The Agencies should revise the Proposed Rules to provide that there would only be one group of SEOs per consolidated organization, similar to the approach taken with determining "executive officers" under Rule 3b-7 of the *Securities Exchange Act of 1934* (the "*Exchange Act*") and Rule16a-1(f) of the *Exchange Act*. Many Covered Institutions have large corporate organizations that consist of many subsidiaries, which themselves would be considered Covered Institutions. As currently drafted, the Proposed Rules could easily result in such organizations having hundreds of SEOs. We do not believe such a result was the intention of the Proposed Rules, but rather that the SRT concept was intended to address a broader group of potential risk-takers within an organization.

The Proposed Rules' application of the SEO determination on a per-Covered Institution basis would capture relatively low-level employees within a large and diversified Covered Institution's consolidated group, such as individuals serving the function of a "President" or even "Chief Legal Officer" for relatively small Covered Institution subsidiaries.

[17] *See* Section 236.2(gg), 81 Fed. Reg. at 37,808.

For example:

> Assume Mr. Smith is the President of Sub Y, a subsidiary of Parent Company that holds $2 billion in assets. As a large and diversified financial institution with hundreds of subsidiaries, the consolidated Parent Company holds over $300 billion in assets. Based on his role, Mr. Smith is normally considered to be among the "middle management" of Parent Company. Under the Proposed Rules however, Mr. Smith would be considered an SEO based on his title as the President of Sub Y.
>
> Likewise, assume Mrs. Brown is a relatively junior attorney in Parent Company's in-house legal department who is responsible for providing primary legal services to Sub Y. Mrs. Brown would also likely be classified as an SEO under the Proposed Rules.
>
> Inherent in their positions within Parent Company, these individuals and their responsibilities do not pose significant risk to the consolidated Parent Company and their compensation arrangements should not be subjected to the enhanced restrictions contemplated by the Proposed Rules.

The Agencies should also provide a safe harbor to avoid uncertainty concerning what constitutes a "major line of business" for purposes of the SEO definition. We believe an appropriate safe harbor for a major line of business would be any line of business that constitutes 25 percent or more of a Covered Institution's annual revenue for the prior reporting period. We believe that this standard will identify lines of business that are truly significant to a Covered Institution. In addition, it provides a uniform methodology that is already calculated by Covered Institutions for other financial reporting purposes. Moreover, referencing revenues avoids potential manipulation that might occur if any offsets were allowed. For example, determining a major line of business based on its net income could produce unexpected results based on adjustments for costs of doing business, depreciation, interest, taxes, and other expenses. Conversely, referring to revenue references a financial metric that is not then subject to subsequent adjustments.

In sum, the SEO definition is overly broad and should (i) be revised to provide an exclusion for certain positions with no responsibility for risk-taking activities, (ii) be limited to one group of SEOs per consolidated organization, and (iii) include a safe harbor to avoid uncertainty concerning what constitutes a "major line of business."

C. If the SRT definition in the Proposed Rules is retained, there should be limits, carve-outs, and other modifications made to avoid over-broad application, improve workability, and provide a more precise nexus better aligned to an individual's actual risk-taking responsibilities.

The Proposed Rules identify SRTs using two proxies for significant risk-taking responsibility: a relative compensation test and an exposure test. The relative compensation test

identifies the top five percent (Level 1 Covered Institutions) or top two percent (Level 2 Covered Institutions) highest compensated employees who receive at least one-third of their compensation via incentive-based compensation.[18] The exposure test is a measure of an employee's ability to "commit" a Covered Institution's capital or total net worth.[19] As a practical matter, the Proposed Rules use the term "commit" as a term of art that does not have its natural meaning within the industry.

As discussed above, we believe that both the SEO and SRT definitions should be replaced by a role-based analysis that provides a more precise nexus and is better aligned to an individual's actual risk-taking responsibilities, such as the MRT analysis currently performed by financial institutions that were subject to the Horizontal Review process. In the event that the Agencies determine to retain the current method for identifying SRTs, we recommend the Agencies make the following changes to the SRT definition.

1. *If the compensation test is retained, the SRT definition should be limited to individuals with "compensation" of $1,000,000 or more.*

We recommend the Agencies provide a compensation threshold of $1,000,000 determined according to the same methodology used to determine an employee's status as a Covered Person—under which no employee will be considered a SRT. Such an approach would be consistent with the CRD IV requirements, which recognize that individuals whose compensation falls below a certain threshold should not be subjected to such prescriptive and onerous compensation regulations. Moreover, any dollar threshold should provide for automatic annual adjustment to prevent inflation from effectively lowering it over time. We recommend reference to the consumer price index—or another objectively determinable measure—to ensure consistent application of any dollar threshold.

2. *Even if the compensation and/or the exposure tests are retained, the SRT definition should be clarified to cover only those individuals who could expose a Covered Institution to material financial losses based on their actual roles and risk-taking responsibilities.*

The Agencies should provide a carve-out from the definition of SRT for individuals with little or no ability to expose a Covered Institution to material financial losses based on their actual roles and risk-taking responsibilities. As the Agencies recognize in the preamble, the SRT definition would likely capture thousands of employees at large and diversified Covered Institutions, many of whom are well below the level of significant risk-taking or oversight functions.[20]

[18] *See* Section 236.2(hh)(1), 81 Fed. Reg. at 37,808.
[19] *See* Section 236.2(hh)(1)(iii), 81 Fed. Reg. at 37,808.
[20] *See* 81 Fed. Reg. at 37,694.

For example:

> Assume Bank G is a Level 2 Covered Institution. Bank G's SRT group could easily include a highly-skilled and well-compensated member of its cyber security team, whose responsibility it is to protect Bank G's proprietary information and its customer's confidential personal data. This individual has no role in Bank G's risk-taking, but instead, is employed to mitigate and prevent risks associated with cyber threats. It would be a bizarre result for such individual to be subject to the enhanced incentive-based compensation arrangement restrictions contemplated by the Proposed Rules and we do not believe this is the intent of the statute. Rather, the statute is intended to specifically identify those individuals whose compensation may encourage inappropriate risk-taking that could lead to material financial loss to the Covered Institution.

Such a broad scope would require significant structural changes in compensation programs for those individuals identified by the Proposed Rules and would require massive amounts of additional "back-office" recordkeeping and documentation processes that are not currently in place. We view the costs associated with implementing these changes and maintaining ongoing compliance programs as largely outweighing any potential benefits since many of the potential SRTs identified in the Proposed Rules have little ability to expose a Covered Institution to material risk.

3. *Financial advisors should be excluded from the SRT definition, as they manage assets for unrelated third-parties and cannot encourage Covered Institutions to take inappropriate risks that could lead to material financial loss.*

The enhanced compensation restrictions for SRTs contemplated by the Proposed Rules are intended to cover those persons who can receive more or less reward for their risk-taking at the Covered Institution, and thus, subject the Covered Institution to material financial loss. Financial advisors should be excluded from the definition of SRT because they do not expose a Covered Institution to risks that would be effectively mitigated by the enhanced restrictions on incentive compensation.

Financial advisors do not commit the capital or assets of a Covered Institution. Instead, financial advisors typically deliver wealth management solutions, including a broad range of banking, investment management, and other services, to third-party clients in exchange for fees or commissions. While their activities certainly affect their clients' assets, financial advisors cannot directly or materially affect a Covered Institution's assets. The risk associated with financial advisors is primarily limited to the amount of fees they collect, which varies from year-to-year, but creates little risk of material financial loss for the Covered Institution.

We acknowledge, of course, that financial advisors—like any other employee at an organization—could subject the entity to some risk. However, regulators have previously acknowledged that financial advisors, based on the role and activities in which they are engaged,

have a relatively low risk-profile. We believe that Covered Institutions already have developed compensation frameworks in collaboration with regulators that ensure that financial advisors are not paid excessively and do not engage in inappropriate risk-taking. In particular, financial institutions have developed policies and procedures for financial advisors that monitor incentive-based compensation payments, detect outlier or outsized awards, provide for follow-up due diligence of such payments, and provide for consistent and periodic analysis of applicable compensation programs to determine whether structural adjustments are appropriate. These policies and procedures effectively manage the potential risks actually present in the activities of financial advisors.

By contrast, the Proposed Rules take a prescriptive approach to regulating the compensation arrangements of all SRTs, inadvertently capturing financial advisors in the enhanced compensation restrictions (e.g., downward adjustment, deferral, forfeiture, clawback, and volume-driven and relative performance measure prohibitions). We believe this prescriptive approach would be ineffective for financial advisors because the enhanced compensation restrictions are intended to diminish risks to financial institutions that financial advisors are incapable of causing, such as strategic, credit, market, and liquidity risks. The services performed by financial advisors do not expose a Covered Institution to the types of losses which the enhanced restrictions are designed to mitigate.

Accordingly, the incentive-based compensation programs in which financial advisors participate should be exempt from the prescriptive and enhanced compensation requirements of the Proposed Rules if the financial advisor is solely investing assets for unrelated third parties. Instead, we recommend that the Agencies revise the Proposed Rules to exclude such individuals from the SRT population and continue to regulate their compensation through the principles-based requirements of the Proposed Rules applicable to all covered persons.

The prescriptive approach taken by the Proposed Rules is at such variance with established market practices for financial advisor compensation—large components of which typically consist of cash payments made as often as monthly—that it is likely many financial advisors would find it unacceptable as a term of their employment. Since financial advisors with sufficient compensation to be deemed to be SRTs comprise the most successful and economically mobile financial advisors, the ultimate impact of covering them may be to simply encourage them to move to organizations wholly unregulated by the Proposed Rules (e.g., independent investment advisors with less than $1 billion in assets). It would be fundamentally inequitable for one financial advisor who happens to work for a large and diversified Covered Institution, engaging in the same activities, generating the same revenues, and creating the same risk to have fundamentally different compensation restrictions as another financial advisor who happens to work at a regional broker-dealer or as an independent registered investment adviser. This would increase the risk to the financial system both by removing financial advisors from the basic oversight requirements of the Proposed Rules applicable to all Covered Persons and by depriving large Covered Institutions of a diversified revenue stream unrelated to risk taking.

We also urge the Agencies to consider the effects the Proposed Rules could have on the millions of Americans who rely on financial advisors to help them prepare for their future and garner the financial stability to buy a home, provide an education for their children, care for their

parents, save for their retirement, and otherwise meet their financial goals. If financial advisors are considered SRTs, a significant number may transition their employment to smaller entities that are not subject to the prescriptive compensation restrictions contemplated by the Proposed Rules. Their clients would be disadvantaged, as these financial advisors would no longer have access to the same products and services currently available to clients of financial advisors employed by large and diversified Covered Institutions. In addition, financial advisors who move to smaller non-regulated companies would inherently be subject to more limited oversight and supervision (both internal and external), which in turn, also could harm many consumers who are seeking financial solutions and products to support every aspect of their financial lives.

