Center On Executive Compensation

July 22, 2016

VIA Electronic Delivery

Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219
Docket ID OCC-2011-0001

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
400 7th Street SW, Eighth Floor
Washington, DC 20219
Attention: Comments/RIN 2590-AA42

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1536/RIN 7100 AE-50

Gerard S. Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428
RIN 3133-AE48

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
Attention: Comments/RIN 3064- AD86

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549
File Number S7-07-16

RE: Comments on Proposed Rule Implementing Section 956 Dodd-Frank Wall Street Reform and Consumer Protection Act

To Whom It May Concern:

The Center On Executive Compensation ("Center") is pleased to submit comments to the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the National Credit Union Administration, and the Federal Housing Finance Agency (collectively referred to as the "Regulators") to provide its perspective on the implementation of Section 956 of the Dodd-Frank Act, the financial services incentive compensation rules. As proposed, the rules implementing Section 956 require covered financial institutions to take steps to ensure their incentive compensation plans do not encourage covered employees to take so-called "inappropriate risks", potentially subjecting the firm to material financial harm. Larger financial institutions are subject to additional requirements, including mandatory deferrals of up to 60% of incentive compensation as well as additional risk control and governance requirements. This letter articulates our concerns with the unintended consequences of the proposed rule, specifically that the rule focuses not on risk but rather almost solely on the presence (and magnitude) of incentive compensation.

The Center is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 370 large companies, and the Center's more than 125 subscribing companies are HR Policy members that represent a broad cross-section of industries, including the financial services industry. The Center filed extensive comments on the original rule proposal in 2011 and participated in industry meetings with the consortium of regulators responsible for its implementation.

I. Executive Summary

The Center On Executive Compensation believes strong yet practical risk mitigation in executive compensation plan design and oversight is a fundamentally important element of effective executive compensation policy and practice and is necessary to maximize shareholder value. To this end, a company's compensation committee currently must actively work to assess the risk inherent in incentive compensation arrangements and how that level of risk corresponds to the overall business strategy and competitive environment of the company. The proposed rule implementing Dodd-Frank Section 956 is an attempt at providing an expanded risk management structure for company incentive compensation plans. A proposed rule was originally introduced in 2011 and largely followed the structure and format of the 2010 Standards on Incentive Compensation Safety and Soundness Standards. While not perfect, by following the 2010 Standards, the 2011 proposed rule recognized the unique nature of each individual company when identifying potential risk areas by requiring institutions to identify individuals who, alone or working with others, had the ability to expose a firm to a material financial loss. Since the introduction of the 2010 Incentive Compensation Standards, financial services firms have made significant and noteworthy steps to reduce the potential of inappropriate risk taking by introducing effective and comprehensive risk-management strategies formulated through extensive work with local regulators.

Unfortunately, the 2016 proposed rule appears to be an attempt to push tougher compensation restrictions on a wide array of bank employees rather than to minimize inappropriate risks in compensation plans. The rule adopts a one-size-fits-all approach which is mechanically difficult, if not impossible, to implement and comply with on an ongoing basis. Even more troublesome, however, is the fact that the proposed rule will have a highly detrimental effect on the ability of covered firms to attract and retain top talent.

Section 956 was included in the Dodd-Frank Act to prevent financial services firms from offering incentive compensation in a way which encourages or allows certain employees, in an effort to maximize pay, to take inappropriate risks that expose the firm to material financial harm.[1] However, the 2016 re-proposed rule implementing Section 956 eschews a focus on risk potential and instead is premised almost entirely on two fundamentally misguided generalizations regarding incentive compensation plans:

[1] Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37673 (June 22, 2016) (to be codified at 12 C.F.R. pt. 42, 12 C.F.R. pt. 236, 12 C.F.R. pt. 372, 12 C.F.R. pts. 741 and 751, 12 C.F.R. pt. 1232, and 17 C.F.R. pts. 240, 275, and 303).

1. All incentive compensation plans, regardless of plan structure or the participants, have the potential to pay excessive compensation and inherently encourage plan participants to take inappropriate risks, and thus deserve the same level of regulatory scrutiny; and
2. An individual's total incentive compensation received annually dictates that individual's risk potential, and thus, the higher paid an individual is, the more risk they create or are likely to create.

These generalizations yield a proposed regulation that not only fails to effectively achieve the underlying purpose of Section 956 but also imposes excessive and unnecessary burdens on financial services firms that will severely harm the ability of those firms to recruit and retain top talent while not effectively reducing inappropriate risk-taking.

The re-proposed rule implementing Section 956 contains a universal set of requirements aimed at preventing "excessive" incentive compensation which encourages risk-taking that could potentially subject a firm to material financial harm.[2] These requirements, in addition to well-intended but overbroad recordkeeping requirements, apply to all covered financial institutions (CFIs) regardless of size. For larger CFIs, the proposed rule includes additional requirements, including mandatory deferrals of incentive compensation, clawbacks, and enhanced risk monitoring and governance procedures. Similar to the structure of the proposed rule, the Center's comment letter first addresses the universal CFI requirements followed by a discussion of the additional burdens facing Level 1 and Level 2 (L1 and L2) companies. The following summarizes the Center's primary concerns with respect to the proposed regulation:

- <u>Section 956 Has the Effect of the Government Picking Winners and Losers</u>. The re-proposal's onerous and excessively broad requirements will only apply to covered financial institutions while other types of financial institutions, simply because they will not have to comply with Section 956, will be given distinct advantages in terms of the recruitment and retention of key employees and avoiding the enormous compliance burdens associated with the proposed rule. Thus, as an overarching principle, the agencies responsible for implementing Section 956 should take affirmative steps to ensure compliance with Section 956 most closely mirrors the currently existing, principles-based framework stemming from the 2010 Incentive Compensation Standards.
- <u>A Final Rule Needs to Recognize Covered Institutions' Work with Local Regulators</u>. Many, if not most covered institutions have already been doing extensive risk-mitigation work as part of implementing and complying with the 2010 Incentive Compensation Standards. Center Subscribers have indicated that these compliance efforts have included the identification of individuals with the ability to subject a firm to material financial harm as well as revision of incentive plans to reduce risk-potential. In advance of completing a final rule, the Regulators need to engage these local regulators to create a dialogue and discussion of the current risk-mitigation practices that covered institutions have already developed and implemented. This dialogue would be tremendously helpful in honing a final rule which takes into

[2] *Id*.

account current practices and, unlike the proposed rule, is not unnecessarily broad in scope.

- The Proposed Rule Undermines Firms' Ability to Retain Essential Talent. The most troublesome aspect of the proposed rule is the negative impact it will have on the ability of covered institutions, particularly L1s and L2s, to attract and retain top talent. The extraordinarily broad definition of Significant Risk-Taker will result in the inclusion of an unnecessarily large pool of employees at L1 and L2 CFIs in the incentive limitations, even though the vast majority have no ability to expose the firm to material financial harm. While some of the covered employees will be traders and other bankers who are most likely to seek employment at another L1 or L2 institution and thus would face the same restrictions anywhere, many of the employees covered under the Significant Risk-Taker definition will be in managerial or administrative roles that also exist in industries where the proposed rule's requirements will not apply. These cross-industry roles include cyber security and technology employees – a fundamentally important role for financial institutions in the technology age and app-driven economy – as well as other executives and top level program managers. Under the proposed rule, CFIs trying to recruit talent to fill these essential roles would have to advise potential employees that up to 60% of their incentive compensation could be required to be deferred for four years and then on top of that would be potentially subject to a clawback for an additional seven years. These restrictions will make employment in non-financial firms more attractive, since such firms will be able to make competitive offers with CFIs without having to comply with Section 956 restrictions. This is likely to put CFIs at a definite and severe disadvantage in recruiting and retaining talent and likely will force CFIs to increase fixed compensation to compete. Even more troubling, however, is that without the ability to secure the best people because of the proposed rule's requirements, , the rule could actually *create* financial instability.

- Apply Incentive Plan Limitations to Employees with the Greatest Potential to Take Risks That Could Lead to Material Harm. The Center believes the best approach to the implementation of Dodd-Frank Section 956 is to provide for a principles-based baseline risk-litmus test. Under such a test, a covered institution would evaluate the structure and characteristics of participants in its incentive plans in order to identify plans which have the potential to facilitate improper risk behavior that may lead to material financial harm. Institutions are already familiar with this type of framework stemming from compliance with the 2010 Incentive Compensation Standards. The Agencies should abandon the 2016 proposal's identical treatment of all plans and all participants and focus on incentive compensation plans with a structure and participant pool that have the actual potential to incentivize inappropriate risk-taking. This would eliminate the "one-size-fits-all" approach utilized in the 2016 proposed rule while also reducing exorbitant compliance burdens that provide little additional protection against material harm. It would also recognize the role of a company's board of directors in structuring incentive compensation plans to attract, retain, and motivate employees to manage the firm and create shareholder value.

- The Standards in the Universal Requirements Are Only Subject to Evaluation Using Hindsight Judgment, Stifling Board Innovation. The Center supports the principle in the proposed rule's universal requirements that incentive compensation should not be excessive nor should it encourage inappropriate risk-taking that could potentially lead to a material financial loss. However, the Center is concerned that the only way of evaluating a CFI's compliance with either requirement will involve the use of hindsight judgment, which would essentially second-guess the good-faith decisions made by a company's Board of Directors otherwise protected by the business judgment rule. Further, the persistent threat of agency second-guessing, combined with the proposed rule's lack of standards allowing CFIs and regulators to distinguish between ill-advised compensation-driven risk-taking and legitimate, good faith business risk, is likely to have the unintended consequence of encouraging boards of covered institutions to be excessively conservative in their approval of strategy and otherwise reasonable compensation plans out of concern that their decision-making might be later called into question, regardless of good faith.

