CENTER ON
EXECUTIVE COMPENSATION℠

September 12, 2024

Mr. James P. Sheesley
Assistant Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Ms. Melane Conyers-Ausbrooks
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Mr. Clinton Jones
General Counsel
Federal Housing Finance Agency
400 Seventh Street SW
Washington, DC 20219

Mr. Ted Dowd
Senior Deputy Comptroller (Acting)
Office of the Comptroller of the Currency
400 Seventh Street SW, Suite 3E-218
Washington, DC 20219

Re: Incentive-Based Compensation Arrangements - RIN 3064-AD86 (FDIC); OCC-2011-0001 (OCC); RIN 3133-AE48 (NCUA); RIN 2590-AA42 (FHFA)

Dear Mr. Sheesley, Ms. Conyers-Ausbrooks, Mr. Jones, and Mr. Dowd:

The Center On Executive Compensation (Center) submits these comments in response to the Notice of Proposed Rulemaking (NPR) regarding incentive-based compensation arrangements issued on May 6th, 2024 by the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), National Credit Union Administration (NCUA), and Federal Housing Finance Agency (FHFA). The NPR represents the latest effort by regulators to implement Section 956 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Section 956).

The Center is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of Chief Human Resource Officers at over 160 large companies, representing a broad cross-section of industries. These comments reflect the input of the top human resources and executive compensation professionals at our member companies, who have extensive experience in crafting compensation disclosures and in engaging with institutional investors on executive compensation matters.

As a threshold matter, Section 956 stipulates that six agencies – the FDIC, OCC, NCUA, FHFA, along with the Federal Reserve (Fed) and Securities and Exchange Commission (SEC) – "*jointly* shall prescribe regulations or guidelines"[1] (emphasis added) to implement incentive-based compensation rules for certain financial institutions. These six regulators have jointly proposed two rulemakings – in 2011 and 2016 – to implement Section 956, however no final rule was ever issued. It is not compatible with the clear language of the Dodd-Frank Act for the four

[1] 12 USC § 5641

agencies that issued the NPR to finalize a Section 956 rulemaking on their own without the Fed and the SEC participating in the process. Nevertheless, because the six agencies will at some point have to implement this mandate under the Dodd-Frank Act, the Center welcomes any opportunity to reiterate our views and concerns with the approach that regulators have taken so far with regard to Section 956.

The Center submitted comprehensive comments to the joint regulators in July 2016 in response to the proposed rulemaking from that year. Because the NPR re-proposes the text of the 2016 proposal without change, our previous comments remain relevant and are attached as an addendum to this letter. The NPR also asks several questions about alternative approaches that the agencies may consider when they ultimately finalize a Section 956 rulemaking. This letter outlines some of the Center's most pressing concerns with both the 2016 proposal and some of the alternative approaches contemplated in the NPR.

I. General concerns with 2016 proposal

Section 956 was included in the Dodd-Frank Act to prevent financial services firms from structuring incentive compensation plans in a manner that encourages employees to take risks that threaten the stability of their firm or even the broader financial system. Unfortunately, as the Center commented previously, the 2016 proposal did not properly focus on risk potential and the prevention of incentive compensation plans that can encourage inappropriate risks. Instead, the 2016 proposal was effectively based upon two misguided principles:

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.

If ultimately implemented, not only would the 2016 proposal fail to achieve the underlying goals of Section 956, but its prescriptive nature would impose an enormous compliance burden upon financial institutions and make it harder to for these institutions to attract and retain top talent. The regulators charged with implementing Section 956 should seek to address these fundamental flaws and draft a rule that is both workable and effective in practice. Unfortunately, the NPR indicates that at least four agencies remain comfortable with the framework of the 2016 proposal. Further, some of the alternative approaches discussed in the NPR would, if adopted, *exacerbate* many of the defects of the 2016 proposal.