In sum, applying the definition of SRT to financial advisors would likely capture thousands of employees at large and diversified Covered Institutions who do not take significant risks. Such a broad application would require significant structural changes in compensation programs for these individuals and would disadvantage large and diversified firms in recruiting and retaining wealth management talent. Moreover, it would also lead to more potential risk for the financial advisors' clients if they move to an entity with less regulatory supervision and fewer safeguards in place. The costs associated with implementing these changes and maintaining ongoing compliance programs would far outweigh any potential benefits, since financial advisors typically have little capacity to expose a Covered Institution to material risk.

4. *The exposure test should be eliminated because it is overly broad and unworkable.*

Whether or not these quantitative and qualitative limits are incorporated, we recommend the Agencies eliminate the exposure test, as its application will likely pick up individuals within a Covered Institution who have little, if any, role in the Covered Institution's risk-taking activities. For example, an employment lawyer at a Covered Institution would likely have technical authority to approve settlements of employment-related claims against the Covered Institution. Often, such individual's technical authority to sign a settlement of a potential claim could exceed the exposure test, thereby causing the individual to be considered a SRT under the Proposed Rules. Such a result is plainly antithetical to the purpose of the Proposed Rules' objective to limit the concern that compensation programs may induce inappropriate risk-taking. The exposure test's failure to measure actual ability to expose a Covered Institution to material financial losses is further highlighted by the fact that the Proposed Rules treat an employee who only has the authority to trade large amounts of low-risk treasury the same as an employee that may be able to trade highly volatile high-yield bonds.

Moreover, Covered Institutions have not historically tracked each of their employees' potential to commit capital, especially measured on a per-Covered Institution basis. The massive complexity and cost required to do so is exemplified as follows:

> Bank A, which is a large and diversified Covered Institution, employs 75,000 Covered Persons and owns 100 subsidiaries, of which 74 are Covered Institutions. The Proposed Rules would apparently require Bank A to test whether each Covered Person could commit 0.5 percent of Bank A's and each of its 74 Covered Institution subsidiaries' respective capital. Thus, Bank A would be required to perform a total of 5,625,000 exposure test calculations each year to determine whether or not each Covered Person has the authority to commit 0.5 percent of the parent Covered Institution's capital and the capital of each of its 74 Covered Institution subsidiaries.

As the example above demonstrates, the sheer volume of calculations potentially required would likely result in inadvertent errors and would certainly require a significant amount of resources be poured into running and checking the results of each year's exposure test. Such time and efforts would be better placed elsewhere. The number of calculations could actually be increased significantly from the amount described above, if Covered Institutions are not permitted to utilize a single identification date, as discussed in further detail below. Therefore, we recommend eliminating the exposure test from the definition of SRTs.

5. *If the exposure test is retained, it should measure the exposure made by the individual through actual commitments of capital (as opposed to hypothetical commitments) and intra-company transactions should be excluded.*

In the event the exposure test is retained, we recommend the Proposed Rules at least be revised to reflect the amount of commitments actually made by a Covered Person, rather than the hypothetical commitments that may possibly be made. In our experience, many employees of a Covered Institution may not be limited by a specific dollar value of commitments. Under the Proposed Rules, these employees would automatically be treated as SRTs because they would be deemed to have unlimited authority to commit the Covered Institution's assets. In practice, however, financial institutions have many institutional checks and balances already in place that would prevent employees from over-committing a Covered Institution.

For example, many loan officers are not limited in the dollar value of loans that they may originate. However, each loan is subject to a multi-layer review process such that each loan is heavily scrutinized prior to its approval. According to the Proposed Rules, such loan officer would be deemed to be a SRT based on his or her ability to originate an unlimited number of loans even though, in practice, such individual is constrained by a thorough review process that is designed to ensure that all such loans satisfy the Covered Institution's risk tolerance. As a result of the internal review and approval process, the loan officer is in fact practically constrained in the amount of a Covered Institution's capital he or she may commit.

We recommend the Agencies revise the Proposed Rules to determine SRT status under the exposure test based on the commitments actually made by a Covered Person during a particular year, rather than the hypothetical commitments that could, in theory be made, but in reality would not be possible due to applicable internal review processes. Moreover, we recommend the Agencies exclude from the exposure test transactions between Covered Institutions that are within a consolidated group. For example, a Covered Person may be able to transfer funds from one Covered Institution to another Covered Institution, both of which are within the same consolidated group. We believe the exposure test is designed to reflect transactions between third-parties; therefore, transactions between related parties should be exempt from the SRT exposure test.

6. *Covered Institutions should be able to choose a single, consistent date on which to identify SRTs for all performance periods beginning during a single year.*

In order to provide consistency and a reasonable framework for determining which covered employees are considered SRTs, the Agencies should provide that Covered Institutions may designate a specific date or a date chosen each year within a prescribed time-period (e.g., the first three months of each calendar year) on which SRTs will be determined for the year and be able to rely on such designations for the remainder of the year. Such an approach would be consistent with rules applicable for determining "specified employees" for purposes of Code Section 409A. Under those rules, an employer is required to generate a list of employees subject to mandatory six-month delays for nonqualified deferred compensation paid upon a separation from service. This framework provides employers with consistency with respect to the administration of compensation arrangements during an applicable year.

D. The Covered Person definition is overly broad, anti-competitive, and unrelated to a person's ability to expose the Covered Institution to material financial risk; any individual with less than $200,000 in compensation and whose total compensation is less than one-third incentive-based should be exempt from the definition of Covered Person to avoid unintended coverage.

If the MRT structure is not adopted, the definition of Covered Persons should be narrowed to ensure the coverage is appropriately connected to an individual's ability to expose a Covered Institution to material financial losses. As discussed above, the Proposed Rules' Covered Person definition would likely result in a large and diversified Covered Institution having over 100,000 Covered Persons, including information technology personnel, administrative staff, legal staff, and other individuals whose roles have little to no nexus to a Covered Institution's exposure to material financial risks.

As discussed in greater detail in Section IX.B and IX.C of this letter, this overly broad coverage of thousands of individuals makes the recordkeeping and corporate governance requirements contemplated by the Proposed Rules unworkable due to the sheer volume of individuals designated as Covered Persons. Furthermore, it will only compound the anti-competitive effect of the Proposed Rules because it unnecessarily disadvantages Covered Institutions when competing for talent. To avoid these unintended consequences and to improve workability for Covered Institutions in practice, we recommend the Agencies set a quantitative compensation limit below which individuals will not be classified as Covered Persons. We believe $200,000 in compensation is an appropriate limit.

We also recommend the Agencies apply the one-third incentive-based compensation test consistent with the Proposed Rules applicable to SRTs in addition to the compensation limit described above. We believe that the combination of the dollar threshold and the one-third incentive-based compensation requirement appropriately limits the application of the Proposed Rules to individuals whose incentive-based compensation arrangements could possibly motivate them to take inappropriate risk that could lead to material financial loss for the Covered Institution.

IV. The Definition of Incentive-Based Compensation is Overly Broad and Results in Unnecessary Complexity and Coverage of Compensation Arrangements with No Nexus to Risk-Related Behavior.

A. Quantitative and qualitative thresholds should be applied to avoid inadvertent coverage of incentive-based compensation arrangements that do not influence a Covered Person's risk-related behavior.

The Proposed Rules generally define "incentive-based compensation" as any variable compensation, fees, or benefits that serve as a reward for performance.[21] The Agencies indicate that they have proposed a broad definition to provide flexibility as forms of compensation evolve.[22] We generally agree that the definition of incentive-based compensation must be

[21] *See* Section 236.2(r), 81 Fed. Reg. at 37,807.
[22] 81 Fed. Reg. at 37,702.

flexible to address a variety of types of compensation arrangements. However, the prescriptive prohibitions provided in the Proposed Rules coupled with the recordkeeping requirements would prove extremely difficult to comply with in light of such a broad definition. Therefore, we recommend the Agencies consider the following exclusions with respect to the definition of incentive-based compensation.

1. *There should be a minimum amount below which payments are deemed to not be paid pursuant to an incentive-based compensation arrangement (e.g., $10,000).*

For the reasons discussed above, a quantitative minimum would greatly reduce the administrative burdens Covered Institutions face with respect to recordkeeping without limiting regulators' access to material incentive-based compensation arrangements. Setting the minimum at $10,000 would ensure that material incentive-based compensation arrangements are not inadvertently excluded, but that truly *de minimis* arrangements are not subject to the recordkeeping requirements.

2. *Covered Institutions should have the ability to apply qualitative standards to exclude compensation arrangements that do not influence risk-taking.*

Covered Institutions should also be able to apply qualitative standards to determine that compensation arrangements do not influence risk-taking and therefore, are excluded from the definition of incentive-based compensation. For example, a Covered Institution should be able to determine that certain recognition bonuses—such as spot bonuses for bank tellers or merit awards for secretarial staff—do not influence risk-taking and are therefore not subject to the rules. To ensure a thorough analysis is completed, the Covered Institutions should be required to document such determinations and retain this information for review by regulators.

3. *Time-based equity or equity-like awards that are not awarded for performance (e.g., buyouts and retention awards) should be specifically excluded.*

We also recommend the Agencies clarify that time-based equity or equity-like awards that do not have a performance-based component are excluded from the definition of incentive-based compensation. The preamble to the Proposed Rules states that "compensation, fees or benefits that are awarded solely for, and the payment is solely tied to, continued employment (e.g., salary or a retention award that is conditioned solely on continued employment) would not be considered incentive-based compensation."[23]

The prevailing compensation mix at financial institutions is generally comprised of base salary, annual and long-term incentive opportunities, and time-based awards. These time-based awards generally take the form of restricted stock, restricted stock units, and/or option awards that vest over a multi-year period based solely on a recipient's continued service rather than on the achievement of certain performance goals. We believe the Agencies intend to exclude such time-based awards from the definition of incentive-based compensation because an individual's opportunity to realize compensation has no link to performance or risk-taking, but rather is tied to that individual's continued service. Given the prevalence of such equity and equity-like

[23] 81 Fed. Reg. 37,702.

awards, we recommend the Agencies specifically list such time-based awards as excluded from the definition of incentive-based compensation.

