FINANCIAL SERVICES ROUNDTABLE

July 22, 2016

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RE: **Incentive-based Compensation Arrangements** (FRB Docket No. 1536 and RIN No. 7100 AE-50; OCC Docket ID OCC-2011-0001; SEC File No. S7-07-16; and FDIC RIN 3064-AD86) (81 FR 37670, June 10, 2016)

Dear Sirs or Madams:

The Financial Services Roundtable ("FSR," "we" or "our") welcomes the opportunity to submit this letter to the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), the Office of the Comptroller of the Currency (the "OCC"), the Securities and Exchange Commission (the "SEC") and the Federal Deposit Insurance Corporation (the "FDIC") (each an "Agency" and collectively, the "Agencies") in connection with the Agencies' joint proposal (the "Proposal") on incentive-based compensation arrangements. The Proposal, designed to implement Section 956 (the "Statute") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), mandates prescriptive requirements for a wide range of financial institutions. We believe these requirements are unsupported by the Statute's language.

FSR represents nearly 100 of the largest U.S. integrated financial services companies providing banking, insurance, financial and investment products and services to American consumers. FSR member companies directly account for $54 trillion in managed assets, $1 trillion in revenue and 2 million jobs. FSR members, directly or through subsidiaries, engage in holding company, banking and securities activities regulated by the Agencies. In addition, a number of FSR members directly engage in insurance activities regulated by state law that appear to be included in the scope of the Proposal. Adoption of the Proposal would directly affect FSR members through increased costs associated with employment, compliance, and risk management. Further, adoption of the Proposal would hamper FSR members in their ability to attract and retain qualified employees.

General Comments

FSR supports the policy of relating incentive compensation to risk. FSR members have already taken significant steps to respond to and comply with Guidance on Sound Incentive Compensation Policies (the "2010 Guidance")[1] issued by the Banking Agencies (as defined below) in 2010 by refining and modifying their incentive compensation arrangements, corporate risk management programs, corporate governance policies and other related practices to discourage imprudent risk-taking. The Proposal, however, significantly departs from the Agencies' original proposed rulemaking issued in 2011 (the "2011 Proposal")[2] and conflicts with the principles-based 2010 Guidance.

FSR appreciates the opportunity to comment on this re-proposal. FSR believes that the current Proposal has serious flaws that must be addressed. If the Agencies fail to address these flaws, each financial institution covered by the Proposal will be at a serious competitive disadvantage to less regulated firms—both financial and nonfinancial.

The prescriptive nature of the Proposal precludes each Covered Institution from designing incentives, risk management, corporate governance and related practices to fit the needs of the Covered Institution and the markets in which it competes. Without the ability to compensate employees on a competitive basis, Covered Institutions may be unable to attract and retain critical talent. A loss of institutional knowledge may increase risk. Increased employee turnover will result in increased expenses in talent acquisition and training. Of most concern, the loss of critical talent and management continuity may ultimately jeopardize the financial stability of Covered Institutions, a consequence surely unintended by the Agencies.

Federal law under the Administrative Procedure Act, discussed below, requires the Federal Reserve Board, the OCC, and the FDIC (collectively, the "Banking Agencies") to assess whatever administrative burdens new regulations would place on insured depository institutions. While the Proposal evidences the SEC's consideration of such administrative burdens, the Proposal does not reflect such consideration by the Banking Agencies. The lack of such consideration is a serious flaw in the Banking Agencies' process and should be corrected.

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[1] 75 FR 36395 (June 25, 2010).

[2] 76 FR 21170 (April 14, 2011).

FSR has six key areas of concern with the Proposal:

1. The Proposal exceeds the mandate of the Statute;

2. Adoption of the Proposal would undermine the industry's ongoing risk-based modifications to incentive compensation arrangements;

3. Adoption of the Proposal would place the regulated financial services industry at a harmful competitive disadvantage to both financial and nonfinancial institutions, in retaining critical talent and recruiting skilled employees;

4. The prescriptive nature of the Proposal is unworkable;

5. Adoption of the Proposal would have additional negative unintended consequences; and

6. The costs of implementing the Proposal would be enormous, add complexity without improvements and outweigh any benefits of adoption of the Proposal.

FSR believes that there are less costly, more efficient and more appropriate ways to balance incentive compensation with risk. We present our suggestions for these alternative methods following discussion of the areas of concern.

