July 15, 2016

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In re: OCC Docket ID OCC-2011-0001, Incentive-Based Compensation Arrangements

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In re: Docket No. 1536 and RIN No. 7100 AE-50, Incentive-Based Compensation Arrangements

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In re: RIN 3064-AD86, Incentive-Based Compensation Arrangements

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In re: Comments/RIN 2590-AA42, Incentive-Based Compensation Arrangements

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In re: CII comments on Notice of proposed rulemaking for Incentive-Based Compensation Arrangements

Brent J. Fields
Secretary
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In re: File Number S7-07-16, Incentive-Based Compensation Arrangements

Dear Messrs. Tierney, Frierson, Feldman, Pollard, Poliquin and Fields:

The Council of Institutional Investors ("CII" or "Council") is a non-profit, non-partisan association of pension funds, other employee benefit funds, endowments and foundations with more than $3 trillion in investments. Our voting members include corporate, public and union defined benefit plans responsible for ensuring a secure retirement for millions of American workers. Additionally, the Council's associate (non-voting) members include asset management firms with more than $20 trillion under management.

We appreciate the opportunity to comment on the proposed rule[1] jointly developed by five agencies—the Office of the Comptroller of the Currency ("OCC"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); Federal Housing Finance Agency ("FHFA"); National Credit Union Administration ("NCUA"); and the U.S. Securities and Exchange Commission ("SEC"); (collectively, "Agencies")—to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The proposed rule includes changes to a version introduced in 2011—changes made "to incorporate practices that financial institutions and foreign regulators have adopted to address the deficiencies in incentive-based compensation practices that helped contribute to the financial crisis that began in 2007."[2]

We believe the proposed rule represents a positive and meaningful response to some of the most important lessons learned from the 2008 financial crisis. The proposed rule preserves a role for incentive-based compensation at financial institutions—one that points toward greater emphasis on risk management and long-term outcomes, and by extension, greater stability for the overall market.

The proposed rule is largely consistent with CII's member-approved policies on executive compensation. CII policies support reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term, consistent with a company's investment horizon.

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[1] Incentive-Based Compensation Arrangements, 81 Fed. Reg. 112 (proposed June 10, 2016), available at https://www.gpo.gov/fdsys/pkg/FR-2016-06-10/pdf/2016-11788.pdf.
[2] Ibid. at p. 37679

With respect to how to carry out such a compensation program, CII believes that it is the job of the compensation committee to ensure compensation programs are reasonable with respect to critical factors including risk considerations.[3] Yet, as vividly illustrated by the 2008 financial crisis, compensation committees have not always succeeded in fulfilling this responsibility.

The Financial Crisis Inquiry Report stated that leading into the crisis, compensation systems had "too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the down-side limited. "[4] In the aftermath, former FDIC Chair Sheila Bair stated that "the crisis has shown that most financial institution compensation systems were not properly linked to risk management."[5] Former SEC Chair Mary Shapiro pointed out that "many major financial institutions created asymmetric compensation packages that paid employees enormous sums for short-term success, even if these same decisions result[ed] in significant long-term losses or failure for investors and taxpayers."[6]

Moreover, the Investors' Working Group, a blue-ribbon panel of industry and market experts, jointly sponsored by CII and the CFA Institute, stated in its final report that "[p]oorly structured pay plans that rewarded short-term but unsustainable performance encouraged CEOs to pursue risky strategies that hobbled one financial institution after another and tarnished the credibility of the U.S. financial markets."[7]

In light of both CII policies and the experience of the financial crisis, CII supports the proposed rule's over-arching requirements that incentive-based compensation arrangements at covered financial institutions 1) appropriately balance risk and reward, and 2) bar arrangements that could encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. We also support the proposed rule's recognition of the board's important role to oversee incentive-based compensation programs. We address particular aspects of the proposed rule below.

Definition of "significant risk taker"

The proposed rule applies to senior executive officers ("SEOs") at financial institutions holding at least $1 billion in average total consolidated assets ("assets") and significant risk takers ("SRTs") at financial institutions holding at least $50 billion in assets ("systemically important financial institutions").

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[3] CII Corporate Governance Policies, Section 5.1. "Long-term" is generally considered to be five or more years for mature companies and at least three years for other companies. All CII policies on corporate governance are available at http://www.cii.org/corp_gov_policies.

[4] See p. xix of the Financial Crisis Inquiry Commission's final report, http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

[5] FCIC Report, p 64.

[6] Ibid.

[7] See IWG report (2009), http://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf.

For potential SRTs at systemically important financial institutions, the proposed rule provides two paths to exemption from SRT status. A potential SRT would avoid automatic designation if:

- The individual's incentive-based compensation is less than one-third of his or her total compensation; or
- The individual meets both of the following tests:
    1) Total compensation below a sliding percentile among non-SEO employees at the institution; and
    2) Does not hold the authority to commit at least 0.5 percent of the capital of the covered institution.