B. The Agencies should clarify that if incentive-based compensation is awarded in the form of a new award that is subject to financial performance conditions, then the new award is not considered incentive-based compensation (i.e., it is not subject to additional downward adjustment, deferral/forfeiture, clawback, etc. restrictions).

The Proposed Rules generally provide that once incentive-based compensation has been "awarded" it must be deferred for a period during which it is subject to forfeiture and subsequent clawback periods once the deferred amounts have become "vested." Many financial institutions maintain compensation programs in which an employee is provided the opportunity to earn an incentive award that is then paid in a mix of time-based and performance-based equity or equity-like awards. For example:

> Assume Mr. Thomas may be granted an opportunity to earn a bonus based on performance over a calendar year. After the performance period, the amount of the annual bonus is determined and then awarded in a mix of cash, time-vested equity, and performance-vested equity. The performance-vested piece would only vest based on the achievement of additional performance goals measured over a subsequent period. At its core, the performance-vested piece is designed to ensure that the performance originally attained is sustainable over the long-term.

We recommend the Agencies clarify that incentive-based compensation that is awarded in whole or in part in the form of a new incentive-based compensation arrangement would not subject the subsequent incentive-based compensation arrangement to a new and potentially overlapping deferral, forfeiture, and clawback period. Thus, using the annual bonus program example above, the annual bonus would be considered to have been "awarded" under the Proposed Rules at the end of the original performance period and the portion of such bonus paid in performance-based equity (e.g., performance restricted stock units) would not start a new deferral, forfeiture, and clawback period. Otherwise, the Proposed Rules may have the unintended effect of effectively discouraging financial institutions from using these performance-based awards.

C. Amounts deferred from incentive-based compensation arrangements should be permitted to have limited upside leverage.

The Proposed Rules generally prohibit increases in deferred qualifying incentive-based compensation or deferred long-term incentive plan amounts for SEOs or SRTs. We view this prohibition as arbitrary and counter to current best practices in incentive compensation design.

In our experience, many Covered Institutions require a portion of qualifying incentive-based compensation earned be deferred subject to additional performance conditions. This structure is designed to reward performance during the initial performance period, but also to

ensure that such performance is achieved in a sustainable fashion when measured over a longer performance period.

SEOs and SRTs with deferred amounts subject to new performance conditions should be permitted to realize upside gains on such amounts if their longer-term performance merits additional increases. As discussed in Section VIII.B below, we recommend leverage associated with these arrangements be limited to 200 percent—an amount that is consistent with wide-spread incentive compensation program designs.

V. The Deferral Requirements are Overly Broad and There Is No Nexus to the Level of Risk-Related Activities.

A. The fixed minimum deferral amount is arbitrary and does not allow for needed flexibility to address risk-related behavior.

Under the Proposed Rules, the minimum deferral amount is a specified percentage: 40 percent for Level 2 SRTs, 50 percent for Level 2 SEOs and Level 1 SRTs, and 60 percent for Level 1 SEOs.[24] These deferral amounts are arbitrary and do not allow an institution to take into account each specific individual's risk-related behavior.

1. *Covered Institutions should be given flexibility to set minimum deferral amounts based on factors that reflect an employee's overall level of responsibility and the actual risk such individual's activities pose to the institution as a whole.*

The arbitrary minimum deferral amounts in the Proposed Rules do not adequately take into account the variety of factors that should be considered when determining an appropriate deferral amount, such as:

- the employee's specific position within the company;
- his or her ability to commit capital;
- his or her control functions;
- his or her management responsibilities and decision-making authority; and
- the overall risk his or her specific activities may pose to the institution.

As a result, the Proposed Rules would require the same minimum deferral amount for a Senior Managing Director of an investment banking group whose total annual compensation averages $10 million as a Vice President of information technology whose total annual compensation averages $500,000, each of whom are employed by a Level 1 Covered Institution. As with other aspects of these individuals' compensation packages (e.g., salary, performance goals, and availability of benefits) and as acknowledged by the Federal Reserve in its October 2011 report on incentive compensation practices as part of the Horizontal Review process, a one-size-fits-all approach is not appropriate or necessary.[25] In its report the Federal Reserve

[24] *See* Section 236.7(a), 81 Fed. Reg. at 37,810.
[25] *See* Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations, October 2011 by the Board of Governors of the Federal Reserve System

acknowledged that "rigid, one-size-fits all supervisory limits or formulas" could create "potential hazards or unintended consequences."[26]

Instead, Covered Institutions should be given flexibility to determine an appropriate minimum deferral amount based on factors applicable to the specific SEO or SRT. We recommend the Agencies allow Covered Institutions to determine the appropriate minimum deferral percentages for SEOs and SRTs based on the role and risk-taking ability each such individual has within the organization. Covered Institutions management and compensation committee can then continue to require increased deferrals for specific employees when necessary. To prevent abuses, we recommend the Agencies set a minimum deferral percentage of 20 percent. This approach would still be more restrictive than the 2011 proposed rules, which only included deferral requirements for executive officers at larger financial institutions.[27]

If specific minimum deferral amounts are retained, the current thresholds for long-term incentive plans should be lowered. These awards already have been subject to a performance period that—in most instances—is at least three years. Practically speaking, 100 percent of a SEO's or SRT's compensation under a long-term incentive plan has already been put at risk for at least three years and earned for past performance, because it is contingent on the achievement of specified performance metrics and goals during that time period. Requiring approximately one half of the award (40 percent to 60 percent depending on the classification of the employee and the Covered Institution) to be "deferred" (as defined by the Proposed Rules) and thus subject to forfeiture for a total of at least five years is overly burdensome and excessive. These requirements would have a significant impact on a covered employee's liquidity and financial planning capabilities resulting in a substantial competitive disadvantage for the Covered Institutions when competing for talent. Therefore, we recommend requiring a minimum of 20 percent be deferred for an additional time period beyond the initial performance period of three years or more.

2. *The application of the enhanced restrictions to excess deferrals should be reduced or, in the alternative, the Agencies should at least clarify that the enhanced restrictions do not apply to excess amounts an individual voluntarily defers.*

The Proposed Rules currently enumerate certain factors, such as financial and reputational harm, past behavior, causes of the triggering event, and actions the SEO or SRT could have taken, that must be considered when determining whether the minimum deferral amount should be forfeited during the deferral period.[28] In the preamble, the Agencies note that these restrictions "would apply to all unvested deferred incentive-based compensation, regardless of whether the deferral of the incentive-based compensation was necessary to meet the requirements of the proposed rule."[29]

(http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf).

[26] *Id.*

[27] Section 236.5(b)(3)(i), 76 Fed. Reg. 21,170, 21,207 (Apr. 14, 2011).

[28] *See* Section 236.7(b)(4), 81 Fed. Reg. at 37,811.

[29] 81 Fed. Reg. at 37,681.

We recommend that if amounts in excess of the minimum deferral amounts are deferred, there is no requirement that these "excess deferrals" be subject to the same list of forfeiture considerations. If excess deferrals must comply with the same restrictions as the minimum deferral amounts, Covered Institutions will be discouraged from implementing any excess deferrals despite the potential benefits they allow, such as a further reduction in risk. The Agencies acknowledge this risk of discouraging excess deferrals when discussing the prohibition on acceleration: "[t]he prohibition on acceleration except in cases of death or disability would apply only to deferred amounts that are required by the proposed rule so as not to discourage additional deferral, or affect institutions that opt to defer incentive-based compensation exceeding the requirements."[30]

The Proposed Rules allow the amounts representing the excess deferral to be awarded to the applicable individual without any additional deferral, so it seems reasonable that they should also allow these amounts to be subject to less stringent forfeiture requirements if they are voluntarily deferred. Therefore, we recommend removing the requirement that excess deferrals comply with the forfeiture requirements of the Proposed Rules.

If the requirements remain applicable to excess deferrals, they should only apply if the additional amounts are deferred by the Covered Institution. These requirements should not apply if an individual voluntarily elects to defer excess amounts.

B. The requirement to use the present value of incentive-based compensation at the time of the award to determine the deferral amount significantly overcomplicates deferrals with little to no benefit and should be removed.

When calculating the minimum deferral amount, the preamble notes that "a Level 1 or Level 2 covered institution generally should use the present value of the incentive-based compensation at the time of the award."[31] This requirement imposes an additional operational burden and significantly increases the risk of an inadvertent violation of the rule while causing only a negligible change to the amount of compensation that will be subject to the deferral requirements. For example, it is easy to envision inadvertent calculation errors to be made when determining the value of restricted stock units that would be paid out in multiple installments over a period of years. Moreover, it seems unclear, without issuance of additional regulatory guidance, how a Covered Institution would calculate the present value of a stock option as of the date of its "award" (as defined by the Proposed Rules). We also note that the CRD IV deferral requirements do not contain a similar present value determination, putting U.S. regulations out-of-step with global standards.[32]

Because of the complexity of the calculation, requiring this additional step greatly increases the likelihood that a Covered Institution could make every good faith effort to comply with the requirements of the Proposed Rules, but an inadvertent mathematical error or failure to

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[30] *Id.* at 37,719.

[31] 81 Fed. Reg. at 37,718.

[32] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, 2013 O.J. (L 176) 338.

discount to present value could result in non-compliance with the contemplated deferral requirements. At its core, the present value requirement would generally result in a slightly larger amount of incentive-based compensation being deferred than if the value of the deferral amount was calculated as of the "award" date. Adding such complexity to the deferral calculations is not justified by the minor change in value that will result. Therefore, we recommend removing the requirement that Covered Institutions calculate the present value of awards to comply with the deferral requirements.

C. The minimum deferral period requirements should be less prescriptive to allow compensation practices to align with retention and risk management needs.

1. *The minimum deferral period is unnecessary and anti-competitive, especially in light of the other enhanced restrictions applicable to the incentive-based compensation arrangements.*

The Proposed Rules' minimum deferral periods for incentive-based compensation are excessive and redundant, especially considering the totality of the protections in place. Under the Proposed Rules, long-term incentive plan awards are required to be deferred for an additional year for SEOs and SRTs at Level 2 Covered Institutions and an additional two years for SEOs and SRTs at Level 1 Covered Institutions.[33] An additional deferral period of one to two years is excessive. By definition, amounts payable under long-term incentive plans already have been subject to a performance period and risk of forfeiture based on the potential failure to achieve the requisite performance goals for at least three years (during which time they are subject to downward adjustment). In addition, once paid, the Proposed Rules contemplate these amounts would remain subject to a seven-year clawback period. To require SEOs and SRTs to defer portions of the award for an additional one to two years is unnecessary when the entire award is already subject to: (a) a risk of forfeiture for the three or more years in which the performance goals must be achieved, (b) downward adjustment during such performance period, and (c) a contemplated seven-year clawback period.