1. <u>The Proposal exceeds the mandate of the Statute.</u>

Generally, in considering whether federal agencies have adopted final regulations consistent with a statutory mandate, a reviewing court may find that any final rule exceeds the statutory authority granted by the Statute. Agencies may not impose a burden that the statute does not contain.[3] When regulations impose extraneous and extralegal burdens, the Administrative Procedure Act[4] would require a reviewing court to hold the final rule unlawful and set aside the Agencies' actions adopting it.[5]

Subsection (b) of the Statute requires the Agencies to prescribe "regulations or guidelines" that prohibit any type of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by Covered Institutions: (1) by providing an executive officer, employee, director or principal shareholder of the Covered Institution with excessive compensation, fees or benefits; or (2) that could lead to material financial loss to the Covered Institution. Subsection (c) of the Statute requires that the Agencies shall (1) ensure that any *standards* for compensation established under subsections (a) or (b) are comparable to the *standards* established under the Federal Deposit Insurance Act[6] ("FDIA") for insured depository institutions; and (2) in establishing such *standards* under such

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[3] *Brown v. Gardner*, 513 U.S. 115, 120 (U.S. 1994).

[4] 5 U.S.C. 551 et seq.

[5] 5 U.S.C. 706(2)(C).

[6] 12 U.S.C. 1811 et seq.

subsections, take into consideration the compensation standards described in Section 39(c) of the FDIA.[7] Thus, the Statute clearly contemplates that the Agencies would establish broad standards and suitable guidance regarding incentive compensation plans that are unique to the institutions that they regulate.

The Proposal, however, issued separately by each Agency and with certain differences in each, includes more than 706 printed pages of detailed, prescriptive requirements. Nothing in the statutory language compels, or even suggests that Congress intended the Statute to create the level of prescriptive detail that is set forth in the Proposal. The Proposal contains numerous, detailed and complex requirements and would impose extraordinary and unprecedented limitations on the incentive-based compensation arrangements of most Covered Institutions. For example, Section __.7(a) requires deferral of various specified percentages of incentive compensation depending on the asset size of the parent holding company or firm and the status of the recipient. Section __.7(a) further mandates the period of time that such compensation is to be deferred depending on the asset size of the parent or firm. Section __.7(a) also dictates the vesting speed and even composition of incentive compensation, including limiting the amount of equity options that may be deferred. Section ___.5 requires Covered Institutions to create certain detailed records annually—with newly imposed seven-year retention requirements. These records, never before maintained in this manner, require (1) the identities of senior executive officers and significant risk-takers, listed by legal entity, job function, organizational hierarchy and line of business; (2) incentive-based compensation arrangements for such persons (including the percentage of such compensation deferred and form of award); (3) forfeiture, downward adjustment and clawback reviews and decisions for such persons; and (4) material changes to arrangements and policies. The Proposal would require additional recordkeeping by Covered Institutions to demonstrate control, risk management, oversight of triggering events, investigations, and corporate governance. All of these records would be open to Agency examination, thus creating additional regulatory burdens.

In discussing the Proposal, the Agencies repeatedly assert that the Statute mandates each of its requirements.[8] The Agencies, however, have not set forth the basis of any such determination. Only Sections ___.1 through ___.4 of the Proposal are actually required by the Statute. The Statute requires the Agencies to prescribe regulations or guidelines that prohibit incentive compensation arrangements and features that the regulators determine encourage inappropriate risks by either providing excessive compensation or possibly leading to a material financial loss. Rather than stopping at Section ___.4, the Proposal continues in Sections ___.5 through ___.11 to require deferral, forfeiture, downward adjustment, clawbacks, controls and specific governance. None of these requirements is either mentioned or mandated by the Statute. Furthermore, none of these requirements has been examined, tracked, identified or proven to

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[7] 12 U.S.C. 1831 p-1(c).

[8] The Proposal cites Section 956 and its requirements five times in its Introduction (81 FR 37672 and 81 FR 37673) and explains that the Proposal is to implement Section 956 (81 FR 37673). The Proposal's Section-by-Section analysis explains that the Proposal is issued pursuant to Section 956 (81 FR 37682) and is consistent therewith (81 FR 37682). It further explains that exclusion of institutions with less than $1 billion in assets is consistent with Section 956 (81 FR 37688), etc.

help mitigate or prevent inappropriate risk taking, excessive compensation, or material financial loss.