CII is concerned that under the proposed definition, non-SEO employees placing billions of dollars at risk at systemically important financial institutions would avoid automatic SRT status. For example, traders in each of the following hypothetical scenarios could be exempted:

	Institution's assets	Basis for SRT status exemption under proposed rule
Trader A, authorized to commit $9.5 billion	$2.2 trillion	$9.5B constitutes <0.5% of institution's capital *and* Trader A's compensation falls below 95th percentile among non-SEO employees
Trader B, authorized to commit $11.4 billion	$1.7 trillion	<33.3% of Trader B's total compensation meets definition of incentive-based compensation
Trader C, authorized to commit $1.1 billion	$239 billion	$1.1B constitutes <0.5% of institution's capital *and* Trader C's compensation falls below 98th percentile among non-SEO employees

We believe the final rule would better serve investors and the safety and soundness of the capital markets if the SRT definition were revised to more broadly cover non-executive significant risk takers.

Appropriate balance of risk and reward

Under the proposed rule, incentive-based compensation will not be considered to balance appropriately risk and reward unless three conditions are met:

- Inclusion of financial and non-financial measures to measure performance
- Allowance of non-financial measures to override financial measures when appropriate
- Permission to make any amount awarded subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures

CII's member-approved policies support the use of multiple performance measures that align the recipient with both short- and long-term strategic goals.[8] CII policies envision the use of both qualitative and quantitative performance measures.[9] Although the three conditions above by no means assure a balance of risk and reward, we believe this guidance increases the likelihood of an appropriate balance.

Forfeiture, downward adjustment and clawback

The proposed rule would require systemically important financial institutions *to consider* forfeiture or downward adjustment of incentive-based compensation in the event of certain developments, but such forfeiture or downward adjustment is not mandated. The developments triggering the consideration requirement include: poor financial performance attributable to significant deviation from risk parameters stipulated in the institution's policies and procedures; inappropriate risk-taking (regardless of impact on financial performance); and material risk management or control failures.[10]

The proposed rule would further require systemically important financial institutions to adopt clawback mechanisms by which they could seek to recover incentive-based pay for seven years after such compensation has vested. Such policies would provide for *optional* recovery in the event of misconduct resulting in significant financial or reputational harm, fraud or intentional misrepresentation of information used to determine incentive-based pay.

CII supports mechanisms ensuring the recovery of erroneous incentive-based compensation and mechanisms to prevent erroneous awards from being paid in the first place. We expect companies to pursue recovery when clawback terms are triggered, except in very limited circumstances , such as when "costs of recovery could exceed or be disproportionate to the recoverable amounts."[11] The text of CII's related policy reads as follows.

> The compensation committee should ensure that sufficient and appropriate mechanisms and policies (for example, bonus banks and clawback policies) are in place to recover erroneous bonus and incentive awards paid in cash, stock or any other form of remuneration to current or former executive officers, and to prevent such awards from being paid out in the first instance. Awards can be erroneous due to acts or omissions resulting in fraud, financial results that require restatement or some other cause that the committee believes warrants withholding or recovering incentive pay. Incentive-based compensation should be subject to recovery for a period of time of at least three years

[8] CII Corporate Governance Policies, Section 5.5d
[9] CII Corporate Governance Policies, Section 5.5h
[10] Under the proposed rule, "forfeiture" is reduction of the amount of deferred incentive-based compensation awarded but unvested. "Downward adjustment" is reduction in incentive-based pay not yet awarded for performance periods which have already begun.
[11] See letter to SEC from Jeff Mahoney, General Counsel, Council of Institutional Investors (April 27, 2015),http://www.cii.org/files/issues_and_advocacy/correspondence/2015/08_27_15_letter_to_SEC_clawbacks.pdf, describing at p. 7 narrow circumstances in which CII supports limited exceptions to recovery.

following discovery of the fraud or cause forming the basis for the recovery. The mechanisms and policies should be publicly disclosed. [12]

We observe that the proposed rule does not identify any circumstance for which forfeiture, downward adjustment or clawback is *mandatory*. In light of failure of some compensation committees to seek appropriate clawbacks in the past and the importance of systemic risk posed by covered financial institutions, we encourage the Agencies to consider the feasibility of identifying in the final rule some circumstances when forfeiture, downward adjustment or clawback of incentive-based compensation is mandatory, while preserving discretion for less conclusive situations.

Additionally, while we do not view seven years after vesting as an unreasonable period to adopt, we note CII policies provide that all incentive-based compensation should remain subject to recovery for at least three years following discovery of the basis for recovery.[13]

Deferrals

For systemically important financial institutions, the proposed rule mandates deferral of 40 percent to 60 percent of incentive-based pay, with short-term incentive-based pay requiring longer deferral than long-term incentive-based pay, as indicated below.

