



VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS
AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

July 22, 2016

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Incentive-Based Compensation Arrangements

Dear Secretary Fields:

On June 10, the U.S. Securities & Exchange Commission (SEC) along with the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Federal Housing Finance Agency published its request for public comment on a joint proposed rule limiting incentive-based compensation practices at certain financial institutions (Proposed Incentive-Based Compensation Rule).¹ Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) instructs financial regulators to jointly issue regulations or guidelines prohibiting incentive-based payment arrangements that they determine may encourage inappropriate risk-taking or that could lead to material financial loss. The regulations or guidelines must also require financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate financial regulator.

The Financial Services Institute² (FSI) appreciates the opportunity to comment on this important proposal. FSI members support the agencies' efforts to promote healthy financial markets by reducing inappropriate risk, while recognizing the important role that risk plays in the marketplace.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the U.S., there are approximately 167,000 independent financial advisors, which account for approximately 64.5% percent of all producing registered representatives. These financial advisors are self-employed independent contractors, rather than employees of Independent Broker-Dealers (IBD).

¹ Incentive- Based Compensation Arrangements, 81 Fed. Reg. 37669 (June 10, 2016).

² The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.

FSI member firms provide business support to financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners who typically have strong ties to their communities and know their clients personally. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations and retirement plans with financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their investment goals.

Discussion

FSI appreciates the opportunity to comment on the Proposed Rule. FSI and its members recognize the role that poorly structured incentive-based compensation practices in the financial industry played in the recent financial crisis. However, we believe that incentive-based compensation arrangements promote the health of financial institutions and the broader financial system by allowing financial institutions to attract and retain highly qualified staff, encourage quality performance, and reward individual employees. In order to appropriately reap the benefits of incentive-based compensation, the arrangement must align the interests of employees with those of the institution's shareholders and other stakeholders. In seeking to reduce the negative consequences of inappropriate risk-taking, individual institutions need to be able to tailor policies appropriately for their businesses to hold accountable those employees who have the ability to expose the financial institution to material risk and significant loss.

We provide our comments and suggestions in the sections below.

I. Changes From the 2011 Proposal

A. Supervisory Experiences

In 2011, the Federal banking agencies proposed a rule (the 2011 Proposal) requiring incentive-based compensation arrangements to be consistent with three key principles: they should appropriately balance risk and financial rewards; be compatible with effective risk management and controls; and be supported by strong corporate governance.³ “The Agencies proposed that financial institutions with \$1 billion or more in assets be required to have policies and procedures to ensure compliance with the requirements of the rule, and submit an annual report to their Federal regulator describing the structure of their incentive-based compensation arrangements.”⁴ Institutions with \$50 billion or more in total consolidated assets would be required to defer fifty percent of incentive-based compensation for executives for at least three years and the board of directors would be required to approve compensation agreements for certain employees. The current proposal revises the 2011 Proposal and establishes general requirements applicable to the incentive-based compensation arrangements of all covered institutions. FSI appreciates the changes made in this re-proposal reflecting the Agencies' collective supervisory experiences since the initial proposal, as well as industry and stakeholder comments.

³ Incentive Based Compensation Arrangements, 76 Fed. Reg. 21170 (April 14, 2011).

⁴ *Id.* at 37677. The 2011 Proposal does not specify whether this is \$1 billion in assets under management or total consolidated assets.

The Proposed Rule distinguishes covered institutions by asset size, applying less prescriptive requirements to smaller institutions and progressively more rigorous requirements to larger institutions. FSI supports this tiered application of the proposed rule's requirements, which allows institutions to better tailor their policies to discourage inappropriate risk.

FSI commends the Agencies for including a grandfathering provision for any incentive-based compensation plan with a performance period beginning before the effective date of the Proposed Rule. FSI also supports replacing the previously proposed annual reporting requirement with a record keeping requirement of seven years to better align the proposed rule with the SEC's record retention rules.⁵

B. Principles-based Approach

In order to address the far-reaching, negative consequences for the economy arising from inappropriate risk-taking by larger financial institutions, the Federal banking agencies adopted in 2010 principles-based guidance regarding incentive-based compensation programs. The guidance was intended to encourage institutions to ensure that these arrangements tie rewards to longer-term performance in a way that does not undermine the safety and soundness of financial institutions or the financial system as a whole. FSI appreciates such a principles-based approach, which allows advisory firms to tailor their plans as appropriate for their business.

Under the Dodd-Frank Act, Congress has required the Federal banking agencies to jointly prescribe regulations or guidelines that cover financial institutions; using their collective supervisory experiences, the agencies are proposing a uniform set of enforceable standards. While FSI members still believe that guidelines would be the best approach, we appreciate that the Proposed Rule would promote better incentive-based compensation practices, while still allowing for some flexibility in their design and operation to allow firms to address individual needs more effectively.