The Proposal further exceeds the statutory authority in that it seeks to regulate all variable compensation systems without regard to whether they present any potential for encouraging "inappropriate risk." The Agencies are charged with regulating any incentive-based compensation system that "encourages inappropriate risk," not with regulating all variable compensation systems. Section 956 requires regulators to determine whether a variable compensation system encourages inappropriate risks. The Proposal exceeds the statute's authority it that it effectively assumes that all variable compensation systems encourage inappropriate risk without the statutorily required determination of whether it actual encourages inappropriate risk.

2. <u>Adoption of the Proposal would undermine the industry's ongoing risk-based modifications to incentive compensation plans.</u>

Following the adoption of the 2010 Guidance, each of the Covered Institutions subject to the Guidance has engaged in substantial activities over the past six years to refine and change its own unique incentive compensation program, corporate risk management structure, corporate governance and other related practices to conform to the 2010 Guidance. In addition, the Banking Agencies have modified guidance to their examiners based on the Banking Agencies' experience and the marketplace. As a result, Covered Institutions subject to the 2010 Guidance and the Banking Agencies have made substantial progress in aligning incentive-based compensation arrangements to institutional risk tolerances and regulatory expectations. FSR recommends building on this progress and the experience gained under it by expanding the 2010 Guidance to implement Section 956 in a principles-based approach applicable to all Covered Institutions. It is not at all clear how the Proposal would affect—or conflict with—the existing 2010 Guidance that has worked so well to reduce risks that pose a threat to institutional safety and soundness, whether the Proposal would replace the 2010 Guidance and, if not, how inconsistencies between the 2010 Guidance and the Proposal might be resolved.

Currently, examiners review and evaluate each institution holistically for purposes of determining the risk profile of the institution and how it manages such risk. The detail and prescriptive nature of the Proposal would upend this institution-specific process as well as decades of incentive compensation definitions and common usage of terms. Thorough consideration needs to be given by the Agencies to how these changes would impact current plans and particularly the requirement that publicly traded financial institutions must accurately disclose these compensation arrangements to their shareholders. Adoption of the Proposal will create significant uncertainty and substantially lengthen public company compensation disclosures, which may frustrate the purposes of securities laws by potentially decreasing shareholder comprehension of compensation programs. In addition, the SEC is on the verge of further revising requirements for executive compensation, as it implements the remaining provisions of the Dodd-Frank Act. It is uncertain how those new changes and the Proposal will be implemented—particularly with the newly invented compensation terms and conditions contained in the Proposal. The magnitude of change that would come from the adoption of the

Proposal is unnecessary and is likely to have the unintended effect of *adding risk* to institutions in administering plans, describing them accurately to employees, and making public disclosures about how the plans work.

FSR would advise the Agencies instead to adopt portions of Sections .__5 to .__11 of the Proposal as guidelines rather than a final rule. We recognize that the Agencies must implement some portion of the Statute, such as the reporting requirements under Subsection (a) of the Statute, with formal rules. However, as discussed above, FSR believes that the Agencies should continue to build on the 2010 Guidance process, which is rooted in balancing the institutional specific risk and incentives, rather than mandate a rigid, "one size fits all" approach based on overall industry risk.

3. <u>Adoption of the Proposal would place the regulated financial industry at a harmful competitive disadvantage to both financial and nonfinancial institutions in retaining and recruiting employees.</u>

If the Proposal were to be adopted, senior executive officers and significant risk-takers at Level 1 and Level 2 Covered Institutions would receive readily available incentive compensation in amounts significantly less than they would receive from other potential employers. These critical employees are financially sophisticated and will be keenly aware of such a disparity, as will lower level employees aspiring to these positions. Many will act upon that information and seek employment in other industries or in non-regulated financial institutions that can lawfully provide a broader array of incentive compensation options. Employees impacted by the Proposal will immediately assess a discount on the value of a compensation package with mandatory deferrals, clawbacks and changed vesting requirements. Notably, this discount would cause the anomalous result of higher total compensation costs for Covered Institutions as they strive to offset the negative effects of the Proposal on retention and recruiting of employees. In addition, it is likely that the most talented recruits and employees would either not join or leave the industry entirely.

The impact of the Proposal may best be illustrated by the ability of a competitor to only pay an employee as little as 41 cents in incentive compensation to provide more immediate benefit to an employee than a dollar of incentive compensation provided from a Covered Institution if the Proposal were to be adopted.[9] This illustration does not even account for the time-valued discounting of compensation subject to delayed vesting periods mandated by the Proposal. If the Proposal goes into effect, potential employees will discount employment offers from Covered Institutions and some current employees may choose for the same reason to leave Covered Institutions. During periods of low unemployment, such as the country is currently experiencing, Covered Institutions will face even greater competition for skilled employees.