The Proposed Rules require qualified incentive-based compensation, on the other hand, be deferred for an additional three years for SEOs and SRTs at Level 2 Covered Institutions and an additional four years for SEOs and SRTs at Level 1 Covered Institutions.[34] This is also excessive and forces SEOs and SRTs to wait five years before receiving any award and then having it be subject to an additional seven-year clawback period. This ultimately leads to the individual having to wait 12 years from the date of grant before he or she can fully earn the compensation. This is excessive and limits employees' ability to plan for their financial futures.

[33] Section 236.7(a)(1), 81 Fed. Reg. at 37,810.
[34] Section 236.7(a)(2), 81 Fed. Reg. at 37,810.

For example:

> Assume Mr. Jones is a SRT who works as a Senior Vice President in charge of a Level 1 Covered Institution's information technology and cyber security operations and has typically received $500,000 in compensation during his tenure. Mr. Jones's compensation has come in the form of a $250,000 salary and $250,000 in incentive-based compensation payable in cash each year based on his participation in the Covered Institution's annual bonus plan. It is easy to imagine the shock Mr. Jones will experience when he learns that his annual take-home pay has been reduced by $125,000 (or 25 percent) as a result of the deferral requirement contemplated by the Proposed Rules. Further, it can be expected that Mr. Jones would be highly incentivized to begin looking for employment in another sector of the economy (e.g., technology) where he could perform the exact same job-function, at the same rate of pay, but without the stress of having to wonder if he will ever receive the $125,000 subject to deferral, forfeiture, and clawback.

The example above shows not only the competitive disadvantage the Proposed Rules' overly broad application would have on financial institutions, but also the inherent problems in attempting to impose excessive restrictions on employees who have minimal impact on an institution's risk-taking activities. As an IT specialist, Mr. Jones has no risk-taking role within the organization, but his high pay would nonetheless subject him to the same deferral, forfeiture, and clawback requirements as the head of a derivatives trading group.

If the three-level structure is retained, we recommend requiring applicable portions of long-term incentive plan compensation be deferred for a maximum of six to twelve months for all Covered Institutions and applicable portions of qualified incentive-based compensation be deferred for a maximum of three years for all Covered Institutions. In the alternative, we recommend at least reducing the minimum deferral periods for SRTs because they typically have lower compensation and less decision-making authority than the SEOs within the organization.

2. *Requiring the same deferral period for awards subject to pro rata vesting as those subject to cliff vesting results in overly burdensome restrictions and unnecessarily inhibits a Covered Institution's ability to utilize a cliff vesting schedule. Therefore, minimum deferral periods should be reduced by 50 percent if subject to cliff vesting.*

As noted above, the Proposed Rules require minimum deferral periods ranging from one to four years depending on the type of incentive-based compensation and the category of employee. This requirement effectively limits the use of a cliff vesting schedule rather than a pro rata vesting schedule during this time period. As noted in the preamble, it is customary to have equity awards that will be subject to a cliff vesting schedule.[35] Cliff vesting means 100 percent of the award will vest on one specific date rather than vesting in installments over time.

[35] *See* 81 Fed. Reg. at 37,718.

Under the Proposed Rules, if a Covered Institution subjects an award to a cliff vesting schedule, 100 percent of the award would need to be deferred for the entire minimum deferral period.[36] Because of this overly burdensome restriction, Covered Institutions will be effectively disincentivized from using a cliff vesting schedule despite its potential advantages. The Agencies should provide for a reduced minimum deferral period if cliff vesting is used. A reduced minimum deferral period may allow some portions of the deferred amounts to be vested at an earlier date, but this would be justified by the fact that it would also subject other, equal portions of the deferred amounts to a later vesting date than a pro rata schedule. We recommend reducing the minimum deferral period by one-half if an award is subjected to a cliff vesting schedule.

D. The requirements relating to the composition of deferred amounts are arbitrary and will unnecessarily limit the ability of Covered Institutions to develop innovative compensation practices.

1. *The requirement that deferrals consist of substantial portions of both cash and equity-like instruments is arbitrary, anti-competitive, and prevents innovation.*

The Proposed Rules require that certain deferrals be made up of substantial portions of both cash and equity-like instruments:

> For a senior executive officer or significant risk-taker of a Level 1 or Level 2 Covered Institution that issues equity or is an affiliate of a covered institution that issues equity, any deferred qualifying incentive-based compensation or deferred long-term incentive plan amounts must include substantial portions of both deferred cash and equity-like instruments throughout the deferral period.[37]

This requirement is arbitrary and unnecessarily limits a Covered Institution's ability to innovate and adopt new compensation forms. For example, this requirement restricts a Covered Institution's potential use of deferred debt, performance bonds, convertible contingent bonds, or any other theoretical vehicle that may be used to further align an individual's compensation with his and his employer's overall performance. Setting a rigid requirement to defer substantial portions of both cash and equity-like instruments prevents the Proposed Rules from being workable and appropriate for current practices as compensation forms develop over time. In addition, Covered Institutions will effectively have to either decrease the use of deferred equity or increase an employee's overall compensation in order to account for the required cash component of any deferral. Therefore, we believe it is more reasonable to remove the arbitrary requirement to defer substantial portions of both cash and equity-like instruments.

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[36] *Id.*

[37] Section 236.7(a)(4)(i), 81 Fed. Reg. at 37,811.

2. *The limitation on options is arbitrary, unnecessary and overly restrictive.*

The Proposed Rules limit the amount of incentive-based compensation in the form of options that may be used to satisfy the minimum deferral amount requirements:

> If a senior executive officer or significant risk-taker of a Level 1 or Level 2 covered institution receives incentive-based compensation for a performance period in the form of options, the total amount of such options that may be used to meet the minimum deferral amount requirements of paragraph (a)(1)(i) or (a)(2)(i) of this section is limited to no more than 15 percent of the amount of total incentive-based compensation awarded to the senior executive officer or significant risk-taker for that performance period.[38]

This limitation on options is arbitrary and unnecessary. The Agencies acknowledge in the preamble that Covered Institutions already have addressed the potential risks associated with options by reducing their reliance on options as a form of incentive-based compensation after the financial crisis.[39] This voluntary adjustment to compensation practices demonstrates that Covered Institutions are appropriately addressing the use of options and should be permitted flexibility in determining when options are warranted.

Furthermore, the preamble notes that the Agencies are concerned that options may "increase the incentives under some market conditions 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."[40] Once an option is exercised, however, the individual often owns the underlying equity and remains incentivized to increase its long-term value. Although the shares obtained may be sold, this is also true for shares of restricted stock once vested. Even if options did not adequately encourage appropriate weight be given to long-term risks, this concern fails to take into account the other requirements under the Proposed Rules. The deferral, downward adjustment, forfeiture, and clawback requirements all serve to ensure that long-term risks are appropriately considered and, if necessary, compensation is reduced.

Lastly, the preamble argues that—unlike restricted stock—options are limited in how much they decrease in value.[41] Options, however, do have the potential to become completely valueless if the current market price for a share is less than or equal to the option's strike price. Thus, the Covered Person is incentivized to engage in activities that do not expose the Covered Institution to significant risks that could jeopardize the value of such individual's options.

Even if a specific percentage limitation on options is retained, there should be different standards to address the characteristics of the option granted. For example, there should be less stringent limitations for options with a strike price that is substantially higher than the fair market value of the underlying equity than for options with a strike price at fair market value as of the date of grant.

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[38] Section 236.7(a)(4)(ii), 81 Fed. Reg. at 37,811.
[39] *See* 81 Fed. Reg. at 37,727.
[40] *Id.*
[41] *Id.*

E. The list of permissible acceleration events for deferred amounts should include the payment of income taxes, a change-in-control, retirement, unexpected financial hardship, and involuntary termination of employment.

1. *Acceleration should be permitted for all Covered Institutions in the case of the payment of income taxes becoming due.*

As currently drafted, all six versions of the Proposed Rules provide that a Level 1 or Level 2 Covered Institution "must not accelerate the vesting of a covered person's deferred qualifying incentive-based compensation that is required to be deferred under this part, except in the case of death or disability of such covered person."[42] Only the NCUA's version of the Proposed Rules also allows for acceleration in the case of "the payment of income taxes that become due on deferred amounts before the covered person is vested in the deferred amount."[43] The preamble explains that the NCUA provides for this additional acceleration event because "credit union executives' incentive-based compensation awards may be subject to immediate taxation on the entire award, even deferred amounts."[44]

This possibility of immediate taxation, however, is not limited to credit unions. Employees at other Covered Institutions may also be subject to immediate taxation on deferred amounts before they are vested. For example, a SEO or SRT who receives a grant of performance-based restricted stock could be subject to tax on the full value of those shares of restricted stock at the conclusion of the performance period, even though a significant percentage of the shares are subject to deferral. This result could occur because Code Section 83 governs the taxation of restricted stock and generally provides tax is owed upon the lapse of conditions constituting a "substantial risk of forfeiture," as defined by these rules.[45] As discussed in greater detail below, it is unclear whether the potential for forfeiture based on the enumerated events described under the Proposed Rules would be considered sufficient to qualify as extending the period in which the restricted stock is considered to be subject to a substantial risk of forfeiture. Therefore, a recipient of such an award could owe tax on the full amount of his or her restricted stock, but not receive a significant portion of that stock until its "vesting" (as defined by the Proposed Rules).

[42] Section 236.7(a)(2)(iii)(B), 81 Fed. Reg. at 37,811.
[43] Section 751.7(a)(2)(iii)(B)(2), 81 Fed. Reg. at 37,823.
[44] 81 Fed. Reg. at 37,718.
[45] *See* 26 U.S.C. § 83.

In addition, Covered Institutions regularly employ individuals subject to taxation outside of the United States where there is an even greater likelihood of taxes becoming due before the deferred amounts are vested.

> For example, Canadian tax law generally provides that the full value of shares of restricted stock is taxed as of the date of grant (i.e., similar to if a U.S. employee had made a Code Section 83(b) election). Further Canadian tax law provides that additional taxes (similar to capital gains taxes in the U.S.) are owed when shares of restricted stock vest. Therefore, Canadian employees considered SEOs or SRTs of Covered Institutions would likely be required to pay taxes on these awards both at the date of grant and at the conclusion of the performance period, but would not receive the value of the restricted stock until such shares "vest" for purposes of the Proposed Rules.