- The Determination of "Significant Risk-Taker" Should Focus on Risk Potential, Not Pay Magnitude. In addition to the 2016 proposal's expansion of the deferral term, it also expanded the individuals covered from executive officers to a new and much broader category known as "Significant Risk-Takers" (SRTs). The Center believes that the definition of SRTs should be changed fundamentally in the final rule. As currently defined, the threshold trigger as well as the more expansive of the two tests for identifying SRTs is based on compensation, without regard to the individual's potential of taking significant risks that could lead to material financial harm (*i.e.*, his or her "risk potential"). The misguided emphasis on compensation is based on an incorrect assumption that pay composition and magnitude are indicative of risk potential. In the final rule, the Center believes the superior approach to defining the pool of SRTs at a covered institution would be to refer to a set of parameters outlined in the 2010 Standards on Incentive Compensation Policies for identifying employees that individually or in the aggregate have the capacity to potentially subject the firm to material financial harm. This approach has achieved an effective focus on *risk potential* while recognizing the unique structure of each covered institution and the need to minimize the burdens associated with identifying these individuals on an ongoing basis.

- The Expanded Deferral and Mandatory Clawback Further Undermine the Ability of Covered Institutions to Recruit and Retain. The Center believes the 2016 proposal's expansion of the deferral requirement term to four years as well as the addition of a duplicative seven-year mandatory clawback does little to further the purposes of Section 956 while imposing considerable impediments on the ability of L1 and L2 entities to recruit and retain talent. The Center believes a superior approach would be to limit the deferral to only qualifying incentive compensation, in recognition that long-term incentive pay inherently allows risk and performance to impact payouts. Further, to mitigate the potential effects on talent without measurably limiting the risk mitigation potential, the Center recommends using a scaled deferral approach whereby individuals new to the deferral requirement would be required to defer lower portions of pay in early years before scaling to the full required amount.

- L1 and L2 Incentive Plan Requirements Push Towards One-Size-Fits-All. The proposed rule appears to have unintentionally limited incentive compensation plan design structures in two specific places. First, the ambiguity stemming from the requirement that deferrals must be made in "substantially" both cash and equity will limit how companies can structure incentive plans.[3] Second, the limitation on the value of options which can be deferred to 15% of the total deferral value also has the effect of prohibiting certain incentive compensation design structures by restricting the effective use of options as a pay for performance tool in order to stay under the amount limitation. The Center believes that both provisions of the proposed rule fail to effectuate the stated goals of Section 956 and should be replaced with language which would permit a company's board of directors the latitude to structure a deferral in a manner which it believes best benefits the corporation and its stakeholders.

Universal Requirements for All CFIs

The proposed rule implementing Section 956 contains universal requirements that apply to all CFIs regardless of size and prohibit incentive compensation plans which award excessive compensation or which encourage employees to take inappropriate risks which could subject the firm to material financial loss. Additionally, the rule's recordkeeping requirements mandate that all CFIs inventory every incentive plan and participant as well as oversight mandates which impose additional standards on boards as they oversee and approve the incentive compensation plans and awards of senior executive officers. The effectiveness of the universal requirements as well as the compliance scope and depth hinge almost entirely on two key definitions outlined in the proposed rule – the definition of "Covered Persons" and the definition of "Incentive Compensation." Unfortunately, the proposed rule defines each term in an unnecessarily broad manner which results in the inclusion of incentive compensation plans that have no ability to award excessive incentive compensation and participants that have no ability to facilitate inappropriate risk-taking.

The inclusion of these plans and participants under the regulatory scheme does nothing to further the stated objectives of Section 956 and imposes excessive compliance burdens on CFIs. As the Center will explain in depth below, the Agencies should permit CFIs to conduct a baseline risk litmus test whereby covered firms would evaluate their incentive compensation arrangements, taking into account the participant pool and plan structure to identify plans which actually have the potential either to pay excessive compensation or encourage inappropriate risk-taking. Accordingly, only plans which trigger the risk litmus test would be covered by the rule's requirements, thus significantly scaling back compliance burdens while keeping true to the goal of Section 956 – to prevent incentive plans which encourage unnecessary risk-taking that could cause material financial harm to a company.

---

[3] *Id*. at 37680.

I. Section 956 Should Focus on Incentive Plans with Actual Risk Potential Instead of the Proposed Rule's One-Size-Fits-All Treatment of All Plans and Participants.

The structure of and individuals participating in an incentive compensation plan dictate the potential for excessive incentive compensation and inappropriate risk-taking. Accordingly, the Center urges the Regulators to implement Section 956 in a manner which recognizes the diversity of incentive compensation plan participants (the "participant pool") as well as the widely varying risk implications stemming from individual incentive plan structures. To this end, the Center recommends the Regulators provide for an institution-managed "Risk Litmus Test" whereby an individual firm would use its specific knowledge of its organization and incentive plans, taking into account the varying participant pools in different plans as well as the underlying plan structures, to identify plans which actually have the potential to pay excessive compensation or encourage inappropriate risk-behavior potentially leading to a material financial loss. By providing a Risk Litmus Test as a threshold for the application of the Section 956 universal requirements, the Regulators will be telling covered firms to focus on arrangements which actually could pose a risk to the institution while avoiding wholly unnecessary and extremely burdensome data collection and monitoring requirements. Furthermore, covered institutions already have been utilizing this type of framework in compliance with the 2010 Incentive Compensation Standards, and as a result, a process and rapport with local regulators already exist.

a) <u>A Risk Litmus Test Is Necessary in Light of the Difficulty in Prescribing Definitions of Incentive Compensation and Covered Persons Which Reflect Risk Potential</u>.

As the Center detailed above, incentive compensation plans come in a wide variety of structures with differing terms, incentive targets, and participants. These characteristics of incentive plans directly impact the potential for inappropriate risk behavior and dictate whether or not a plan can pay excessive compensation. It appears that to accommodate for this diversity, the proposed rule defines incentive compensation broadly as "any variable compensation which serves as an incentive for performance" while providing a few exceptions, such as sign-on bonuses and pay awarded for continued employment.[4] Similarly, the proposed rule's definition of covered person includes all employees of a covered institution.[5] The broad definitions, however, belie the purpose of Section 956, which is to prevent inappropriate risk behaviors and excessive incentive compensation, because they fail to include a consideration of whether or not a particular form of incentive compensation could lead to excessive compensation or whether a particular covered person has the capacity to engage in inappropriate risk-taking that can potentially lead to material financial harm.

The proposed rule's decision to define "incentive compensation" and "covered person" without regard to the potential for inappropriate risk or excessive compensation results in the over-inclusion of incentive compensation plans and participants. The vast majority of these plans cannot pay excessive compensation to the participants, and the vast majority of participants do not have the authority, scope of influence or capacity to act in an overly-risky manner potentially subjecting a covered institution to material financial harm. For some covered institutions, this will result in hundreds of incentive compensation plans and tens of thousands of participants

---

[4] *Id*. at 37702.
[5] *Id*. at 37690.

being unnecessarily covered under the Section 956 universal requirements. Not only will the coverage of the large majority of these plans and participants do nothing to further the goals of Section 956, but it will also impose excessive compliance burdens on covered firms stemming from the requirement that covered institutions ensure plans do not pay "excessive" compensation while also having to inventory all plans and all participants. In other words, by taking a broad approach designed to cover as many plans and participants as possible, the Agencies have diluted the proposal's risk mitigation effectiveness. As proposed, CFIs would be required to focus on inventorying irrelevant plans and participants rather than focusing on the ones most likely to incentivize risk that could result in a material financial loss to the institution.

We understand and acknowledge the Regulators' desire to limit excessive incentive compensation and inappropriate risk-taking to the greatest extent possible. However, we believe that by proposing such a broad standard through the definitions of incentive compensation and covered person, the Regulators risk adopting a final rule which will be less effective at accomplishing its objectives by forcing covered institutions to be less focused on the individuals and plans that are likely to put a firm at risk.

For example, under the proposed rule, the following incentive plan, which is used by one of our Subscribers, would be classified under the definition of "incentive compensation" despite the fact that the plan cannot lead to the type of risk taking contemplated by Section 956.[6] The incentive compensation plan applies to entry-level tech employees. Last year, the plan applied to about 1,450 participants with a total payout amount of about $4.3 million– thus the average payout was about $3,000. As part of this incentive plan, these entry-level tech employees are eligible to receive five percent of salary as a target incentive award. The actual amount awarded is based on individual performance, typically derived from a performance rating, as determined by their managers. An individual's maximum payout could be up to 200% of target (or a total of 10% of base salary), but very few people obtain this level. These entry-level employees have 11 bands of employees above them and all their work is reviewed and their decisions are actively managed. Additionally, the projects these individuals work on are diverse, meaning there is little to no risk of collective action.

Other examples of types of plans which do not carry inherent risk as contemplated by Section 956 are firm-wide plans and profit-sharing plans. Firm-wide incentive plans are aimed at rewarding broad populations of employees for personal contributions while allowing them to share in the overall success of an institution. These plans typically permit all professional and managerial employees to participate. This often includes all employees at all levels of the organization, including entry-level professionals such as new college graduates. Funding for the *plan* – the size of the reward pool available to divvy out – is typically determined by overall company performance based on achievement of one or two financial measures. However, while an individual employee's award may be limited by the overall funding level which is based on financial performance, the magnitude of the *individual award* is typically determined by the individual's role and performance against personal goals which are often non-financial in nature. These individual awards are often expressed as a percentage of target level and are usually capped.

[6] In fact, this plan does not trigger oversight by the 2010 Incentive Compensation Standards.

Similar to firm-wide bonus plans, profit sharing plans allow employees to share in the overall success of the company. Profit sharing plans have participant pools which include substantially all employees, including those in administrative, clerical and other support roles. Similar to firm-wide plans, the amount of funding available to a profit sharing plan is typically determined by a company's performance on a profit measure (*e.g.* operating earnings, Earnings Before Interest and Taxes (EBIT), Earnings Per Share (EPS), *etc.*). Individual awards, however, are typically based on a formula linked to an employee's level – regardless of whether it is in a support or revenue-generating role. Additionally, discretion in determining profit sharing awards is generally not allowed.

b) <u>Allow Companies to Focus On Incentive Compensation Plans With the Potential to Pay Excessive Compensation and Incentivize Inappropriate Risk Behavior</u>.