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[9] For example, if Ms. Ledger, a senior executive officer at a Level 1 Covered Institution, earned $115,000 under annual incentive plans for the performance period ending on December 31, 2024, at least 60% of that amount would be required to be deferred for at least three years and Ms. Ledger would only receive cash and equity with an aggregate value of $46,000 in March 2025. To provide a *greater immediate benefit* to Ms. Ledger, a competing non-Covered Institution could offer to pay her an annual incentive bonus in March following the end of a performance period of as little as $47,000. This amount also would not be subject to a forfeiture or clawback.

4. The prescriptive nature of the Proposal is unworkable.

FSR is concerned that the Agencies seem to be moving in an unprecedented direction. Historically, the Agencies have not attempted to prescribe or influence compensation that an institution provided to employees, but instead have required a sound rationale, appropriate policies and procedures, board oversight and full disclosure of such compensation. The Agencies have focused on principles-based regulation and required institutions to establish appropriate levels and forms of compensation, based on the characteristics of the institution, including its risk profile. In that way, compensation practices that are unique to an institution could support the unique strategy and profile of the institution. FSR does not believe that the Agencies should change this principles-based approach. The concept of "excessive compensation" is vague and subjective, and rules that prescribe the deferral of a specific percentage of compensation are unprecedented, unworkable and inappropriate.

5. Adoption of the Proposal would have negative unintended consequences.

FSR is concerned that these overly prescriptive rules will inevitably lead to negative unintended consequences. For example, the Proposal seems certain to force competitively Covered Institutions and their employees toward more fixed compensation such as base salaries, as has occurred in the United Kingdom.[10] Compensation market practices have evolved to provide greater variable and less fixed compensation as employers have had to control expenses and look for ways to meet profitability goals and provide total shareholder return. Additionally, as noted above, the Proposal seems likely to push Covered Institutions to increase the amount of total compensation, in order to match the amounts of compensation that is immediately available to employees at competitors not subject to the deferral (and other) requirements of the Proposal. Both of these results would be counterproductive at a time when shareholders demand fewer increases in total compensation and performance-based compensation that aligns employees' interests with their own. The Proposal will cause Covered Institution compensation programs to diverge dramatically from non-covered institutions, and could subject Covered Institutions to heightened scrutiny from governance groups, institutional investors and the media as they are forced to justify increases in fixed compensation and decreases in pay for performance.

6. The costs of implementing the Proposal would be enormous, add complexity without improvements and outweigh any benefits of adoption of the Proposal.

FSR has surveyed its members as to how costly it would be to implement the Proposal. The results of that survey suggest that the costs would be enormous. To the extent our members can quantify the impact of the Proposal, several of our members have estimated that the annual direct costs to implement the Proposal for their institution would be at least $10 million. Additionally, our members have indicated that they would have to hire as many as 30 new full-time employees on a permanent basis to comply with this rule. While the SEC has performed an

[10] An international benefits consulting firm study of 71 global financial services in November 2015, indicated that 61% of financial services companies had increased their employee's fixed pay by more than 5%, while 58% had reduced variable pay by more than 5%. http://www.mercer.com/newsroom/bonus-caps-impact-pay-mix-more-than-total-pay-as-banks-and-insurers-continue-to-embed-sound-risk-culture.html.

analysis of the costs that the Proposal would impose upon the firms it regulates, it appears that the Banking Agencies have not undertaken such an analysis. The OCC estimates that the maximum one-year cost the Proposal would impose on the private sector would be approximately $50 million, but the basis of that estimate has not been disclosed. FSR's survey suggests that costs of implementation as the Proposal exists in its current form, will not only greatly exceed the OCC's estimate on a cumulative basis, but will in fact frequently exceed that estimate even when only Level 1 institutions are included.

The Agencies need to balance these enormous costs against the benefits of the Proposal and, where the costs are so high, reasonably tailor the Proposal to solve more narrowly the problem being addressed. The Agencies should consider less costly alternatives. By law, the Banking Agencies are obligated, in determining the administrative compliance requirements of new regulations that impose requirements on insured depository institutions, to consider any administrative burdens that such regulations would place on depository institutions.[11] It appears that the Agencies have failed to do so. Further, two recent Presidential Executive Orders have urged that regulatory agencies propose and adopt regulations only upon reasoned determinations that their benefits justify their costs.[12] It is not at all clear that the Agencies have made that kind of reasoned determination in this case.