Systemically important financial institution's assets	Short-term incentive-based pay deferral	Long-term incentive-based pay deferral
$50-250B	40% for three years for SRTs 50% for three years for SEOs	40% for one year for SRTs 50% for one year for SEOs
>$250B	50% for four years for SRTs 60% for four years for SEOs	50% for two years for SRTs 60% for two years for SEOs

Under the proposed rule all deferrals would vest on an equal, annual basis starting from the end of the performance period. Covered individuals subject to the most stringent deferral requirement (SEOs at institutions with assets of more than $250 billion) would see their incentive-based compensation become unrestricted according to the following schedule:

Milestone	Short-term incentive-pay vested (cumulative)	Long-term incentive-pay vested (cumulative)
Conclusion of performance period	40%	40%
1-year anniversary	55%	70%
2-year anniversary	70%	100%
3-year anniversary	85%	100%
4-year anniversary	100%	100%

[12] See CII policy 5.5d
[13] Ibid.

We would support revisions to further increase the percentages of annual incentive-based compensation subject to mandatory deferral.

Record keeping

The 2011 version of the proposed rule would have required covered institutions to deliver an annual report to their appropriate regulator. In lieu of such a report, the proposed rule creates a seven-year record-keeping requirement on key information to be made available at the regulator's request. CII does not oppose the proposed record-keeping approach, which requires preserving specific information about deferrals, forfeitures, downward adjustments, clawback reviews and changes to incentive-based pay design.

Certain prohibitions

Under the proposed rule, systemically important financial institutions:

- May not purchase hedging instruments to offset any decrease in a covered individual's incentive-based compensation
- May not distribute incentive-based compensation in excess of 125 percent of target awards for SEOs and 150 percent for SRTs
- May not rely solely on industry peer performance comparisons to determine incentive-based compensation
- May not provide incentive-based pay based solely on transaction or revenue volume without regard to transaction quality or the covered person's compliance with sound risk management

CII opposes hedging by executives and discourages companies from allowing other employees to hedge equity-based awards or other stock holdings.[14] In line with that position, CII supports the proposed rule's provision preventing covered institutions from hedging on employees' behalf to limit their risk associated with incentive-based compensation. However, we believe the rule could better serve investors and the fundamental objectives of incentive-based compensation if it also barred SEOs and SRTs from directly engaging in hedging activity to off-set risk connected with their incentive-based compensation.

With respect to the proposed rule's percentage limits on payouts for target awards, CII policies support committee-determined caps on annual incentive pay[15] and "appropriate" limits with respect to long-term awards.[16] We support the limits outlined in the proposal, as they would serve to flatten the risk/reward curve for SEOs and SRTs.

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[14] See CII policy 5.8d. To be clear, CII policies have no objection to companies using hedging strategies to limit downside risk in the ordinary course of business.

[15] See CII policy 5.7b

[16] See CII policy 5.5a

Benchmarking compensation to industry-wide practices has little value if industry-wide practices encourage excessive risk-taking or are otherwise not justified. CII policies explicitly provide that while benchmarking may be constructive in some cases, it "should not be relied on exclusively."[17] We support the proposed prohibition on solely relying on peer comparisons to determine incentive-based pay.

We support the proposed prohibition against basing incentive-based pay on transaction or revenue volume without regard to transaction quality or the covered person's compliance with sound risk management. The provision would deter, for example, mortgage originators from being rewarded solely for the volume of loans they approve. CII and many experts believe this type of incentive-based compensation contributed directly to the 2008 financial crisis.

Independent risk management and governance

Under the proposed rule, systemically important financial institutions would be required to:

- Adopt a risk management framework that is independent of any lines of business and includes an independent compliance program
- Provide individuals in key control functions with the authority to influence the risk-taking of their business areas[18]
- Ensure covered individuals in control functions are compensated in accordance with the achievement of performance objectives linked to their control functions and independently from the performance of the business areas they oversee
- Provide for independent monitoring of risk/reward balance, events related to forfeiture and downward adjustment, and compliance of incentive-based compensation with the covered institution's policies and procedures
- Have a compensation committee comprised solely of non-SEO directors, who would be required to obtain input from the risk and audit committees
- Direct management to provide the compensation committee with an annual assessment of the effectiveness of the incentive-based compensation program and related compliance and control processes
- Direct the compensation committee to obtain an independent assessment from the internal auditor or risk management function of the incentive-based compensation program and related compliance and control processes

CII generally supports the safeguards proposed above, which would reduce conflicts of interest and the likelihood of inappropriate risk-taking. Our policies' explicit support for fully independent compensation committees and robust board oversight of risk share these common objectives.[19]

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[17] See CII policy 5.5i

[18] Control functions under the proposed rule are: compliance, risk management, internal audit, legal, human resources, accounting, financial reporting and finance roles involving responsibility for identifying, measuring, monitoring or controlling risk taking.

[19] See CII policies 2.5, 2.7

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CII commends the Agencies for the work involved to implement Section 956 of the Dodd-Frank Act, and we appreciate the Agencies' consideration of the Council's views.

Sincerely,

Glenn Davis
Director of Research