The Center recognizes the impossibility of crafting definitions of incentive compensation and covered persons in a manner which accommodates the diversity of incentive plan structures and participants while still providing for the rigorous regulation of arrangements that carry the potential for risky behavior and excessive compensation. The Center therefore proposes that, in lieu of dictating the scope of Section 956 through the definitions of incentive compensation and covered persons, the Agencies should adopt a Risk Litmus Test which allows covered financial institutions to hone the application of the Section 956 universal requirements to focus on those plans with the potential to pay excessive compensation or encourage inappropriate risk-taking. The Risk Litmus Test would constitute a principles-based extension of the existing framework which institutions have been utilizing to comply with the 2010 Incentive Compensation Standards.

The concept that certain incentive compensation plan structures and plan participants embody different degrees of risk potential and thus deserve differing levels of risk moderation is already exhibited in the proposed rule in several locations. For example, this is seen in the proposed rule's decision to subject select employees of larger financial institutions to additional requirements, such as mandatory deferrals and fault-based clawbacks.[7] Another example, this time pertaining to incentive plan structure, is the proposed rule's determination that upon meeting several enumerated requirements, including maintaining mechanisms which balance risk and financial rewards, an incentive plan will not be deemed as potentially encouraging risk which could lead to a material financial loss.[8]

The Risk Litmus Test would constitute a firm-driven, principles-based analysis, with a particular emphasis on the risk potential of the participants in an individual and group capacity, incentive plan structure (*e.g*., the amount of compensation earned for achieving a certain level of performance at threshold, target and maximum, with a cap on total awards), award potential, award history, and any other relevant factors. The objective would be to identify the subset of plans out of their entire suite of incentive plans which actually have the potential to pay excessive compensation or those which could encourage inappropriate risk-taking potentially exposing the firm to material financial harm. Accordingly, the universal requirements of Section 956 would only have to be applied to those identified plans. Pursuant to the recordkeeping requirements, the Agencies could require that covered institutions disclose the process and

---

[7] *Id*. at 37691.
[8] *Id*. at 37741.

factors used in the Risk Litmus Test to identify subset of incentive plans to be subject to the universal requirements, as well as the number of plans which did not trigger the test. This helps ensure that, upon request from regulators, covered firms are held accountable for the process.

The Risk Litmus Test creates several measurable benefits:

- First, it eliminates the burdens associated with a covered institution having to apply Section 956's universal requirements to incentive compensation plans and participants that lack the ability to pay excessive compensation or engage in inappropriate risk-taking potentially subjecting the firm to material financial harm. Specifically, the approach eliminates the substantial burdens associated with being required to catalogue, on an annual basis, all incentive compensation plans and arrangements. This enables firms to focus more clearly on situations where excessive compensation or inappropriate risk taking are a possibility.
- Second, the Risk Litmus Test acknowledges that the covered institutions themselves are in the best position to determine which plans and participants have the potential to create inappropriate risk and pay excessive incentive compensation because they understand how their own incentive plans and participant pools work. This avoids the needless difficulties and consequences of trying to apply a one-size-fits-all regulatory regime to all incentive plans.
- Third, the process of executing a risk litmus test is very similar to requirements imposed by the 2010 Safety and Soundness Standards in Incentive Compensation which requires companies to identify personnel that have the ability in an individual capacity or in the aggregate to subject a firm to material financial harm. Firms and regulators have a history of compliance with this provision and a rapport which will make for an easier transition to Section 956 compliance.

c) A Final Rule Should Clarify That Employer Contributions to Qualified Retirement Plans Under IRS Code Section 401(a) Are Not Incentive Compensation Under Section 956.

A final rule should make it clear that Qualified Retirement Plans under Section 401(a) of the Internal Revenue Code (the "Code") including Qualified Pensions, Profit Sharing Plans, and Stock Bonus Plans are not considered incentive compensation for the purposes of Section 956. We note at the outset that the proposed rule already excludes employer contributions to 401(k) plans which are computed based on a fixed percentage of the individual employee's salary.[9] The logic behind this already existing exemption from the definition of incentive compensation is that these employer contributions are not intended to reflect individual performance and are aimed at encouraging retirement savings. Furthermore, the Center believes that the Regulators, in exempting employer contributions based on fixed salary percentages, implicitly recognized that these plans are already subject to significant regulatory oversight under the Code. The Center notes that the same logic the Proposed Rule uses to exclude employer contributions to 401(k) plans based on employee salary also applies to employer contributions to 401(k) plans based on the employees' bonus and other types of plans, such as Qualified Pensions, Profit Sharing Plans, and Stock Bonus plans covered under Section 401(a) of the Code. These

[9] *Id*. at 37702.

qualified retirement plans are intended to encourage employees to save for retirement and are not designed to incentivize current or future performance. Furthermore, such contributions are subject to extensive rules under the IRC and Treasury regulations and can only be withdrawn from the qualified plan under limited circumstances, including termination of employment, retirement and death. These existing regulatory regimes would make subjecting these types of employer contributions to forfeitures, adjustments, and clawbacks inconsistent with other applicable laws.

d) Broad-Based Incentive Plans and Profit Sharing Plans Should Be Excluded from Section 956.

If the Agencies choose not to follow the recommendation by the Center to include a Risk Litmus Test to identify incentive plans which actually have risk potential, the Center requests that broad-based incentive plans and profit sharing plans be excluded from the definition of incentive compensation. As explained above in detail, these plans do not encourage risk-taking behavior or facilitate a threat to an institution's financial stability. In each case, an individual's award is inherently limited by the overall award pool which is determined by company performance. Additionally, the size of the individual's award is capped and is based on separate, personal performance measures which may be non-financial in nature.

Because the largest employee populations participate in these plans, the plans present the largest burdens with regard to the recordkeeping and oversight requirements stemming from compliance with Section 956. As a result, the exclusion of both types of plans from the definition of incentive compensation would reduce compliance burdens for covered institutions without inhibiting the goals of Section 956.

II. In Determining Whether an Incentive Plan Pays "Excessive" Compensation or Encourages Inappropriate Risk-Taking, Good-Faith Board Decisions Will Be Subject to Hindsight Judgment.

As part of the universal requirements for all covered institutions, Section 956 contains two primary prohibitions for covered financial institution incentive compensation plans: (1) incentive compensation plans cannot pay "excessive compensation;" and (2) incentive compensation plans, or any feature of a plan, cannot encourage the taking of inappropriate risks which could lead to a material financial loss to the covered institution.[10] As proposed, Section 956 includes a principles-based definition of "excessive compensation" while providing a list of conditions an incentive plan must meet in order not to be considered as encouraging inappropriate risk-taking potentially leading to a material financial loss.[11]

The Center believes that prudent risk management is a necessary part of an effective incentive plan design process and is a fundamental element of effective executive compensation policy. Accordingly, the Center supports the concepts in the proposed rule that covered financial institutions should work to prevent incentive plans from rewarding excessive compensation or encouraging inappropriate risk-taking. Paramount to a covered institution's ability to mitigate these risks is the need for flexibility for its Board of Directors in crafting the risk approach, designing internal controls, and developing a governance structure to oversee the risk program.

---

[10] *Id*. at 37803.
[11] *Id*.

The Center notes that the proposed rule, on its face, appears to provide covered institutions with such flexibility. However, the Center has grave concerns that the only manner of evaluation of the effectiveness of a covered institution's compliance with these provisions is through a hindsight-driven assessment by a regulator without expertise in incentive compensation arrangements. A hindsight-driven compliance framework would subvert the well-established precedent that compensation-related decisions by the Board are protected by the Business Judgement Rule so long as they are made in good faith. Furthermore, the framework adopted by the proposed rule lacks the flexibility to allow regulators to distinguish between these good-faith, legitimate business risks which are thoughtfully considered and approved by the Board and ill-advised, compensation-driven risk-taking. The unintended consequence of this framework is that it could have the real effect of chilling a Board's willingness to engage in incentivizing prudent goals which involve risk-taking through compensation programs, thus stifling innovation which would otherwise have the potential to result in stakeholder growth. The Center, therefore, believes that a final rule should make clear that, absent bad faith or fraud, the utilization of the flexibility in the proposed rule will not subject a covered institution to hindsight second guessing of good faith board judgment.

a. <u>Requiring Companies to Certify that All Incentive Compensation Awards Are Not "Excessive" Is Exceedingly Difficult, If Not Impossible</u>.

As noted above, the first incentive compensation plan prohibition bans incentive compensation plans which pay "excessive" compensation. The proposed rule provides a principles-based definition for determining when incentive pay is "excessive," stating pay is "excessive" when amounts paid are "unreasonable or disproportionate" to, "among other things," the "nature, quality, and scope of service provided by the covered person."[12] The proposed rule then provides a non-exclusive list of factors to consider in making the determination, including the magnitude of pay, comparable practices at peer entities, the financial condition of the covered firm, and any other factors the evaluating regulator considers to be important.[13] The Center wholeheartedly supports the statutory goal that companies should not be paying "excessive" incentive compensation. However, the Center's view is based on its long held belief that pay should reflect performance and be appropriate to the context within which it is awarded. We are concerned that the "excessive" standard might focus solely on magnitude without regard to the correlation of pay with superior performance or the broader context of the business.