II. Questions and alternative approaches discussed in the NPR

Collapsing the three-tier approach of the 2016 proposal to two tiers

One potential alternative discussed in the NPR would be going from a three-tier approach to classify institutions down to two tiers. The 2016 proposal defined Level 1 institutions as having $250 billion or more in assets; Level 2 institutions as having between $50 billion and $250 billion; and Level 3 institutions as having less than $50 billion in assets. Each of these levels would be subject in some instances to certain restrictions. For example, mandatory deferrals of executive compensation in short-term arrangements (50-60% for senior executives; 40-50% for significant risk-takers) would be for a period of four years for Level 1 institutions and three years for Level 2 institutions. For long-term arrangements, it would be two years for Level 1 and one year for Level 2.

The NPR suggests that regulators may instead adopt a two-tier approach, with one level including institutions with assets under $50 billion, and another level of institutions $50 billion and above. The Center urges the regulators to avoid adopting only two tiers. Mid-size financial institutions with just over $50 billion in assets would be lumped in with the largest financial institutions in the country, and potentially become subject to additional recordkeeping, clawback, and other mandates contained in the 2016 proposal. Doing so would make it even harder for regional banks and other middle market institutions to compete both for talent and against their larger counterparts in local markets across the country.

Changing the definition of "significant risk-taker"

The NPR requests comments on two ways that the criteria to identify a significant risk-taker (SRT) at a covered institution could be changed. The first is a risk-based approach that requires an institution to identify its SRTs and submit notification to its primary Federal regulator. SRTs would be defined as an individual (other than a senior executive officer) that an institution identifies because that individual's ability to expose their firm to risk could result in material financial loss. The second option uses a compensation-only test and would require that an institution's identification methodology, at a minimum, capture individuals that are among either the top 2% (L2) or 5% (L1) of highest-paid employees at their firm.

As the Center explained in our 2016 comments, the agencies should provide for an institution-managed "Risk Litmus Test" that permits firms to utilize their specific knowledge of their operations and incentive compensation plans to identify plans that could pose a risk of material financial loss to the institution. This is by far preferable to a one-size-fits-all regulation that does not account for the unique profile of every firm that would be covered by Section 956. An overly broad approach could also lead to homogeneity of incentive compensation plans across the financial services sector in a manner that actually increases overall risk to individual institutions and the financial system.

The Center also strongly disagrees with using a compensation-only test to determine SRTs as it follows the inaccurate assumption that the magnitude of pay is directly correlated with an employee's risk potential. This approach will inevitably include employees in functional and

cross-industry skills groups with no risk potential and inadvertently exclude those outside the 2/5% whose role may have the potential to expose them to harmful financial risk. The compensation-only approach will unnecessarily cover incentive plans that have no ability to award excessive compensation and participants with no ability to facilitate inappropriate risk-taking.

Limiting the use of options

The 2016 proposal would have limited the use options to no more than 15% of the amount of total incentive-based compensation awarded to a senior executive officer or SRT for a particular period. Without any further quantitative or other analysis, the NPR indicates the agencies are considering further restrictions of option use, from 15% to 10%.

The Center previously disagreed with the proposed rule's views on limiting options to 15%, 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 agencies should remove the option deferral value limitation altogether. However, if the agencies determine that a limitation is necessary, a 25% threshold is more appropriate. 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.

Clawbacks

The NPR states that regulators are considering a *mandate* that Level 1 and Level 2 institutions claw back compensation in certain circumstances, rather than a requirement that covered institutions consider clawbacks as part of their incentive compensation plans. If the agencies were to ultimately adopt that mandate, all vested incentive-based compensation would be subject to a clawback for a period of no less than seven years from when the incentive-based compensation vests.

The Center previously argued that prudent risk management is a necessary part of an effective incentive plan design process and a fundamental element of good 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 its governance structure to oversee the

risk program. The Center continues to believe that the board should have the flexibility and discretion in good faith to determine the appropriate punitive actions in accordance with the facts and circumstances of the situation.