The risk of taxes become due prior to "vesting" (as defined by the Proposed Rules) is not limited to credit unions. Consequently, the permissible acceleration event should not be limited to credit unions either. We recommend allowing all Covered Institutions to accelerate amounts required to be deferred under the Proposed Rules in the case of death, disability, or the payment of income taxes becoming due on such amounts.

2. *Acceleration should be permitted in the case of a change-in-control.*

The Agencies should allow for acceleration in the case of a change-in-control of a Covered Institution. In practice, a large majority of equity plans currently allow for acceleration on a change-in-control. This is because a change-in-control can have potentially far-reaching effects on the organizational structure of the company, an individual's duties and employment relationship, and the equity structure of the seller. In addition, acquiring companies may decide not to assume or replace equity awards for a variety of reasons. If acceleration is prohibited on a change-in-control, management may be effectively discouraged from accepting change-in-control proposals because of the substantially negative effect on potentially thousands of their employees if the awards are not accelerated. Therefore, the Agencies should permit acceleration on a change-in-control to prevent these unintended negative consequences.

In the alternative, the Agencies should at least permit acceleration on the occurrence of a double trigger change-in-control. A double trigger change-in-control provision generally means that vesting of the award accelerates only if there is an acquisition of the company *and* the employee is terminated within a certain time period. Typically the employee's termination must be without "cause" to prevent the employee from intentionally getting fired and having his awards accelerate as a result. The Agencies state in the preamble that the limitation on acceleration events is necessary because acceleration "could also provide covered persons with an incentive to retire or leave a covered institution if the covered person is aware of the risks posed by the covered person's activities that are not yet apparent to or fully understood by the covered institution."[46]

[46] 81 Fed. Reg. at 37,719.

In the case of a double trigger change-in-control requirement however, it is important to note that an employee cannot typically retire or leave because he knows of certain risks posed by his activities. There must a change-in-control and *the company* must decide to terminate the employee. Therefore, permitting acceleration upon the occurrence of a double trigger change-in-control does not create a risk of the employee controlling the acceleration of his own award. In addition to the case of death, disability, and the payment of income taxes becoming due on such amounts, we recommend allowing for accelerated vesting of deferred amounts in the case of a double trigger change-in-control.

3. *Acceleration should be permitted in the case of an individual's retirement.*

To require an employee to continue to defer receipt of his or her compensation after retirement is unnecessary and excessive. Once an employee has retired, deferral of compensation is no longer an effective tool for controlling the employee's actions. In addition, it prevents an employee from being able to adequately plan for and assess his or her liquidity and overall financial profile to plan for retirement. The compensation at issue has already been earned during a prior performance period, so to prevent a retired individual from receiving it is unnecessary, creates uncertainty in an individual's retirement planning, and does not serve the Proposed Rules' purpose of reducing the financial risk of a Covered Institution.

4. *Acceleration should be permitted if an individual experiences an unexpected financial hardship.*

Unfortunately, many employees of Covered Institutions may incur unexpected and unpreventable financial hardships during their employment, such as illness or catastrophic injury, loss of property due to casualty, or similar unforeseeable circumstances arising out of events beyond the employee's control. This has previously been acknowledged by regulators and addressed by federal tax and retirement rules under Code Section 409A by allowing plan sponsors to accelerate payouts in the event these unexpected financial hardships.[47] Although some may argue that a chief executive officer of a large financial institution is not likely to have an unexpected financial hardship, the deferral and forfeiture provisions contemplated by the Proposed Rules, as drafted, may cover over thousands of individuals within a single organization. It is unavoidable that some of these individuals will incur an unexpected financial hardship. To allow for acceleration under these circumstances will not affect the purpose of the Proposed Rules because these unexpected financial hardships, by definition, are not something an employee planned for or expected. Therefore, the Agencies should permit acceleration of awards in the case of an unexpected financial hardship.

[47] *See, e.g.*, 26 U.S.C. § 409A(a)(2)(A)(vi)-(a)(2)(B)(ii).

VI. The Downward Adjustment and Forfeiture Requirements are Overly Burdensome and Anti-Competitive.

A. The enforcement or legal action trigger for downward adjustment and forfeiture is over-inclusive and does not have any nexus to risk-related activities.

The downward adjustment and forfeiture requirements are overly broad and could have far-reaching and unanticipated impacts. The conditions which trigger any downward adjustment or forfeiture should be modified so that they are directly tied to the risk-related activities of the individual and so that the individual cannot be unknowingly subject to such restrictions.

1. *The enforcement or legal action trigger's reference to actions brought by any "federal or state regulatory or agency" is far-reaching and could include an action brought by agencies completely unconnected to risk-related activity (e.g, the Occupational Safety and Health Administration).*

The forfeiture and downward adjustment provisions of the Proposed Rules provide that a Level 1 or Level 2 Covered Institution must consider forfeiture and downward adjustment of incentive-based compensation of SEOs and SRTs due to an enumerated list of events, including:

> (1) Non-compliance with statutory, regulatory, or supervisory standards that results in:
>
> (A) Enforcement or legal action against the covered institution brought by a federal or state regulator or agency; or
>
> (B) A requirement that the covered institution report a restatement of a financial statement to correct a material error[.][48]

To require Covered Institutions to consider downward adjustment and forfeiture upon the occurrence of every possible enforcement or legal action brought by every federal or state regulator or agency is overly expansive and unnecessary. Not only are Covered Institutions regulated by multiple agencies that could possibly bring enforcement or legal actions, but each agency has promulgated a multitude of regulations and other requirements which are applicable to Covered Institutions.

> For example, California Financial Code Section 13040 requires that operators and owners provide lighting during hours of darkness for all open and operating automated teller machines and in certain surrounding areas. While this requirement may be obscure and have no relationship to risk-related behavior, a violation by a Covered Institution would trigger downward adjustment and forfeiture considerations under the Proposed Rules. In addition, the Proposed Rules would also include actions brought by agencies such as Occupational Safety and Health Administration that have no bearing on an individual's ability to expose a Covered Institution to material financial risk.

[48] Section 236.7(b)(2)(iv)(A), 81 Fed. Reg. at 37,811.

To avoid the unintended result described in the example above, the Agencies should narrow the trigger to refer only to the Agencies and not any governmental regulator or agency.

2. *The enforcement or legal action trigger should be modified to include a materiality threshold and an intent element, and should only require a review upon a final determination or resolution of an action.*

The Agencies should also limit the enforcement or legal action trigger by including a materiality threshold. The restatement of financial statements only triggers downward adjustment and forfeiture consideration requirements if the new statements correct a *material* error. A similar materiality threshold is appropriate and reasonable in the case of the enforcement or legal action trigger. Moreover, a consideration of downward adjustment and forfeiture of awards should not be required when the employee did not intend or was not aware of the events that led to the triggering event. Otherwise, the triggering event may result in downward adjustment or forfeiture on account of actions that were only discovered to be inappropriate in hindsight. Adding an element of intent would still deter from intentional excessive risk-taking or deviation from risk parameters, but would remove the requirement that an employee accurately predict the potential risk of all actions to avoid downward adjustment or forfeiture. Therefore, we believe adding an element of intent to the triggering events both adequately protect the financial stability of a Covered Institution and sets a realistic expectation for employees to minimize risk.

Similarly, only awards of SEOs and SRTs with a clear nexus to the event or action that led to such enforcement or legal action should be subject to review. The requirement to consider downward adjustment or forfeiture based solely on a SEO's or SRT's responsibility, role, or position is overly expansive. Employees with no knowledge of or connection to the underlying actions or events should not be subject to a potential penalty. Otherwise, it is unclear where the "responsibility" would end. For example, if a lower level loan officer's award is subject to forfeiture because of his actions, his supervisor may be subject to review based on his role or responsibility as well as his supervisor's supervisor and on up the chain. This may effectively result in every high level SEO or SRT being subject to review for every single triggering event based on their position rather than any clear nexus to the underlying event or action. This does not provide a sufficient connection to hold the individual responsible and is unnecessary and overly burdensome.

The timing of the trigger is also overly broad and excessive. The requirement to consider downward adjustment and forfeiture as soon as an action is brought, rather than upon a final adverse decision, could lead to unnecessary and unfair downward adjustment and forfeiture reviews. Although an enforcement or legal action may be initiated, a Covered Institution or individual may still be cleared of any wrongdoing. It is most prudent for a Covered Institution to wait until the applicable agency/regulator has determined whether wrongdoing actually existed before enforcing a penalty. Otherwise, an agency may clear an individual or organization of any wrongdoing after a Covered Institution has already required an employee to forfeit his award. Attempting to reverse the Covered Institutions decision on account of the agency's or regulator's ultimate determination would be unnecessarily complex and lead to even greater uncertainty.

Therefore, the downward adjustment and forfeiture review should not be required until a final determination or resolution has been made by the applicable agency or regulator.

Lastly, the Agencies should clarify the Proposed Rules to specifically provide that when a review is required on account of any triggering event, it is acceptable for a Covered Institution to perform the review and find that no amount should be adjusted downward or forfeited. Not all triggering events are caused by the actions of an employee, especially considering there is a catch-all triggering event that includes "other aspects of conduct or poor performance as defined by the covered institution."[49] If Covered Institutions are required to implement some sort of reduction if any triggering event occurs, they will be effectively discouraging Covered Institutions from identifying triggering events beyond those specifically enumerated. In addition, they will be effectively discouraging individuals from reporting triggering events. A Covered Institutions relies on its employees to identify and report these triggering events so that it can prevent them from occurring again. If the expectation were that a downward adjustment or forfeiture will occur every time there is a triggering event, then employees would simply stop identifying such events for fear of the impact. The final rules should address this ambiguity by clarifying that it is permissible for a review to result in a finding that no amount should be adjusted downward or forfeited.

B. Fully discretionary plans should be excluded from the downward adjustment requirements because the terms of these plans already allow an award to be reduced to zero.

The Proposed Rules require that a Level 1 or Level 2 Covered Institution place *all* of a SEO's or SRT's incentive-based compensation amounts not yet awarded at risk of downward adjustment. This requirement does not account for the use of fully discretionary plans with no set targets. Fully discretionary plans, by their nature, are already subject to a form of "downward adjustment" because the employer is not bound by any hardwired or rigid performance goals or thresholds. Therefore, it is unnecessary to subject these plans to the downward adjustment requirements of the Proposed Rules. We recommend that the rules be clarified to provide that the downward adjustment requirements are not applicable to fully discretionary plans with no set targets.

C. The Proposed Rules should not require downward adjustment and forfeiture reviews be conducted more than once each year to avoid creating undue burdens with respect to plans that have more than one performance period per year.