The Center is concerned that a lack of available market data on the details of broad-based incentive plans for the wide range of personnel covered under the proposed rule will make a CFI's evaluation of whether or not compensation is "excessive" very difficult and subject to hindsight judgment by a regulator that at best has experience with a subset of employees in certain roles. Specifically, the proposed rule indicates that a CFI is required to have proactively justified levels of compensation to ensure they are not "excessive."[14] However, market data on incentive compensation pay plan design that would be necessary to carry out such an analysis compliant with the terms of the rule, including data on payout curves, performance management and performance targets, is not readily available in the form or scope contemplated by the

[12] *Id*.
[13] *Id*.
[14] *Id*. at 37709.

proposed rule and would be tremendously burdensome to obtain, if this were even possible. This issue is further amplified by the proposed rule's inclusion of all employees receiving incentive compensation and its failure to adjust the range of employees covered by the rule to reflect risk potential, necessitating the provision of market data for an expansive pool of employees. This would require some companies, for example, to engage in an extremely difficult (if not impossible) data gathering exercise to justify the compensation for tens of thousands of employees throughout their organization. Further complicating the matter, organizational differences between CFIs significantly limit the comparability of the design and structure of broad-based incentive plans, limiting the ability of CFIs to determine definitively that no incentive plan in the company pays what the rule considers "excessive compensation."

The lack of data will make it difficult, if not impossible, for the risk control personnel within a CFI to certify that none of their compensation plans pay "excessive" incentive compensation. The Center strongly recommends, as detailed above, the adoption of a Risk Litmus Test which would refine the employees and incentive plans covered by the proposed rule to only those with actual risk potential as this would significantly lessen, but not remedy, the difficulties in developing the scope of data needed to make the "excessive" determination.

Alternatively, the Center proposes requiring covered institutions to have documentation on the risk-mitigation process employed to prevent excessive compensation and how the plans, at a broader level, are in sync with the market and the nature of the role targeted by the plan in lieu of individual plan-level documentation.

b. Clarity Is Needed Regarding How a Regulator Will Evaluate Whether a CFI Paid "Excessive" Incentive Compensation.

The proposed rule is unclear as to how exactly a regulator would approach an evaluation of whether or not a CFI paid "excessive" compensation when the proposed rule quite clearly states that disclosure of actual compensation pay levels is not required in the recordkeeping requirements.[15] Presumably, an investigation into whether or not a CFI paid excessive compensation would be triggered following a market event which resulted in material financial harm to the CFI. Subsequent to the event, the appropriate regulator would evaluate the CFI's incentive pay arrangements for the individual(s) involved in triggering the event, which would include the regulator requesting and receiving the compensation levels for those individuals. A final rule needs to detail exactly how such a process would proceed, including whether or not a CFI would be required to disclose an individual's compensation level.

III. As Proposed, the Recordkeeping Requirements Unwittingly Impose Excessive Burdens on Covered Financial Institutions.

The 2016 proposed rule replaced an annual recordkeeping requirement whereby CFIs are required to create annual records which "demonstrate compliance with the proposed rule."[16] Pursuant to the requirement in the re-proposal, a CFI must gather (1) copies of all their incentive plans; (2) lists of the participants in each plan; and (3) a description of how each plan is

[15] *Id*. at 37810.
[16] *Id*.

compatible with effective risk management and controls.[17] These records must be kept for seven years and must be available to be furnished to a regulator upon request.[18] As discussed in depth above, the proposed rule's definitions of incentive compensation and covered persons eschew a focus on risk potential and as a result cover an excessively broad employee population, the vast majority of which have no potential to engage in the type of risk behaviors envisioned by the drafters of Section 956. For large financial institutions which can have hundreds of incentive compensation plans and tens of thousands of plan participants spanning the globe, these recordkeeping requirements present an unprecedented and enormously burdensome data collection challenge.

For large financial institutions, particularly those having a global scope, incentive compensation plan coverage can penetrate deep into the organization and serve distinct employee populations in various localities across the globe. The incentive compensation plans serving these distinct localities are designed by local management, not by corporate headquarters. This allows the plan to be crafted for the local employee population, taking into account local compensation practices and cultural norms, by individuals who understand the local norms. The subsequent management and administration of the incentive plan is then also carried out locally, incorporating the covered financial institution's risk-monitoring and governance controls. However, the exact plan details and participant pools remain local in nature as there is no business purpose for transmitting the data to a centralized location such as corporate headquarters. As a result, the data gathering exercise, which for some companies would involve gathering data on tens of thousands of employees who participate in hundreds of plans world-wide on an annual basis, would be a monumental undertaking imposing significant costs and diverting resources for something which would otherwise serve no legitimate business purpose. To help remedy (at least partially) this issue, the Center recommends the adoption of the above explained "Risk Litmus Test" which would put the focus of the recordkeeping requirements only on plans which have actual risk-potential and reduce needless data collection.

IV. A Final Rule Should Clarify That the Compensation Committee Membership Limitation for Senior Executive Officers Does Not Apply to Committee Membership at All Covered Financial Institutions.

The proposed rule includes a requirement that a covered financial institution's Compensation Committee is comprised solely of directors who are not senior executive officers.[19] The proposed rule states that the requirement ensures the compensation committee's independence as is necessary for an effective and risk management and controls framework.[20] The Center believes the proposed rule was written to prevent senior executive officers from serving on the compensation committee of the covered financial institution *where they are actively employed*. The Center is concerned, however, that the proposed rule could be read as prohibiting senior executive officers from serving on the compensation committee of *any other covered financial institution*. Such a prohibition would constitute a dramatic overreach into corporate governance by the Agencies, unnecessarily touching on independence standards which are already subject to

[17] *Id*.
[18] *Id*.
[19] *Id*. at 37812.
[20] *Id*. at 37738.

several sets of rules and requirements as part of 162(m), Section 16 of the Exchange Act, as well as the NYSE listing standards. Again, the Center believes the proposed rule intended to prohibit senior executive officers from serving on their own compensation committee as such an arrangement would actively impact the independence of the committee under existing frameworks. The Center simply requests that this is clarified under a final rule.

V. The Center Supports the Proposed Rule's Decision to Require Board Approval of Incentive Compensation Arrangements of Senior Executive Officers.

The Center applauds the clarity of the 2016 proposed rule regarding the role and responsibilities of a CFI's board of directors in overseeing and approving incentive compensation arrangements.[21] The board has responsibility for establishing executive compensation programs to drive the financial institution's broader business strategy. Further, the board is in the best position to assess, with input from the audit and compensation committees and independent external advisors, as well as the organization's risk management division, whether such programs encourage inappropriate risk and if so, to determine risk mitigation strategies.

After the release of the 2011 proposed rule, the Center expressed concerns that the proposed regulations would be interpreted to require compensation committee approval of all incentive compensation for all covered persons, rather than just for executive officers. This is neither an effective approach to risk management, nor does it encompass developing best practices in the financial industry. The Center recommended that the compensation committee should be focused on senior executives and provide oversight of the processes within the institution performing similar functions for other covered employees.

The 2016 proposed rule appears to have followed the Center's recommendations by including a board oversight requirement in the proposal's universal requirements which requires the board to conduct oversight of a CFI's incentive compensation plans in general while requiring more in depth review of the plans for senior executive officers. This best reflects current practice at many financial institutions, which is to have a separate management committee that focuses on the compensation of employees below the senior executive level.

Additional Requirements for L1 and L2 CFIs

In addition to the universal requirements detailed above, CFIs with an average total consolidated asset size exceeding $50 billion are subject to further requirements, with entities over $250 billion subject to the most stringent demands.[22] The bulk of these additional requirements impose substantial restrictions on incentive compensation for two key employee populations – Senior Executive Officers and "Significant Risk-Takers." The other requirements include additional recordkeeping, enhanced risk management controls, additional governance requirements and additional risk-mitigation procedures.

The Center has three chief concerns with the L1 and L2 requirements among the several issues discussed in detail below. First, mirroring the overly broad universal requirements, the definition of "Significant Risk-Taker" is based, at least in part, on the incorrect assumption that

---

[21] *Id*. at 37803.
[22] *Id*. at 37684, 37685.

high compensation must yield high risk potential. This assumption has led to a definition of Significant Risk-Taker which covers an overly broad population of firm employees, many of whom fall under the classification solely due to pay magnitude with total disregard of their actual risk potential. Rather than having the desired effect of reducing inappropriate risk-taking, the tremendous over-classification of individuals as Significant Risk-Takers will create substantial uncertainty among an institution's population of key employees, making retention much more difficult. Further, the fluid nature of the Significant Risk-Taker designation will leave employees wondering on an annual basis whether or not they will receive the classification – which carries serious consequences – rendering it much more difficult to conduct steady financial planning. As for the consequences, depending on role and firm size, an individual receiving either classification will be required to defer at least 60% of incentive compensation for a period of up to four years. This term is then extended by a seven-year clawback, which effectively places an individual's pay at risk for an 11-year period. In light of these major restrictions on a significant portion of their compensation, key employees designated as Significant Risk-Takers are likely to seek – and find – very attractive opportunities at firms outside the financial services industry, or unregulated financial services firms, where these restrictions do not exist.

The Center's second major concern with the L1 and L2 requirements centers on restrictions on incentive plan design resulting from the requirement that deferrals be made in substantial parts equity and cash, the 15% value limitation on deferred options, and the cap on bonus payouts. Each requirement individually has the effect of banning certain incentive compensation plan arrangements from use without justification. Compensation is a unique tool in furthering company strategy, reflecting market forces and allowing companies to distinguish themselves from other employers in the market for talent. Companies should be allowed to use the full range of tools available to them to design effective and efficient compensation plans that help to attract, reward and retain talent that will help the business achieve its long-term goals while maintaining proper risk-incentive balancing. The above-mentioned restrictions on incentive compensation will have the effect of pushing companies towards homogenized incentive compensation plan designs while doing nothing to reduce the potential for inappropriate risk-behavior.

Finally, and most importantly, the L1 and L2 requirements have the effect of picking winners and losers by applying Section 956 unevenly to financial institutions deemed "covered institutions" while many other types of financial services firms which, despite being direct and indirect competitors performing in the same industry undertaking the same types of risk and competing for the same talent, do not have to comply with these requirements. This has the effect of the government giving some institutions a distinct advantage over others and thus must be limited to a reasonable definition of the terms.