Imposing a broad regulatory mandate for clawbacks would also be duplicative (and potentially contradictory) to the voluntary clawback policies that most companies have already adopted. These policies apply to instances of misconduct or fraud – exactly the types of activities that Section 956 is intended to address. The NPR also does not acknowledge that most institutions covered by Section 956 are already complying with the Dodd-Frank Act clawback rules adopted by the SEC in 2022.[2]

In fact, many companies have implemented clawback policies that are more restrictive than SEC rules. According to FW Cook, 80% of large capitalization companies in a recent survey report they maintain a clawback policy that goes beyond the SEC rules. 66% of respondents cover a broader population than the SEC requirements, while 67% have expanded coverage to include more types of compensation.[3] Before any final rule is issued, the Center urges the agencies to consider how companies have already voluntarily established clawback policies and whether new, prescriptive mandates are necessary.

Pre-establishing metrics and targets

The NPR asks whether the agencies should require covered institutions to establish performance measures and targets prior to the beginning of a performance period. Under this requirement, institutions would not be able to change any target after the performance period starts without the documentation and approval of certain personnel. In the case of senior executive officers, such approval would have to come from the board.

The Center supports board approval for establishing or changing incentive compensation plans for senior executive officers. As we have stated previously, the compensation committee should primarily be focused on the compensation packages of senior executives, while providing oversight of the processes used by the company to create incentive compensation plans for other covered employees.

Banning the use of volume or transaction-based metrics entirely

The NPR considers an outright ban on the use of transaction revenue or volume as criteria in incentive compensation plan. Without any additional explanation, the NPR states that the agencies have observed that plans which use such metrics may lead to inappropriate risk-taking.

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[2] 87 FR 73076

[3] https://www.fwcook.com/Blog/Clawback-Provisions-that-Go-Beyond-SEC-Requirements-are-Prevalent-Among-LargeCap-Companies/

A blanket prohibition against incorporating transaction revenue or volume into plan criteria is fundamentally misguided and at odds with the 2016 proposal which would have prohibited plans that use these metrics as the *sole* criteria. Companies select metrics based on their strategic priorities, so eliminating their ability to incentivize employees for a top-line metric is entirely arbitrary and unduly restrictive. Data provided by Equilar showed that in 2023, about 32% of financial services firms used revenue as a short or long-term performance metric. The NPR also does not include any discussion about how such a restriction would discriminate against less mature firms which need to incentivize revenue as part of their strategic objectives.

Required assessments

Under the NPR, agencies are considering a requirement that a "risk management and controls assessment" from the independent risk and control functions be considered when setting incentive-based compensation for senior executive officers and SRTs. Given that such a review is already in place for the many covered firms that already work with independent auditors, the Center believes such a requirement is duplicative and unnecessary.

Reduced compliance timeline from 540 days to 365 days

The Center asserts that the reduced timeline of 365 days is insufficient for companies to re-design their incentive plans, consider all the implications of the changes on their talent and rewards strategies, socialize the proposed changes with business leaders and plan participants, obtain the necessary approvals on the final plan design, and effectively communicate how the program will work to impacted plan participants.

It is important for the agencies to consider that employers have different fiscal years and incentive plan years so the shortened time frame creates unnecessary complexity for in-flight awards. A longer time frame will enable more thoughtful plan design, better understanding of how plans will be administered and increased understanding for employees of their inter-workings of their new compensation programs, particularly with how these plans work from a deferral percentage. As noted in the Center's previous comments, the initial implementation of these plans will result in significant cash flow shortage to an executive for a 3-year period.[4]

III. Conclusion

While the Center appreciates this opportunity to again provide the perspective of our membership on Section 965 implementation, the NPR indicates that the agencies have yet to

[4] From page 25 of the Center's 2016 comments: *"…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."*

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address and correct the most serious flaws of the 2016 proposal. The Center believes that the agencies should re-think their current approach to Section 956 and embrace a more principles-based approach to this rulemaking that would much more effective in protecting covered institutions and the financial system from inappropriate risk-taking. The Center looks forward to continuing to serve as a resource for the agencies on the important topic.

Sincerely,

Ani Huang

Ani Huang
President & CEO
Center On Executive Compensation