The current review requirements would pose excessive burdens on monthly and quarterly plans if a review were required for each performance period. Conducting the review annually allows for proximity to the date of the triggering event to coordinate fact-gathering and appropriately implement adjustments prior to vesting dates, but also allows the Covered Institutions to give focus on their day to day business operations rather than be burdened with reviews throughout the year.

[49] Section 236.7(b)(2)(v), 81 Fed. Reg. at 37,811.

VII. The Clawback Requirements are Excessive, Potentially Unenforceable, and Need Limitations if they are to be Workable in Practice.

A. The clawback period is excessive and should begin at the start of the performance period, or at a minimum, as of the award date, not the award's vesting date.

The Proposed Rules require a Level 1 or Level 2 Covered Institution to include clawback provisions in incentive-based compensation arrangements for SEOs and SRTs that, at a minimum, allow the Covered Institution to recover incentive-based compensation from a current or former SEO or SRT for seven years following the date on which such compensation vests if it determines that the SEO or SRT engaged in certain bad acts.[50] This seven-year minimum clawback period is excessive and should be reduced. As noted earlier, the downward adjustment, forfeiture, and clawback periods combine to subject award compensation under long-term incentive plans to a risk of forfeiture for a total of 11 years or more. An 11-year period of risk is excessive, especially given the variance in positions that are covered as SEOs and SRTs (i.e., as acknowledged by the Agencies, this group could range from the CEO of a Covered Institution to a Vice President[51] (generally a member of middle management within financial institutions)). A seven-year clawback could also result in compensation earned in one performance period being subject to clawback based on actions in a subsequent performance period. If qualified incentive compensation is earned and awarded under a plan with a performance ending December 31, 2009, it could potentially be subject to clawback because of a triggering event that occurs in December of 2020 because of the additional four-year minimum deferral requirements and the seven-year clawback period. This is overly burdensome to both the employer and the employee for financial planning purposes and is unnecessary.

In addition, these clawback periods would be longer than many state statutes of limitation for breach of contract which usually vary between three and six years.[52] We recommend requiring clawback for five years and giving Covered Institutions flexibility to determine if certain awards should be subject to longer periods because of the position of the SEO or SRT or the level of risk their activities pose to the entity. In addition, the clawback period should begin at the start of the performance period, or at a minimum on the date the incentive-based compensation is first "awarded" (as defined by the Proposed Rules).

B. The clawback period should end in the event of death, disability, or a change-in-control.

Under the Proposed Rules, there are no limitations on or reductions of the clawback period on account of an individual's death or disability or upon the occurrence of a change-in-control. To subject a person's estate to clawback does not effectively deter the individual from risk-taking and would likely have far-reaching effects on the administration of estates as it would require holding estates open for up to seven years following an individual's death. In addition, to end the clawback period in the case of disability would not serve to encourage dangerous risk-

[50] *See* Section 236.7(c), 81 Fed. Reg. at 37,811.
[51] *See* 81 Fed. Reg. at 37,695.
[52] *See* Westlaw 50 State Statutory Surveys, Civil Statutes of Limitation, 0020 Surveys 1 (West 2007).

taking behavior because an individual cannot predict his or her disability, while subjecting a person to a potential seven-year clawback period in the case of disability would create unnecessary uncertainty with an individual's financial planning in a time of unpredictable strife. Lastly, as described in Section V.E. above, a change-in-control will often significantly alter the equity structure of an entity and its compensation practices. If the clawback period continues after a change-in-control, it will cause great uncertainty regarding how an award will be administered in the future. To avoid these unintended negative consequences, the Proposed Rules should allow a Covered Institution to close the clawback period in the event of an individual's death, disability or a change-in-control.

C. The Agencies should confirm that a Covered Institution is not required to implement any clawback efforts that it reasonably expects would lead to a violation of state, local, or non-U.S. law.

The Proposed Rules also fail to address the potential conflict the clawback requirements may create with state, local, or non-U.S. laws. State labor laws are often a significant obstacle to implementing compensation clawbacks.

> For example, Section 200 of the California Labor Code defines wages broadly as "all amounts for labor performed by employees of every description, whether the amount is fixed or ascertained by the standard of time, task, piece, commission basis, or other method of calculation." Section 221 of the California Labor Code then makes is unlawful for "any employer to collect or receive from an employee any part of wages theretofore paid by said employer to said employee." While some courts have recognized that the term "wages" does not include stock options or unvested shares of restricted stock, the Proposed Rules' clawback requirements would cover a very broad array of incentive-based compensation including vested equity and cash payments, which could be considered "wages" to which clawback prohibitions apply. In addition, the laws and regulations applicable to clawbacks in non-U.S. jurisdictions may cause inherent conflicts. In Germany and France, for example, a clawback may be completely prohibited (see Section II.D. above). Rectifying the potential for conflict between the clawback requirements in the Proposed Rules and the labor laws of states such as California or other countries such as France and Germany would be inherently complex and problematic.

The Agencies should provide an exemption from the clawback requirements in the event that such actions conflict with state, local, or non-U.S. laws. Otherwise, Covered Institutions may find themselves faced with the dilemma of either failing to satisfy their obligations under the Proposed Rules or risk violating state, local, or non-U.S. laws.

VIII. Certain Additional Enhanced Restrictions on Incentive-Based Compensation Arrangements are Excessive, Unnecessary, Arbitrary and Anti-Competitive.

A. The prohibition on the use of exclusively volume-driven arrangements or relative financial performance metrics is unnecessary in light of the other restrictions.

The Proposed Rules provide that Level 1 and Level 2 Covered Institutions may not sponsor incentive-based compensation programs with respect to any Covered Persons, not just SEOs or SRTs, that provide for payment based solely volume-driven metrics or on industry peer performance comparison.[53] For example, an annual or long-term incentive compensation award based on an employee's checking account referrals or a Level 1 or Level 2 Covered Institution's total shareholder return or "TSR" compared to its peer group would be prohibited with respect to all Covered Persons.

We appreciate the Agencies' concern that incentive-based compensation programs based purely on volume-driven metrics or relative performance metrics may reward individuals based on actions that may create risk or even when absolute performance suffers; however, we believe that these prohibitions are unnecessary and excessive in light of the other enhanced restrictions contemplated by the Proposed Rules. For example, the Proposed Rules already provide that no incentive-based compensation arrangement may be based purely on financial performance measures, but rather that non-financial performance measures must also be a component of any incentive-based compensation program and that these non-financial measures must reflect losses, inappropriate risks taken, compliance issues, or other financial or non-financial performance measures.[54] Moreover, these non-financial measures must be able to override financial metrics, where appropriate.[55] Thus, the required inclusion of non-financial performance measures already provides a safeguard against volume-driven incentive-based compensation programs or those based on relative performance measures.

In addition, the downward adjustment, deferral, forfeiture and clawback periods contemplated by the Proposed Rules also protect against Level 1 or Level 2 Covered Institutions providing for incentive-based compensation payments to SEOs and SRTs even if absolute performance is weak. For example, downward adjustment and/or forfeiture may occur based on the following:

(1) poor financial performance due to deviation from risk guidelines;
(2) inappropriate risk taking;
(3) material risk management or control failures;
(4) statutory, regulatory or supervisory non-compliance that results in legal action or financial restatements; or
(5) other poor performance or misconduct triggers, as may be specified by a Covered Institution.[56]

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[53] *See* Section 236.8(c)-(d), 81 Fed. Reg. at 37,812.
[54] *See* Section 236.4(d), 81 Fed. Reg. at 37,809.
[55] *Id.*
[56] Section 236.7(b)(2), 81 Fed. Reg. at 37,811.

These provisions are intended to protect against excessive risk-taking or other poor performance with respect to incentive-based compensation arrangements. Thus, a prescriptive requirement that prevents a Covered Institution from utilizing a volume-driven formula or relative financial performance metric seems excessive and unnecessary.

B. The rigid leverage maximums are arbitrary and anti-competitive.

The Proposed Rules limit the maximum amount of incentive-based compensation that may be paid to SEOs to 125 percent of the target amount and the maximum amount of incentive-based compensation that may be paid to SRTs to 150 percent of the target amount.[57] These limitations are arbitrary and excessive. The Proposed Rules already address inappropriate risk-taking through substantial restrictions on incentive-based compensation design, including minimum deferral amounts and timing, downward adjustment and forfeiture reviews, and broadly drafted clawback provisions. To pile on these additional leverage maximums will only serve to increase the competitive advantage of competing institutions that are not subject to the Proposed Rules or are not Level 1 or Level 2 Covered Institutions without causing any significant, additional decrease in inappropriate risk-taking.

If leverage maximums are retained, they should at a minimum be increased to allow Covered Institutions to take into account a specific individual's position and responsibilities and set compensation at an appropriate level. As noted above, the definition of SRT and SEO encompasses a wide array of employees with varying levels of compensation and varying abilities to expose the Covered Institution to risk. Setting a maximum of 125 to 150 percent does not give Covered Institutions enough flexibility to design each individual's compensation package to address his specific role. Therefore, we recommend the Agencies increase the minimum to 200 percent for all SEOs and SRTs. In the event the Agencies do not wish to increase the leverage maximums for SEOs and SRTs, we recommend the maximums for both SEOs and SRTs be set at a uniform 150 percent, as we do not see any meaningful distinction between these two groups of Covered Persons and utilizing a uniform leverage maximum would reduce the chance of inadvertent noncompliance.

[57] *See* Section 236.8(b), 81 Fed. Reg. at 37,812.

IX. The Governance and Recordkeeping Requirements Are Overly Broad and Excessive.

A. Consistent with the other Agencies, the SEC should allow a parent Covered Institution to perform any function required on behalf of a subsidiary Covered Institution.

The Proposed Rules set forth by all Agencies, except the SEC, generally provide for a consolidation principle with respect to Covered Institutions that have subsidiaries that are also Covered Institutions. Specifically, the consolidation principle states:

> A covered institution that is a subsidiary of another covered institution may meet any requirement of this part if the parent covered institution complies with that requirement in such a way that causes the relevant portion of the incentive-based compensation program of the subsidiary covered institution to comply with that requirement.[58]

The SEC's version of the Proposed Rules, however, does not include this consolidation provision. As a result, it is unclear whether a covered broker-dealer or investment adviser that is a subsidiary of another Covered Institution must implement separate compliance functions at the subsidiary level.