I. The Test for Significant Risk-Taker Should Focus on Risk Potential, Not Compensation Level.

The "Significant Risk-Taker" designation is the most substantial new element introduced in the 2016 re-proposed rule and was designed with the intention of including individuals under the augmented L1 and L2 requirements of Section 956 "who are not senior executive officers but are in position to put a Level 1 or Level 2 covered institution at risk of material financial loss."[23] As defined in the proposed rule, a Significant Risk-Taker is any person who receives at least one-third of their total compensation in the form of incentive compensation and satisfies at least one of two tests. The first test for Significant Risk-Takers, the "Relative Compensation Test," examines the total compensation of all covered employees who satisfy the one-third threshold test. For L2 organizations and their affiliates the top 2% of compensated employees are classified as significant risk-takers; for L1 organizations and their affiliates, the top 5% are classified this way. The second test, the "Exposure Test," states that all covered persons who can commit or expose 0.5 percent or more of the capital (per year) of the covered institution are Significant Risk-Takers. The proposed rule further states that all individuals with rolling approval of capital commitments without a firm annual limit will also trigger the Exposure Test. The proposed rule envisions that these two tests will work together to capture all employees with the potential to expose a firm to a material financial harm.

The Center has significant concerns with the proposed rule's "Relative Compensation Test" approach for identifying individuals who will be classified as Significant Risk-Takers (SRTs) because the definition focuses merely on the form and magnitude of pay received by the individual while ignoring that individual's actual potential for materially impacting the risk to the firm. This results in an excessive number of individuals falling under the definition and being subject to the severe consequences of the designation. According to the Center's discussions with one financial services firm, the broad definition could result in the inclusion of about 3,200 employees, the majority of whom have no ability to expose the firm to material financial harm. Rather, these individuals are considered SRTs, and subject to mandatory deferrals and clawbacks, simply because of the form and amount of their compensation.

Furthermore, because the "Relative Compensation" test is an annual determination covering a flat 2% or 5% of an institution's highest paid employee population, the population of SRTs will never precisely cover the population of employees with actual risk potential. Instead, using the 2% or 5% thresholds will always lead to some employees being unnecessarily covered and some employees (who might actually have higher levels of risk potential) not being covered because they fall outside of the 2%/5% threshold. To base a regulatory scheme off of such a definition is nonsensical and will severely harm the ability of financial services firms to retain employees when competing against firms in industries that do not have to comply with such restrictions.

As explained below, the excessively wide net cast by the proposed rule does an inefficient job of covering non-executive officers with the potential to expose an L1 or L2 institution to material risk. The Center believes that the Agencies could adopt an alternative approach which replaces both the Relative Compensation Test and Exposure Test with one that mirrors the 2010 Incentive Compensation Standards. Under this approach, L1 and L2 institutions would be required to identify employees who, as an individual or in the aggregate, have the potential to expose the company to material financial harm. Accordingly, these individuals would be classified as SRTs for the purposes of compliance with Section 956. Such an approach alleviates the issues resulting from the 2016 proposed rule's overly broad definition of SRTs while keeping true to the rule's intent of preventing material financial harm by keeping the focus of the definition on risk – not on compensation composition or magnitude.

[23] *Id*. at 37692.

a. As Currently Written, the Significant Risk-Taker Test Creates Uncertainty Among Key Employees, Harming Employee Retention Prospects.

Individuals compensated in the top 2%/5% of their institutions will be an entity's highest performing, most critical employees with a demonstrated performance history. These individuals are also likely to be sought after with no shortage of opportunities elsewhere. The wide scope of the Relative Compensation Test will result in a significant portion of employees in positions with high transferability outside the industry (*e.g.*, those involving technology, marketing, sales, law, accounting, etc.) being designated as SRTs, thus subjecting them to the deferral, clawback, adjustment, and forfeiture requirements.

Being designated as an SRT carries significant implications for the way an individual receives compensation by requiring a deferral of a considerable amount of annual and long-term incentive compensation that would otherwise be received in full on an annual basis or pursuant to a vesting schedule. These serious consequences make the SRT designation undesirable for most employees, and will have significant implications for the ability of L1 and L2 institutions to attract or retain the services of an individual who could easily choose to work in an industry that does not have restrictions on compensation.

Problematically, as proposed, the SRT designation will create substantial uncertainty among key financial services firm employees because many will be unable to anticipate whether or not they will be designated an SRT on an annual basis. The Relative Compensation Test's 2%/5% thresholds will subject a set scope of employees to an SRT designation on an annual basis. However, the fluid nature of the employee population as well as annual changes and updates in compensation practices and levels will render it difficult if not impossible for employees to predict on an annual basis whether or not they will be SRTs. For example, an individual might be designated as an SRT one year, but the following year, might miss a specific financial goal, receive less incentive pay, and thus fail to be designated an SRT for that year despite having engaged in the same risk-behaviors.

Adding to the confusion, differences between individual L1 and L2 firms with regard to employee population and compensation practices create a strong possibility that an individual at one firm could be classified as an SRT while another individual performing the same role for the same pay at another firm escapes the SRT designation. The lack of consistency will only compound the problems resulting from the lack of predictability as to whether an individual will be a SRT and result in significant recruitment and retention challenges for L1 and L2 firms.

b. The Significant Risk-Taker Test Should Follow the Model for Identifying Risk-Taking Employees Included in the 2010 Incentive Compensation Standards.

For a final rule, the Center recommends the Agencies adopt a definition of SRT which mirrors the standard utilized in the 2010 Incentive Compensation Standards for identifying employees who are not senior executive officers but have the potential to expose the firm to material financial harm. Such an approach would effectively shift the focus of identifying SRTs to the risk potential of individuals and groups of employees while recognizing the unique nature of the employee populations of each individual company. Furthermore, because most covered institutions are already compliant with the 2010 Standards, utilizing this definition for identifying SRTs allows a streamlined compliance process because both the covered firm and the local regulators are already familiar with the identification and oversight process. Finally, and perhaps most importantly, using the 2010 Standards to identify SRTs would largely remove the uncertainty associated with the SRT identification process which would otherwise plague employees on an annual basis if the rule was adopted as proposed.

As currently proposed, the Significant Risk-Taker definition largely focuses on pay form and magnitude for the purpose of identifying individuals "who are not senior executive officers but are in a position to put a Level 1 or Level 2 covered institution at risk of material financial loss."[24] Accordingly, the proposed rule seems to operate on the assumption that compensation levels correlate directly to risk levels – the higher the pay, the higher the risk. This assumption is incorrect on multiple levels. For example, financial institutions compete fiercely for technology talent. Technology developments such as cyber security capabilities, phone apps and web tools are critical to driving growth in shareholder value as primary business necessities. Technology employees, despite their importance and often high compensation levels, have a very low risk profile – they do not make trades nor have the ability to expose firm capital. Despite the absence of risk, the proposed rule relies on the assumption that pay scales with risk potential to classify them as SRTs, treating them the same as a trader who has the ability to commit substantial firm capital. The result makes it much more difficult and expensive for financial services firms to retain the services of their key technology employees while doing nothing to lessen the potential risk of material financial harm.

As noted above, the Center's proposed method for identifying SRTs mirrors an approach used to identify the scope of employee subject to the 2010 Incentive Compensation Standards. Specifically, the Center is proposing that a final rule define SRTs as:

> Individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and
>
> Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk.

This framework provides several benefits. First, by placing the emphasis on risk and discarding the incorrect assumption that compensation levels determine risk potential, the definition of SRTs will accurately reflect the pool of employees with the ability to expose a firm to material financial harm while excluding individuals such as technology or internal control professionals whose jobs create no risk-potential. This remedies the problems stemming from using the Relative Compensation Test to define SRTs based on a flat portion of an institution's highest paid employee population. As noted above, the use of the 2%/5% highly paid population thresholds to define the SRT pool is highly problematic and has nothing to do with the individual's potential to create risk for the institution. As proposed, there is still the potential for any individual to be captured under the Exposure Test. While this is possible, the Exposure Test does nothing to remedy the over-designation of SRTs who will be captured by the 2%/5% standards and it is still possible that an individual or group of individuals with risk-potential might go uncovered. Furthermore, the bright-line nature of the Exposure Test renders it as

---

[24] *Id*.

unlikely as the Relative Compensation Test to effectively identify material risk-takers at a covered firm.

The second benefit of the Center's approach is that it allows the population of SRTs to reflect the unique structure of an individual financial firm and their employee population. The mandated 2%/5% employee population of the proposed rule cannot accommodate for differences in the structure of L1 and L2 organizations which yield very different risk and employee profiles.

For example, a particular L1 institution may have a call center and as a result, the top 5% of most highly compensated employees requirement may penetrate much further down into the employee ranks than anticipated by the regulators, especially compared to another L1 institution which does not have a sizable call center. The Center's approach allows L1 and L2 institutions to cover those employees with risk-potential without requiring the inclusion of individuals solely for the purposes of satisfying a quota like the 2%/5% standard endorsed by the proposed rule. It also avoids situations where an employee performing the same job for the same pay at two different institutions may be designated as an SRT at one, but not the other, simply by virtue of differences in organizational structure. Additionally, the actual mechanics of identifying the top 2%/5% of compensated employees at a large, global institution will be extremely difficult and likely take months to accomplish. Replacing the current SRT approach with the Center's recommendation would alleviate these compliance burdens.

Third, in addition to ensuring the SRT population better reflects those individuals with actual risk potential, the Center's approach will result in a significantly higher portion of individuals who are designated as SRTs being traditional financial institution employees. The rule would still pick "winners and losers," because even with regard to traditional financial services employees, there are ample job opportunities at other financial services firms which are not covered by Section 956. However, it would significantly decrease the likelihood that key, high performing employees with skills that are highly transferrable across industries are covered by the SRT designation.

e) <u>Alternatively, the Agencies Should Replace the Relative Compensation Test with a Dollar Threshold Test</u>.