II. **Limiting Material Loss by Prohibiting Inappropriate Risk**

A. Introduction

Risk is an inherent part of the capital markets and is essential to ensure the strength of our financial system. As SEC Chair White recently said, “[The capital markets] are built on taking informed risks in exchange for potential returns on investments that can be used to buy a home, pay for college, and fund a retirement...Risk-taking is essential to this process, and regulators should not seek to eliminate it altogether. But regulators must safeguard the investment and capital raising process from unacceptable risks that can dilute, distort, or disable the fair playing field that is integral to robust free financial markets.”⁶ The 2014 Global Financial Stability Report by the International Monetary Fund (IMF) discussed reforms intended to enhance banks' risk governance and to ensure that pay practices fully reflect the risks that bankers take.⁷ The study acknowledged that risk is a part of a bank's mission, noting that “modern compensation systems

⁵ SEC Retention of Records Relevant to Audits and Reviews Rule, 17 CFR Part 210 (2003).

⁶ Chair Mary Jo White, Chairman's Address at SEC Speaks “Beyond Disclosure at the SEC in 2016” (Feb. 19, 2016), available at <https://www.sec.gov/news/speech/white-speech-beyond-disclosure-at-the-sec-in-2016-021916.html>.

⁷ Risk Taking, Liquidity, and Shadow Banking: Curbing Excess while Promoting Growth, International Monetary Fund (October 2014) available at <http://www.imf.org/external/pubs/ft/gfsr/2014/02/pdf/text.pdf> (last visited July 20, 2016).

grew partly out of concern about insufficient risk taking by managers.”⁸ We agree with Chair White and the IMF on this point and, therefore, support policies that ensure employees who are in a position to expose a financial institution to substantial risk are not incentivized to take inappropriate risks.

B. Balance

FSI supports the Proposed Rule’s effort to incorporate performance measures that balance short and long-term risks. The proposed rule provides that compensation will be considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed, taking into consideration all relevant factors, including:

- The combined value of all compensation provided to a covered person;
- That person’s compensation history;
- Compensation practices at comparable institutions; and
- Any fraudulent act or breach of fiduciary duty by the covered person.

FSI commends the Commission for allowing financial institutions to tailor incentive based compensation arrangements to align their employee’s interests with those of the institution. However, we are concerned that the concept of appropriate risk is not sufficiently defined in the rule. The Proposed Rule would deem an incentive-compensation arrangement to encourage inappropriate risk unless it appropriately balances risk and reward; is compatible with effective risk management; and is supported by effective governance. The rule would create a rebuttable presumption of inappropriate risk rather than affirmatively defining appropriate risk. Because what is appropriate to some may not seem appropriate to others, further clarification of the concept of appropriate risk would help financial institutions better comply with the rule. We therefore urge the SEC to issue interpretative guidance on this important point.

III. **Covered Persons Threshold**

A. Significant Risk-Taker

The Proposed Rule’s definition of “significant risk-taker” is intended to extend the rule’s requirements and prohibitions on incentive-based compensation arrangements to individuals who are not senior executive officers but are in a position to put certain covered institutions at risk of material financial loss. The definition of a significant risk taker incorporates two parts. The “relative compensation test” is based on a covered person’s annual base salary and incentive-based compensation relative to other covered persons working for the covered institution and its affiliate covered institutions. The “exposure test” is based on whether the covered person has authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution. The Proposed Rule’s stated purpose is to reduce inappropriate risk and to minimize the negative impact of such risk on financial institutions. While it is important to ensure that compensation does not jeopardize the overall health of the financial system, financial institutions need to be able to attract and retain qualified staff, particularly at the senior executive officer level. The Global Financial Stability Report found that “the level of executive compensation in banks is not consistently related to their risk taking.”⁹ Rather, banks

⁸ *Id.* at 106.

⁹ *Id.* at 105.

with board independence, risk committees, equity pay, and institutional investors take less risk.¹⁰ FSI believes that using only the exposure test to identify covered persons will minimize inappropriate risk taking, while allowing businesses to properly tailor staff compensation to meet their needs. As a result, we ask that only the exposure test be used to designate which employees are significant risk-takers instead of the relative compensation test.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with the SEC on this and other important regulatory efforts

Thank you for considering FSI's comments. Should you have any questions, please contact me at [REDACTED].

Respectfully submitted,

A handwritten signature in black ink, appearing to read "D. T. Bellaire". The signature is fluid and cursive, with a large initial "D" and "T" followed by "Bellaire".

David T. Bellaire, Esq.
Executive Vice President & General Counsel

¹⁰ *Id.* at 125.