The preamble suggests that this discrepancy is due to the fact that the Agencies believe

> the operations, services and products of broker-dealers and investments advisers are not typically effected through subsidiaries and it is expected that their incentive-based compensation arrangements are typically derived from the activities of the broker-dealers and investment advisers themselves. Because of this any inappropriate risks for which the incentive-based compensation programs at these firms should be localized and the management of these risks should similarly reside at the broker-dealer or investment adviser.[59]

However, the preamble also contains language that appears to support the view that broker-dealer and/or investment adviser subsidiaries would be consolidated with a parent Covered Institution. Specifically, the preamble states that

> broker-dealers and investment advisers that are subsidiaries of depository institution holding companies would be consolidated on the basis of such depository institution holding companies generally, where there is often a greater integration of products and operations, public interest, and assessment of management and risk (including those related to incentive-based compensation) across the depository institution holding companies and their subsidiaries.[60]

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[58] Section 236.3(c), 81 Fed. Reg. at 37,809.
[59] 81 Fed. Reg. at 37,686.
[60] *Id.*

We recommend the SEC clarify that the Proposed Rules would allow a parent Covered Institution to satisfy the requirements with respect to all subsidiary Covered Institutions, including subsidiaries that are broker-dealers or investment advisers. In our experience, the compensation committee at large and diversified financial institutions frequently sets the framework for developing incentive-based compensation arrangements for all entities within the consolidated organization. In setting this framework, the compensation committee often creates the compensation pools, approves the long-term incentive plans, and ultimately approves all material incentive-based compensation grants. While some of the specific details of incentive-based compensation programs, such as setting specific performance targets and determining payment schedules, may be addressed at the subsidiary level, the ultimate responsibility for determining the framework of an institution's incentive-based compensation programs, overseeing the operations of these programs, and managing the associated risk, falls on the enterprise's parent-level compensation committee and board of directors. Likewise, the determination of enterprise-wide strategic plans and management of enterprise risk is accomplished by the parent entity, rather than at a subsidiary level. For example, enterprise risk management is inherently better managed and monitored at the parent level, as opposed to being the purview of multiple subsidiaries. Similarly, parent-level oversight of incentive-based compensation arrangements would produce the most effective means to ensure compliance and appropriately manage any associated risk-taking.

It is customary that the responsibility for major lines of business resides at the parent company level. The ultimate responsibility for products, operations, and assessment of management and risk is customarily done at the top. Thus, a consolidated approach to overseeing a covered institution and all of its subsidiaries that allows a parent Covered Institution to satisfy the proposed requirements with respect to all subsidiary Covered Institutions, including subsidiaries that are broker-dealers or investment advisers, will not result in only one regulator overseeing the entity. Rather there are multiple regulators responsible for various lines of business at the parent level.

In addition, key corporate governance functions, such as maintaining an independent compensation committee responsible for setting and approving incentive-based compensation programs, are located at the parent company level. If the Proposed Rules were to require separate corporate governance functions be created at each subsidiary Covered Institution conducting broker-dealer and/or investment adviser services, many diversified financial institutions would be required to form multiple independent compensation committees throughout the consolidated organization. This would create an unnecessary additional level of complexity that would lead to inefficiencies. Furthermore, there is the increased potential for inadvertent violations of the Proposed Rules' compensation setting, reporting, and recordkeeping requirements.

For example, a large and diversified financial institution could be required to create five or more separate compensation committees, each of which may not be aware of the other committees' actions. These five committees would then each have to receive two reports each year (for a total of ten or more reports) regarding compliance with the Proposed Rules and maintain separate records with respect to each entity's incentive-based compensation programs.

The duplication of these responsibilities, as illustrated in the example above, increases the chance of inadvertent non-compliance with the Proposed Rules and is inherently inefficient as compared to charging a single entity within a consolidated organization with compliance responsibilities. In addition, it would lead to a greater burden on the Agencies by creating multiple bodies and recordkeeping systems the Agencies would need to review for compliance. Charging a single body within a consolidated organization with governance and recordkeeping responsibilities would streamline regulatory oversight for the Agencies by creating a single point of contact at each organization.

In light of these considerations, we recommend the Agencies—and the SEC specifically—clarify that the Proposed Rules would allow a parent Covered Institution to satisfy the requirements with respect to all subsidiary Covered Institutions, including subsidiaries that are broker-dealers or investment advisers.

B. The enhanced recordkeeping requirements should be limited to: (1) incentive-based compensation arrangements in which SEOs and SRTs actually participate or (2) in the case of Covered Institutions not subject to the enhanced restrictions, the incentive-based compensation arrangements in which the top ten percent of Covered Persons participate.

A large and diversified Covered Institution potentially sponsors thousands of compensation programs that would be considered "incentive-based compensation" under the Proposed Rules. The vast majority of these programs are likely focused on lower-level employees who have no ability to influence risk-taking (e.g., small bonuses for bank tellers based on the number of checking account referrals they make during a period). Given the scope of such an entity's operations, the obligation to identify and maintain records with respect to these non-SEO and non-SRT programs would be extremely challenging. Moreover, maintaining information regarding these relatively insignificant arrangements would likely provide little value for regulators and could impede their ability to effectively identify and review incentive-based compensation programs that may actually induce risk-taking.

The recordkeeping requirements should therefore be limited to apply only to incentive-based compensation arrangements for SEOs and SRTs at Level 1 and Level 2 Covered Institutions and the top ten percent of covered employees at Level 3 Covered Institutions. In addition, they should also only apply to downward adjustment, deferral, forfeiture, and clawback requirement reviews that include SEOs or SRTs. To apply the extensive recordkeeping requirements under the Proposed Rules to all Covered Persons will create an excessive and unjustifiable burden on Covered Institutions.

As drafted, the Proposed Rules' recordkeeping requirements would apply to all incentive-based compensation arrangements in which any covered employee participates.[61] This overly broad requirement would technically require a Covered Institution to maintain records for seven years regarding spot-bonus programs incentivizing bank tellers who encourage customers to open savings accounts. Clearly, such a program does not promote excessive risk-taking that could ever result in material financial losses for a Covered Institutions or jeopardize such entity's financial stability. According to the Proposed Rules, SEOs and SRTs are individuals that pose greater potential risk to the financial health of a Covered Institutions, so the recordkeeping requirements should focus on these individuals and their incentive-based compensation arrangements.

Alternatively, the Agencies should consider permitting Covered Institutions to provide aggregated reports or maintain consolidated records with respect to incentive-based compensation arrangements in which SEOs and SRTs (and for Level 3 Covered Institutions lower-level employees) participate. Such approach would be consistent with the statutory language in Section 956(a) of the Dodd-Frank Act, but would provide a more workable framework for both Covered Institutions and the Agencies.

C. As proposed, the six-part analysis required to determine whether each Covered Person within an organization has received excessive compensation would create massive procedural and recordkeeping efforts with little value and thus should be narrowed.

The Agencies propose that Covered Institutions engage in a six-factor analysis of each incentive-based compensation arrangement with respect to each covered employee to make the determination that such arrangement does not provide excessive compensation.[62] We believe that this requirement is overly broad and should be narrowed to enable Covered Institutions to have a meaningful chance at compliance.

First, Level 1 and Level 2 Covered Institutions will have a large number of individuals who qualify as Covered Persons under the Proposed Rules. For example, it would not be uncommon for a large and diversified Level 1 Covered Institution that has a large retail presence to have over 100,000 employees who are considered Covered Persons.

Given the sheer number of Covered Persons, it seems overly burdensome to require Level 1 and Level 2 Covered Institutions to perform the six-part analysis of each incentive-based compensation program with respect to each Covered Person. To better enable these Covered Institutions to engage in a thorough and meaningful analysis, as is required by the Proposed Rules, we recommend the Agencies limit the excess compensation analysis to SEOs and SRTs of Level 1 and Level 2 Covered Institutions.

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[61] *See* Section 236.11, 81 Fed. Reg. at 37,812.
[62] *See* Section 236.4(b), 81 Fed. Reg. at 37,809.

Likewise, we recommend the Agencies consider limiting such review to the top ten percent of all Covered Persons for Level 3 Covered Institutions. In our experience many regional and larger community-based financial institutions will qualify as Level 3 Covered Institutions and these organizations typically have significant retail operations and thus could expect to have relatively large numbers of Covered Persons.

Further, we believe that the compensation, fees, and benefits reviewed with respect to each Covered Person should be clarified to exclude amounts that are of no cost to an employer and should exclude amounts contributed to broad-based retirement plans (such as retirement plans qualified under Section 401(a) of the Code) and broad-based health and welfare arrangements. Appreciation in a 401(k) plan, for example, does not need to be included for this reason. Thus, the Proposed Rules should be clarified to specifically exclude appreciation of deferred amounts under a tax-qualified retirement plan or a non-qualified deferred compensation plan. Likewise, broad-based retirement plan and health and welfare benefits do not discriminate in favor of highly-compensated individuals and should be excluded from the analysis to streamline the data inputs a Covered Institution must collect and consider when conducting its review.

X. The Agencies Should Provide Clarifications Regarding Interaction of the Proposed Rules with Accounting and Tax Requirements.

A. The Agencies should clarify they do not intend for the Proposed Rules to cause awards currently considered stock awards subject to fixed accounting treatment to be re-classified as liability awards subject to variable accounting treatment.

In general, the exchange of services for equity creates an accounting expense that must be recognized on a company's income statement. FASB ASC Topic 718 currently governs the expensing of all stock-based compensation. In general, the accounting rules differentiate between "fair value awards" and "liability awards."[63] While there is a significant amount of analysis that goes into determining which category an award falls into, the results are highly important to companies. At a basic level, fair value awards are subject to fixed accounting treatment, which means they are valued as of the date of grant and expensed over time.[64] Conversely liability awards are subject to variable accounting treatment, which means a liability is booked with the fair value adjusted each quarter based on current conditions.[65] Many companies carefully design their compensation programs to avoid variable accounting treatment and the potential for significant increases in accounting charges due to the "mark to market" variable accounting rules.

The downward adjustment and forfeiture provisions of the Proposed Rules could cause the covered awards to be subject to a change in value for an extended period of time. Under current accounting principles, this potential change in value may result in the classification of these awards as liability awards, subject to variable accounting requirements. It would be extremely unfortunate and potentially very harmful to Covered Institutions if the Proposed Rules

[63] FASB ASC Topic 718.
[64] *Id.*
[65] *Id.*

caused incentive-based compensation programs that were once subject to fixed accounting to lose such status. Therefore we recommend that the Agencies clarify that the downward adjustment, deferral, forfeiture and clawback requirements applicable to incentive-based compensation arrangements are not intended to alter the classification of awards that would have otherwise been subject to fixed accounting treatment.

B. The Agencies should clarify and confirm that current Code Section 162(m) incentive compensation plan designs that enable tax deductibility of incentive-based compensation remain acceptable under the Proposed Rules.