If the Regulators determine not to adopt the Center's recommendation to replace the SRT testing process in the proposed rule with the framework utilized in the 2010 Incentive Compensation Standards, the Center would urge the Regulators either to replace the Relative Compensation Test with the Dollar Threshold Test or allow the use of the Dollar Threshold Test as an alternative to the Relative Compensation Test for the purposes of identifying SRTs. As is detailed in the proposed rule, the Dollar Threshold Test functions by setting a compensation level above which any employee would be considered an SRT.[25] Furthermore, we would recommend the Dollar Threshold Test be structured in a way which creates a rebuttable presumption that anyone who hits the dollar limit is considered an SRT. The rebuttable

[25] *Id*. at 37697.

presumption allows covered firms the flexibility to detail how a specific individual is not a material risk-taker and mirrors requirements in the European Union and United Kingdom.[26]

Use of the Dollar Threshold Test, as the proposed rule points out,[27] is not only significantly less burdensome to implement and monitor, but it provides much more certainty to an L1 or L2 firm's employee population as to whether or not they may be an SRT. This has the potential to assist financial services firms in limiting the negative impact on recruitment and retention. However, the 2016 re-proposal also notes that while both tests were considered, the Regulators chose the Relative Compensation Test because the Agencies believed that it would be more effective at capturing all risk-takers.[28] As the Center details in depth above, the Relative Compensation Test does not do a more effective job at capturing a firm's risk-takers and will instead result in a dramatic over-inclusion of non-risk related roles. Since both tests have weaknesses with regard to capturing the proper pool of risk potential employees, if such a broad-based test must be employed, the Center believes the proper and prudent choice should be to allow the use of the Dollar Threshold Test as it provides specific additional benefits, each enumerated expressly in the proposed rule,[29] that the Relative Compensation Test cannot provide. Further, the EU-style rebuttable presumption that an individual is a risk-taker provides another mechanism which precludes companies from gaming the risk-mitigation system but allows for accommodations to lessen the burdens on talent and recruitment.

Additionally, any concerns that the Regulators have that the Dollar Threshold Test has the potential to result in the coverage of a smaller pool of risk-takers are alleviated by the fact that the L1 and L2 firms will still be required to adhere to the 2010 Incentive Compensation Standards and thus, because the Guidance does a far superior job of identifying risk-takers than either the Relative Compensation Test or the Dollar Threshold, individuals with risk potential will still be identified and appropriately managed.[30] While this is true for both the Relative Compensation Test as well as the Dollar Threshold Test we are proposing as an alternative, only the Dollar Threshold Test avoids the dramatic over-inclusion of non-risky employees and the resulting consequences.

With regard to the dollar threshold that is most appropriate under the Dollar Threshold Test, the Center recommends that a final rule set the amount to $1,000,000. This amount does an acceptable job of identifying a pool of covered employees which better reflects the number of

---

[26] See EU No. 604/2014 (Jun. 6, 2014), supplementing EU Directive 2013/36/EU (Jun. 26, 2013) ("[the] quantitative criteria form a strong presumption that staff have a material impact on the institution's risk profile. However, such presumptions based on quantitative criteria should not apply where institutions establish on the basis of additional objective conditions that staff do not in fact have a material impact on the institution's risk profile…"); PRA PS12/15 / FCA PS15/16 (Jun. 2015) ("Material Risk Takers Regulation means Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU…with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile.").

[27] Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37697 (June 22, 2016) (to be codified at 12 C.F.R. pt. 42, 12 C.F.R. pt. 236, 12 C.F.R. pt. 372, 12 C.F.R. pts. 741 and 751, 12 C.F.R. pt. 1232, and 17 C.F.R. pts. 240, 275, and 303).

[28] *Id*. at 37697, 37698

[29] *Id*.

[30] Id. at 37683.

employees with risk-potential than the Relative Compensation Test while also significantly limiting compliance burdens.

f) Alternatively, the Regulators Should Include a Rebuttable Presumption as a Core Mechanism of the Rule's SRT Test.

If the Regulators decide not to adopt the Center's recommendation to replace the SRT testing process in the proposed rule with the framework utilized in the 2010 Incentive Compensation Standards, the Center would urge the Regulators to include a rebuttable presumption for SRT designations as a core mechanism of the SRT Test. Specifically, if a final rule does nothing to substantially change the SRT tests, the Center would strongly recommend that the SRT designation carry a rebuttable presumption which would allow a covered institution to describe why an individual, a group of individuals, job category, or job band are not actually SRTs as defined by the rule would envision. Such a safe harbor, as noted above, mirrors requirements in the European Union and United Kingdom and would allow institutions to avoid the most serious talent and recruitment consequences stemming from Section 956 compliance.

g) In the Alternative, Cross-Industry Roles Should Be Excluded From the Definition of Significant Risk-Taker.

If the Regulators choose not to adopt the Center's recommendation to structure the SRT test to mirror the 2010 Incentive Compensation Standard detailed above, the Center strongly recommends that a final rule expressly exclude individuals who serve in cross-industry roles (such as technology employees, cyber-security personnel, legal staff and other control functions) from the definition of SRT.[31] These individuals cannot subject an institution to the types of risk envisioned by Section 956. Additionally, individuals with cross-industry skill sets are at the highest risk of being recruited outside the financial services industry where they would not be subject to the compensation restrictions stemming from an SRT designation. By excluding them, the Regulators would allow L1 and L2 firms to remain on even ground with outside industry competition with regard to the recruitment of key cross-industry roles. Without the exclusion, the government would in effect impose significant additional costs on financial services firms which will be necessary to secure top talent.

II. To Avoid Devastating the Recruitment and Retention Prospects of Covered Institutions, the Mandatory Deferral Should Be Limited to Qualifying Incentive Compensation.

The 2016 proposed rule, like the 2011 version, instructs L1 and L2 firms to require the deferral of significant portions of the qualifying and long-term incentive compensation of both Executive Officers and SRTs for a period of years. The 2016 deferral requirements, however, are much more stringent by requiring both augmented deferral amounts – up to 60% for Senior Executive Officers – and increased time-frames – now four years instead of three – while also applying marginally lower deferral requirements to individuals who are designated as SRTs. The 2016 proposal also includes additional language aimed at clarifying confusion surrounding the

[31] The Center is not suggesting that roles which engage in financial transactions and are traditional financial services roles, such as traders and loan officers, be excluded under this exception. Nor would the Center's proposed exception result in the exclusion of individuals who fall under Section 956's definition of Senior Executive Officer from the requirements of Section 956.

mechanics of the deferral process as well as how companies should treat both short and long-term incentive compensation.

According to the proposed rule, the purpose of a mandatory deferral is to ensure that incentive pay reflects actual losses due to the realization of risk over a longer period of time. The logic is that the risk inherent in a decision will take longer to materialize than the incentive performance period and thus by instituting a deferral, the risk in the decision is allowed to mature and incentive pay can then be adjusted.

The Center understands the logic behind the goals of the mandatory deferral requirement. Furthermore, the Center recognizes that the mandatory deferral, working in conjunction with the downward adjustment, forfeiture, and mandatory clawback requirements, is the centerpiece of the risk-mitigation strategy in the proposed rule. The Center is concerned, however, that the proposed rule's approach to the mandatory deferral requirement, specifically the qualifying incentive compensation deferral length as well as the inclusion of "Long Term Incentives," creates an extremely inefficient framework for accomplishing the proposed rule's stated objective of ensuring that incentive pay reflects the actual realization of risk over time. By adopting the Center's recommendations detailed below, the Regulators would create a deferral scheme which more effectively and efficiently accomplishes the stated objectives of the deferral while working to lessen the impact on an institution's ability to attract and retain top talent. Furthermore, the recommended changes alleviate practical concerns that the extended deferral period of four years for short-term and two years for long-term incentive compensation force a misalignment between pay and the business cycles that determine it. The resulting misalignment has the potential to weaken the intended pay for performance link sought by an institution's compensation strategy and plan design.

The Center believes the Regulators could achieve a far more efficient approach to the mandatory deferral by focusing the deferral on only qualifying incentive compensation and removing the deferral requirement for "long-term incentive compensation," or incentive compensation with a performance period equal to or exceeding three years. The nature and structure of long-term incentive compensation inherently allows payouts to reflect the realization of risk due to the multi-year nature of the awards. Additionally, long term incentive compensation payouts are typically based off of *company performance* as contrasted to individual performance and is utilized as a primary retention tool. Furthermore, the overlapping nature of most long-term incentive awards assures there is always an outstanding award available to adjust to reflect realized risk and thus risky decisions made to increase compensation in one period are likely to jeopardize payouts under at least two other long-term incentive periods. The Center notes that long-term incentive compensation would still be subject to the adjustment and forfeiture requirements of the proposed rule to allow institutions to have an active mechanism to adjust awards to reflect realized risk.

Additionally, the Center recommends limiting the deferral period for qualifying incentive compensation to three years, reflecting the 2011 proposed rule. A three-year deferral period for qualifying incentive compensation recognizes that the risks stemming from decisions driving short-term – typically annual – incentive plans have played out in the three-year window adequately allowing incentive pay to reflect realized risk.

Generally, the Center has several grave concerns with the deferral requirement, which far exceeds Dodd-Frank's statutory mandate, the text of which is devoid of any reference to deferrals. The Center does note, however, that the Regulators could reduce the negative impacts of the deferral requirement by following the Center's recommendation to replace the Significant Risk Taker test detailed in the 2016 proposed rule with a definition which mirrors the 2010 Incentive Compensation Standards for identifying personnel with the individual or aggregate capacity to expose a firm to material financial harm. Utilizing this definition would help apply the deferral requirement only to those employees with actual risk potential and would ensure that most SRTs subject to the deferral requirements are traditional financial services employees, who are much more likely to face similar requirements at other potential places of employment, thus reducing the negative implications on a firm's ability to recruit and attract key employees. If no change to the definition of SRT is made, the deferral requirements will cover an excessively large number of key employees, many of whom create no risk to the firm and have cross-industry skill sets.

Because of the deferral requirements, financial services firms will face a real risk of losing key employees and when recruiting candidates from outside the industry are likely to have to increase fixed compensation in order to make the roles attractive compared to similar roles in non-financial services industry enterprises which are not subject to the Section 956 requirements. The increase in fixed compensation will be particularly necessary during the first four years of employment where a requirement to defer up to 60% of incentive compensation may create a significant and unrealistic cash shortfall for the employee. To offset the negative effects this unavoidable cash shortfall will have on the ability to recruit new key employees, covered institutions may be forced to pay significant cash up front or in the form of fixed salary. This will impose meaningful costs on the company as well as shareholders.

In addition, the deferral requirement removes the ability of an institution's board of directors to mitigate risk in the best interest of the institution and its stakeholders. Currently, under the principles-based approach utilized in the 2010 Incentive Compensation Standards, a company's board of directors employs several different approaches to effectively mitigate risk. These tools include not only requiring deferrals but, for example, the ability to exercise negative discretion to reduce incentive award amounts and the ability to cancel an award outright or claw back past payments. While the proposed rule does not limit the ability of a board to continue to use these other tools to mitigate risk, by mandating a deferral, it prescribes a primary course of action even in situations where other methods may be better for the company, its business model, and its stakeholders.

Despite the Center's recommendations above, the Center continues to believe the risk-mitigation goals of Section 956 and the mandatory deferral requirement would be best achieved if replaced with a principles-based approach to risk mitigation which allows an institution's board of directors to craft a risk-mitigation strategy that can include deferrals but not in the form of a strict requirement. This approach could mirror the explanation given in the universal requirements section of the rule which details how an institution can "Balance Risk and Reward" and includes the discretion for a company to use longer performance periods, adjustments, and other tools in conjunction with deferrals to achieve proper risk mitigation. This approach would most effectively allow a company's board to manage and mitigate risk in a way which maximizes company and stakeholder benefit. The Agencies could require disclosure of the risk-mitigation strategy utilized by an institution, including what tools, such as a deferral, the board intends to utilize.

a. <u>In the Alternative, the Regulators Should Provide for a Scaled Deferral for the First Qualifying Incentive Compensation Deferrals Made by an Individual</u>.

As detailed above, the mandatory deferral requirement creates a cash shortfall for key employees during the first three years of the deferral requirement until the deferral payouts catch up with the employee's tenure. For example, in each of the first four years of an individual's time as an SRT or a Senior Executive Officer, that individual will effectively be receiving as little as 40% of their annual incentive compensation in the year after it is earned. For L1 and L2 financial institutions, this presents a significant recruitment and retention handicap and will force institutions to increase fixed pay or incentive pay amounts thereby passing on unnecessary costs to the shareholders.

Fortunately, the Regulators have the opportunity to reduce the consequences stemming from the cash shortfall occurring in the first four years of the mandatory deferral by providing for a scaled deferral for new hires or individuals who are newly designated SRTs or receive promotions to covered Senior Executive Officer roles. The Center proposes that the deferral requirement be lessened in each of the first four years for qualifying incentive compensation to reduce the harmful effects of the cash shortfall. The chart below provides the Center's recommendation on how the scaled deferral of qualifying incentive compensation would work.

		Year One	Year Two	Year Three	Year Four
Executive Officers	L1	10%	25%	50%	60%
	L2	10%	25%	50%	
SRTs	L1	10%	25%	40%	50%
	L2	10%	25%	40%	

Adopting a scaled deferral regime which follows the chart above has several distinct advantages. First, it works to reduce the cash shortfall which would otherwise occur during the first years of a deferral by allowing individuals to keep a larger portion of their qualifying incentive compensation award during that time, so that by the time the full deferral amount is reached, the first long-term awards are vesting. The risk-mitigation prospects of the scaled deferral are still largely maintained because by year three at least 40% of the short-term awards are being deferred. Second, in lessening the initial cash shortfall and allowing the deferrals to catch up to payouts, the Regulators would lessen the recruitment and retention handicaps Section 956 imposes on L1 and L2 institutions and also lessen the need for institutions to increase fixed compensation and other time-based compensation measures to even the recruitment playing field.

III. By Requiring All Deferrals to Be "Substantially" Equity and Cash and Limiting the Value of Deferred Options to 15%, the Proposed Rule Has the Effect of Banning Various Incentive Compensation Structures.

The mandatory deferral of the 2016 proposed rule has several mechanical requirements which must be followed by L1 and L2 institutions. For example, deferrals must be paid in a manner which does not exceed pro-rata amounts.[32] Additionally, the proposed rule also prohibits acceleration of deferred incentive compensation except in the cases of death or disability of a covered person.[33] These requirements make sense and do not impose any additional hardships on companies beyond those already imposed by the deferral requirement itself.

The proposal does, however, include two additional mechanical requirements which unnecessarily impose restrictions on the ability of L1 and L2 firms to design incentive compensation plans to fit their business strategy and objectives.

First, the proposed rule includes a requirement that all deferrals are made "substantially" of both cash and equity. The proposed rule notes that the "substantial" term was placed in the rule in order to allow L1 and L2 institutions "sufficient flexibility in designing their compensation arrangements" and was expressly left ambiguous with regard to its meaning so as to not create unintended restrictions.[34] The ambiguity, however, creates significant confusion.

According to the proposed rule, the total amount of an individual's deferral will consist of amounts from the individual's "qualifying" incentive compensation (defined by the rule as incentives with a performance period of fewer than three years) as well as his or her long-term (three or more years) incentive compensation.[35] The Center believes the "substantial" reference in the proposed rule is intended to refer to the composition of this total, combined amount of an individual's deferral – of *both* qualifying and long-term incentive compensation. This would make the most practical sense as qualifying incentive compensation (short-term incentive compensation) is often paid in cash while long-term plans are more typically paid out in equity. Given this approach, ensuring that deferrals are "substantially" equity and cash is fairly straightforward.

The Center is concerned, however, that the proposed rule could be read in a manner which would require individual deferrals of qualified annual and long-term incentive compensation separately, on a plan-by-plan basis, with deferrals of payouts from both plans having to be "substantially" both cash and equity. As noted above, most short-term incentive plans are cash-based; requiring the deferral to consist of both cash and equity would require many L1 and L2 entities to fundamentally alter their approach to incentive plan design. The Center asks the Regulators to make it clear in a final rule that the "substantial" standard applies to the deferral amount as a whole, and not on a plan-by-plan basis of an individual's qualified and long-term plan deferrals.

---

[32] Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37708 (June 22, 2016) (to be codified at 12 C.F.R. pt. 42, 12 C.F.R. pt. 236, 12 C.F.R. pt. 372, 12 C.F.R. pts. 741 and 751, 12 C.F.R. pt. 1232, and 17 C.F.R. pts. 240, 275, and 303).
[33] *Id*. at 37719
[34] If the Regulators adopt the Center's recommendation to limit the deferral requirement to just qualifying incentive compensation, a final rule would need to remove the substantial standard entirely in recognition that short-term awards are typically done almost exclusively in cash.
[35] Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37801 (June 22, 2016) (to be codified at 12 C.F.R. pt. 42, 12 C.F.R. pt. 236, 12 C.F.R. pt. 372, 12 C.F.R. pts. 741 and 751, 12 C.F.R. pt. 1232, and 17 C.F.R. pts. 240, 275, and 303).

Regarding stock options, the proposed rule states that no more than 15% of the total value subject to deferral can be in the form of options.[36] Citing several studies, the proposed rule notes that there have been concerns on the overreliance on stock options, which "could have negative effects on the financial health of a covered institution due to the options' emphasis on upside gains and possible lack of responsiveness to downside risks."[37] The Center disagrees with the proposed rule's views on options, which are an important pay for performance tool given that without improved stock performance, options have no value. Even restricted stock, which the proposed rule cites as a superior, safer alternative, still provides value to an employee given flat or decreased stock performance, where options would have no value. The limitation on options, therefore, effectively prohibits a valuable incentive tool and limits the strategies that L1 and L2 institutions could use to best incentivize their workforce and maximize the pay and performance connection. Incentive plans are developed specifically by each company to reflect its business strategy and cycle as well as its compensation philosophy. The Center believes the Regulators should remove the option deferral value limitation or in the alternative, increase it to at least 25%. A 25% limitation would provide firms which use options with the necessary flexibility to comply with the deferral requirements while helping to minimize the potential impact on plan design practices.

IV. Mandatory Deferral with the Potential for Forfeitures, Downward Adjustments, and Clawbacks May Force a Move to Variable Stock Accounting.

As a direct result of the proposed rule's deferral requirement, L1 and L2 institutions may be forced to move from fixed to variable accounting, imposing significant and potentially negative consequences on their capital structures and even financial health. Under fixed accounting, equity grants must have all key terms communicated. These terms must be "black and white" and there must be a "mutual understanding" between the company and the employee as to the terms. Without this, under fixed accounting, there can be no grant. This would mean that from the initial grant date until the deferral and clawback periods end – potentially 11 years – the expense attributable to the equity grant would be valued on a mark-to-market basis and be subject to any change in the company's stock price. Companies use fixed accounting to avoid this potential for an uncapped expense which could result from potential stock price increases.

Based on our communications with Subscribers it is clear that some auditors will not feel comfortable certifying that awards subject to the proposed rule's deferral, forfeiture, adjustment, and clawback requirements communicate key terms in a "black and white" manner. Thus, depending on the auditor, some companies may no longer be able to use fixed accounting and will instead need to use variable stock plan accounting. This will result in a potentially uncapped expense on the company's books for up to 11 years, which is likely to have a substantially negative effect on the company's capital structure as well as potentially its financial stability.