Many publicly-traded employers, including Covered Institutions, have adopted incentive-based compensation programs that are designed to qualify for the "performance-based compensation" exception to the $1 million compensation expense deduction limitation under Code Section 162(m). These 162(m) plans generally take the form of providing for a large hypothetical incentive-based compensation payment for a Covered Person (typically the CEO, and three highest executive officers, excluding the CFO) that is then reduced by the compensation committee of the Covered Institution via the exercise of negative discretion.

Often the reduced amount is determined via a structure known as a "plan within a plan" in which an incentive-based compensation arrangement fits inside the larger 162(m) plan potential payment. Thus, the inside plan determines a Covered Person's actual incentive-based compensation and the 162(m) plan ensures all amounts are tax deductible.

In many cases the structure of the 162(m) plan provides that the larger hypothetical payment is based on a single financial performance metric (e.g., a percentage of revenue or net income) and the hypothetical amount payable could be viewed as exceeding the limitations on maximum percentage payments relative to target. For example, a CEO's inside plan target award might equal 100 percent of her base salary; however, the 162(m) plan could provide for a maximum payment of 500 percent of her base salary. Despite these limitations, such amount would be reduced via the compensation committee's exercise of negative discretion.

In order to avoid forcing publicly-traded Covered Institutions to amend and redesign their 162(m) plans and risk losing important compensation expense deductions, we recommend the Agencies provide an exception to the maximum payment percentage and prohibitions on single performance measure rules for these arrangements, as long as the inside plan satisfies the applicable requirements.

For example, a 162(m) plan that provides for a large hypothetical payment for a Covered Person based on a percentage of a Covered Institution's annual revenue would be deemed to have complied with Proposed Rules if the "plan within the plan" or "inside plan" provides for payment based on financial and non-financial measures and contains the leverage or payment maximums. We believe that such an exception would continue to serve the Agencies' interests in regulating incentive-based compensation arrangements while not disturbing long-established programs designed to maximize the tax deductibility of incentive compensation payments made to Covered Persons.

C. The Agencies should confirm that compensation continues to be subject to a "substantial risk of forfeiture" for purposes of Code Sections 83 and 409A during the Proposed Rules' deferral period.

The Agencies should confirm they believe that compensation awarded continues to be subject to a "substantial risk of forfeiture" during the deferral periods contemplated by the Proposed Rules. While Code Section 83 governs the transfer of property and Code Section 409A governs nonqualified deferred compensation plans, both provisions address the concept of property or rights to deferred compensation being subject to a "substantial risk of forfeiture."

In general, Code Section 83 provides that a transfer of property subject to restrictions (e.g., a restricted stock award) is subject to tax upon the lapse of restrictions constituting a substantial risk of forfeiture, or if earlier, the time at which the recipient may transfer the property.[66] It generally provides that a substantial risk of forfeiture exists where the recipient's right to the property is conditioned upon the future performance of substantial services or upon the occurrence of a condition related to the purpose of the transfer (generally, a performance-based vesting condition).[67] The concept of a substantial risk of forfeiture is also important under Code Section 409A as the lapse of such risk relative to the timing a payment is received is critical to determining whether a compensation arrangement is subject to those rules or is exempt as a "short-term deferral" of compensation.[68]

For purposes of Code Section 409A, a substantial risk of forfeiture exists so long as the receipt of deferred compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.[69] A condition must relate to the services provided or to the company's business activities or organizational goals.[70] In each case, the concept of what constitutes a substantial risk of forfeiture has been described in the application regulations to Code Section 83 and 409A and there is a significant body of guidance in the form of Private Letter Rulings under Code Section 83 concerning this concept.

Confirmation the requirements constitute a substantial risk of forfeiture is particularly important, in light of the fact that none of the Agencies (except the NCUA) has proposed to allow for accelerations to satisfy tax obligations. In addition, it is critical for employers to have definitive guidance as to when tax obligation arises in order to comply with their payroll tax withholding and reporting obligations. For example, if an employer is unsure when performance-based restricted stock is no longer subject to a substantial risk of forfeiture, it may not know whether to withhold, remit, and report taxes at the end of the performance period or as the shares vest during the deferral period.

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[66] *See* 26 U.S.C. § 83.
[67] *See* 26 C.F.R. § 1.83-3(c).
[68] *See* 26 C.F.R. § 1.409A-1(b)(4).
[69] *See* 26 C.F.R. § 1.409A-1(d).
[70] *Id.*

Likewise, an employer who has granted performance-based restricted stock units ("RSUs") would need to know whether the substantial risk of forfeiture has lapsed at the end of the performance period or as the deferred RSUs vest for purposes of applying the payroll tax timing requirements. Moreover, the timing of the lapse of the substantial risk of forfeiture could also have implications as to whether the Code Section 409A "specified employee" delay rules would be applicable to the RSUs in the event a Covered Person received payment for such RSUs upon his or her termination of employment.

In light of the expansive and broad categories of events that could trigger forfeiture, we recommend the Agencies confirm that amounts deferred are subject to a substantial risk of forfeiture for purposes of Code Section 83 and Code Section 409A until such amounts "vest" (as defined in the Proposed Rules).

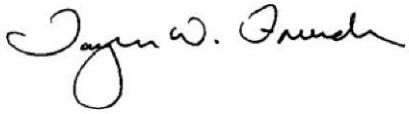
Due to the significant affect the concept of a substantial risk of forfeiture may have on the tax and deferred compensation aspects of many incentive-based compensation arrangements, we believe the Agencies should provide definitive guidance that the enumerated list of events that may trigger a forfeiture of deferred amounts should be considered to constitute a substantial risk of forfeiture for purposes of Section 83 and Section 409A of the Code.

Closing

We would like to thank you for the opportunity to provide you with our comments. We continue to believe that the Agencies should take a more principles-based approach to these rules to provide a level-playing field that does not disadvantage an institution solely based on its size. We urge you to re-propose these rules using such an approach. We remain concerned that the Proposed Rules are overly broad and excessive, and that the prescriptive manner in which they are written fossilizes current compensation practices and inhibits potential evolution and innovation. The Agencies should refine the definitions of Covered Person, SEO, SRT, and incentive-based compensation such that they are more clearly connected to an individual's actual role and risk-taking responsibility. As shown in the examples above, the Proposed Rules, as drafted, would unnecessarily restrict the compensation practices of employees who pose little to no risk to an institution, such as financial advisors, IT personnel, and administrative employees.

We believe that Section 956 of the Dodd-Frank Act was intended to better align incentive-based compensation program design with the risk tolerances of a financial institution. The Proposed Rules, however, provide no evidence of a nexus between the restrictions being imposed on Covered Institutions and Covered Persons and the risk-taking activities of a Covered Institution or Covered Person. Without such nexus, the Proposed Rules are anti-competitive. We believe that a risk-based and role/activity based structure to identify Covered Institutions and Covered Persons is more appropriate.

We welcome the opportunity to further discuss the concerns and recommendations set forth in this letter and hope that we can be a resource to the Agencies as you review and consider all of the comments. If you have any questions, please do not hesitate to contact Taylor Wedge French at (704) 373-8037 or Rosemary Becchi at (202) 359-4270.



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A. The fixed minimum deferral amount is arbitrary and does not allow for needed flexibility to address risk-related behavior....27

B. The requirement to use the present value of incentive-based compensation at the time of the award to determine the deferral amount significantly overcomplicates deferrals with little to no benefit and should be removed....29

C. The minimum deferral period requirements should be less prescriptive to allow compensation practices to align with retention and risk management needs....30

D. The requirements relating to the composition of deferred amounts are arbitrary and will unnecessarily limit the ability of Covered Institutions to develop innovative compensation practices....32

E. The list of permissible acceleration events for deferred amounts should include the payment of income taxes, a change-in-control, retirement, unexpected financial hardship, and involuntary termination of employment....34

VI. The Downward Adjustment and Forfeiture Requirements are Overly Burdensome and Anti-Competitive.....37

A. The enforcement or legal action trigger for downward adjustment and forfeiture is over-inclusive and does not have any nexus to risk-related activities....37

B. Fully discretionary plans should be excluded from the downward adjustment requirements because the terms of these plans already allow an award to be reduced to zero....39

C. The Proposed Rules should not require downward adjustment and forfeiture reviews be conducted more than once each year to avoid creating undue burdens with respect to plans that have more than one performance period per year....39

VII. The Clawback Requirements are Excessive, Potentially Unenforceable, and Need Limitations if they are to be Workable in Practice.....40

A. The clawback period is excessive and should begin at the start of the performance period, or at a minimum, as of the award date, not at the award's vesting date....40

B. The clawback period should end in the event of death, disability, or a change-in-control....40

C. The Agencies should confirm that a Covered Institution is not required to implement any clawback efforts that it reasonably expects would lead to a violation of state, local, or non-US law....41

VIII. Certain Additional Enhanced Restrictions on Incentive-Based Compensation Arrangements are Excessive, Unnecessary, Arbitrary, and Anti-Competitive.....42

A. The prohibition on the use of exclusively volume-driven arrangements or relative financial performance metrics is unnecessary in light of the other restrictions....42

B. The rigid leverage maximums are arbitrary and anti-competitive....43

IX. The Governance and Recordkeeping Requirements Are Overly Broad and Excessive. 44

A. Consistent with the other Agencies, the SEC should allow a parent Covered Institution to perform any function required on behalf of a subsidiary Covered Institution. 44

B. The enhanced recordkeeping requirements should be limited to: (1) incentive-based compensation arrangements in which SEOs and SRTs actually participate or (2) in the case of Covered Institutions not subject to the enhanced restrictions, the incentive-based compensation arrangements in which the top ten percent of Covered Persons participate. 46

C. As proposed, the six-part analysis required to determine whether each Covered Person within an organization has received excessive compensation would create massive procedural and recordkeeping efforts with little value and thus should be narrowed. 47

X. The Agencies Should Provide Clarifications Regarding Interaction of the Proposed Rules with Accounting and Tax Requirements. 48

A. The Agencies should clarify they do not intend for the Proposed Rules to cause awards currently considered stock awards subject to fixed accounting treatment to be re-classified as liability awards subject to variable accounting treatment. 48

B. The Agencies should clarify and confirm that current Code Section 162(m) incentive compensation plan designs that enable tax deductibility of incentive-based compensation remain acceptable under the Proposed Rules. 49

C. The Agencies should confirm that compensation continues to be subject to a "substantial risk of forfeiture" for purposes of Code Sections 83 and 409A during the Proposed Rules' deferral period. 50

Closing 52