Similarly, deferral of a portion of an equity-based award into cash, as required by the rules, creates liability accounting under the accounting rules. This is another significant reason not to require mandatory deferral of incentives into substantial amount of cash and equity.

---

[36] *Id*. at 37804.
[37] *Id*. at 37727.

V. Forfeitures and Downward Adjustments Should Distinguish Between Business-Decision Risk and Exposure Risk.

As proposed, the deferral requirement would work in conjunction with the requirements that all incentive plans permit forfeitures and downward adjustments to allow institutions the ability to reflect the realization of risk in incentive compensation amounts. Conceptually, this makes sense; however, in reality, not all risks are the same. The Center is very concerned that the proposed rule will end up penalizing legitimate and prudent business risks undertaken by a company's executives and other key employees falling under the SRT definition and thus stifle innovation and growth.

Successful management of a business, particularly for entities which face stiff competition, always involves some manner of risk taking. Management and the board must feel free to take careful risks that are a necessary component of growth and innovation. It is noteworthy that such prudent risk taking made in good faith by a company's board and management is protected from litigation by the business judgment rule. This protection is grounded in the well-established principle that a company's board and management must feel free to make informed decisions which involve risk without constant fear of legal reprisal. Further, the business judgment rule distinguishes between prudent risks which are made in good faith and those which are not.

The proposed rule's pervasive theme of treating all risks, incentive compensation plans, and plan participants the same will potentially result in penalizing prudent business decisions, which despite being made in good faith, are in hindsight determined to be imprudent by a third party regulator. Not only does this fly in the face of the established precedent of the business judgment rule, but it has the real potential to stifle the willingness of management, boards, and other key employees to innovate and take prudent business risks which could drive innovation and growth. This is the exact opposite of what our economy needs.

VI. The Clawback Requirement is Vague and Duplicative in Light of Other Regulatory Requirements.

The Center believes the clawback requirement included in the proposed rule is excessive in length, vague, and unnecessary in light of other best practices and statutory mandates. The clawback in the proposed rule targets former and current executive officers and significant risk-takers and applies to all incentive compensation which has vested in the last seven years.[38] Combined with the four-year nature of the deferral requirement, the clawback effectively puts a covered employee's incentive compensation at risk for up to 11 years. This will have devastating effects on a covered institution's ability to attract and retain top talent as other industries competing over talent do not have to comply with the same requirements.

The negative impact on talent is wholly unnecessary because, as the proposed rule points out, companies are already subject to several clawback requirements which penalize bad actors and executive officers in the case of a material financial restatement. Furthermore, the vast majority of companies, as part of pervasive governance best practices, have already implemented clawback requirements.

[38] *Id*. at 37731.

Equally troublesome are the vague standards by which the clawback requirement is triggered, specifically, the "significant financial or reputational harm" to a covered institution. This standard with a specific emphasis on "reputational harm" is impossible to evaluate and is subject to potentially innumerable methods of evaluation.

VII. The Mandatory Clawback Window Should Begin When Incentive Pay is Awarded.

As detailed above, the Center believes the mandatory clawback is duplicative and unnecessary. If the Regulators choose to maintain the mandatory clawback, the Center urges them to structure it such that the clawback window opens upon the awarding of incentive compensation. Under the Center's recommendation, the clawback window would begin upon an award grant or payment date and extend seven years. During this seven-year window, deferred incentive compensation would be subject to the clawback as well as forfeiture and downward adjustment.

By structuring the clawback window to begin upon payment or grant date, a final rule would effectively reduce the time frame for which pay is at risk from eleven to seven years. Although a seven-year period still presents recruitment and retention challenges, the four-year reduction will help mitigate those concerns. Furthermore, the seven-year window effectively ties the window to the recordkeeping period and ensures that records always encompass all awards still at-risk.

VIII. The Board of Directors Should Determine – and Justify Through Disclosure – the Cap on Maximum Incentive Compensation Bonus Potential.

The proposed rule includes additional restrictions on incentive compensation plan design, including a cap on incentive compensation plan bonus potential of 125% for Executive Officers and 150% for Significant Risk-Takers.[39]

The Center believes that mandated and arbitrary caps are wholly unnecessary in light of the extensive risk-controls companies have for these plans, which often already include maximum payout percentages. In lieu of requiring a cap, the Center recommends that the Regulators require a disclosure in the recordkeeping requirements as to the caps of plans as well as an explanation of the bonus cap strategy and how it fits in with the company's risk-mitigation strategy in the policies and procedures requirement. If the Regulators feel strongly that there needs to be a separate cap, the vast majority of caps used today do not exceed 200% and the Center would support such a level as a maximum cap in a final rule.

Mandating an arbitrary bonus cap regardless of the company, type of plan or the role of the employee could have the unintended consequence of disincentivizing superior performance or causing employees to attempt to push performance gains off to later quarters after having hit their bonus caps. In addition, it circumvents the ability of the company to set appropriate performance targets and payout curves consistent with business strategy, forcing a randomly selected percentage of target on each bonus plan and each individual regardless of the company's goals and strategy in any given year.

The consequence of arbitrarily capping bonuses is that covered financial institutions are going to have to raise fixed pay to compete for talent, since other industries will not have

[39] *Id*. at 37734.

artificially low bonus caps imposed upon them. A banker bonus cap implemented in the United Kingdom has already had this effect and has resulted in an increase in fixed compensation.

IX. Mechanics of Risk Monitoring Group

Pursuant to the requirements of the proposed rule, L1 and L2 covered institutions are required to have a risk-control function comprised of individuals who are compensated independently of the people they are monitoring. The real effect of this requirement is that risk-control employees must have their own incentive compensation plans that cannot rely on any measures also relied upon by the plans of the people they monitor. As the proposed rule is currently structured, this means that risk-control personnel would also be ineligible to participate in firm-wide incentive plans and potentially even the firm's profit sharing plan because the individuals they are monitoring also participate in these plans. This is highly problematic, as risk-control personnel typically come from a variety of divisions of the firm including legal and human resources. Thus, under the proposed rule, covered institutions would have to remove specific individuals from the incentive plans to which all of their direct colleagues and team members belong, compensating them differently.

The Center recommends a final version of the rule remove the requirement that individuals working in a risk-management function be compensated independently of those they oversee. Or, in the alternative and if the Regulators do not adopt any of the other changes recommended above which would make this issue moot, the Center suggests the requirement be refined to permit risk-management team members to participate in broad-based and departmental equity plans and still be considered as being compensated independently from those they oversee. The other risk management requirements included in the proposed rule as well as existing requirements stemming from 2010 Standards and other regulatory and best practice risk management programs are already very effective at preventing risky behavior and the compensation independence requirement of the proposed rule does nothing to enhance the effectiveness of Section 956.

X. The Regulators Must Satisfy Legal Standards Regarding Regulatory Alternatives, Rulemakings Decisions.

Rulemaking for Section 956 must adhere to the requirements of the Administrative Procedures Act. Pursuant to the Administrative Procedures Act, U.S. Courts have imparted a number of legal obligations on agencies engaging in rulemaking. For a final rule, the Regulators *must* comply with the following:

- Regarding any final decisions made, the Regulators must "articulate a satisfactory explanation for its action" which draws "a rational connection between the facts found and the choice made."[40]
- The Regulators also have a legal obligation to answer all reasonable objections to a proposed action.[41] For example, if the Regulators determine not to follow the

[40] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[41] See *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962) (overturning adjudicatory order because agency was "unresponsive" to objections); *PPL Wallingford Energy LLC v. FERC*, 419 F.3d 1194, 1198 (D.C. Cir. 2005) ("[U]nless the [agency] answers objections that on their face seem legitimate, its decision can hardly be classified as reasoned." (internal quotation marks omitted)).

Center's recommendations for changing the SRT test to reflect the extremely negative consequences the proposed rule's test will have on recruitment and retention, the regulators would have to detail why the test will not have that result or why the result does not matter.

- The Regulators must support any changes in their decisions with a "reasoned analysis."[42]
- The Regulators cannot use speculation as a replacement for its legal duty to "undertake an examination of the relevant data and reasoned analysis."[43]
- Under established legal precedent, an agency must "cogently explain" why it chose not to pursue alternatives to a proposed regulation.[44] Pursuant to this legal obligation, if the Regulators choose not to adopt some or all of the recommendations received in the comment period, including those in this letter, the Regulators must provide a detailed and cogent justification of its choice as well as an explanation as to why the alternative was not considered.

Failure by the Regulators to fulfill any of the above legal obligations in a final rule would render the rulemaking process defective and unable to survive scrutiny under U.S. law.

---

[42] *Motor Vehicle Mfrs.*, 463 U.S. at 56-56; see also *Ramaprakash v. FAA*, 346 F.3d 1121, 1124 (D.C. Cir. 2003) ("An agency's failure to come to grips with conflicting precedent constitutes 'an inexcusable departure from the essential requirement of reasoned decision making.'").
[43] *Horsehead Res. Dev. Co., Inc. v. Browner*, 16 F.3d 1246, 1269 (D.C. Cir. 1994); see also *Indus. Union Dep't, AFL-CIO v. Am. Petrol. Inst*., 448 U.S. 607, 634, 637 (1980) (agency cannot rely on unfounded assumptions).
[44] *Motor Vehicle Mfrs*., 463 U.S. at 48; see also *Chamber of Commerce of U.S. v. SEC,* 412 F.3d 133, 144-45 (D.C. Cir. 2005).

XI. Conclusion

For the reasons stated above, the Center believes the Agencies working on a final rule should make affirmative changes to the proposed rule to make the focus on the risk-potential of incentive compensation plans and participants rather than the current ineffective focus on pay magnitude and form.

The Center appreciates this opportunity to provide comments on the implementation and rulemaking related to Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. If you have any questions about the Center's comments, please do not hesitate to contact me at [redacted].

Sincerely,

Henry D. Eickelberg
Chief Operating Officer