A recent academic study investigated "the role of executive-specific attributes (or 'styles') in explaining bank business models beyond pay-per-performance incentives."[13] The academic study found that "regressions that only include compensation variables or only include other observable manager attributes produce an average adjusted [difference] of only 4%. In contrast, models that include manager fixed effects as the only variables produce an adjusted [difference] of 72% on average. Therefore, unobservable manager characteristics (as captured by manager fixed effects) far outrank executive compensation and other observable manager variables in terms of their ability to explain variation in bank business models."

FSR respectfully suggests that the Agencies consider the following alternative approaches to the Proposal.

First, FSR respectfully suggests that the Agencies reconsider the Proposal and re-propose rules that use the 2010 Guidance to implement Section 956 in a way that uses a principles-based approach that allows each Covered Institution to design incentive compensation programs that are consistent with its own risk appetite and risk governance structure. The principles in the 2010 Guidance are designed to ensure that incentive compensation policies do not encourage imprudent risk-taking and are consistent with the safety and soundness of the Covered Institution by appropriately balancing risk and reward, ensuring effective controls and risk management and programs supported by strong corporate governance, including active and effective oversight by

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[11] 12 U.S.C. § 4802(a)(1).

[12] Exec. Order 13579, 76 F. R. 41587 (July 14, 2011); Exec. Order 13563, 76 F.R. 41585 (Jan. 18, 2011).

[13] See, Hagendorff, Saunders, Steffen and Vallascas, "The Wolves of Wall Street: Managerial Attributes and Bank Business Models." http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2670525.

the board of directors. The Agencies should eliminate the prescriptive rules in the Proposal, as they do not allow Covered Institutions to incorporate institution-specific risks.

FSR also strongly believes it is inappropriate to apply the Proposal to operating insurance companies or manufacturers that are parent companies to a bank or thrift institution. Insurance companies and captive finance entities are inherently different from banks and do not implicate the same issues in the financial system. The business model of insurance companies involves risk-management of a greatly different nature that would not be usefully or appropriately addressed by the Proposal. Applying the Proposal to the discrete few insurance companies regulated as Covered Institutions, in particular, would harm their ability to retain and attract high quality employees and, thereby potentially reduce the strength and success of such companies and unfairly and unnecessarily put them at a competitive disadvantage to their peers.

Similarly, applying the Proposal to diversified, non-financial companies that own thrift institutions as SLHC's are inherently different than bank holding companies and should not be subject to incentive compensation rules that are based on bank-like activities and bank-like risks. This is another discrete categories of companies for which the Proposal's rules are particularly unsuitable.

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FSR has separated its more detailed comments into two categories, which are discussed in separate Addenda:

1. Issues Applicable to all Regulated Institutions – Addendum A

2. Issues Applicable to Insurance Companies – Addendum B

Thank you for considering our comments. Please do not hesitate to contact me or my colleague Robert Hatch at (202) 589 -2429 if we can provide you with any further information.

Sincerely,

Rich Foster

Rich Foster
Senior Vice President & Senior
Counsel for Regulatory and Legal Affairs
Financial Services Roundtable
[redacted]

ADDENDUM A

Specific Comments on Issues Applicable to all Regulated Institutions

A. The Proposal's Structure is Not Appropriate (§_.2(i)).[14]

FSR believes that the asset thresholds in the Proposal are not the appropriate methodology for determining which requirements apply.

1. Asset size alone is a poor proxy for risk (§_.2(v), (w) and (x)).[15]

Asset size alone is a poor proxy for risk. FSR recognizes that it may be necessary for the Agencies to use asset size as a component of the method for distinguishing among Covered Institutions in terms of the relative potential risk they may pose to the U.S. financial system. However, any distinctions among the requirements applicable to Covered Institutions should also include a component of the actual risk posed by the institution based on the complexity of its operations and the products it offers.

Additionally, applying substantially more restrictive and costly requirements to some financial institutions based solely on their asset size would be anticompetitive, since it would place certain institutions at a significant disadvantage when competing for talent within the financial services industry.

FSR believes that the Proposal should move away from asset-based measures and toward risk-based measures. The Proposal itself recognizes a variety of risk categories that go beyond asset size. We suggest that the Agencies provide for each Covered Institution to conduct an internal review of the complexity of its activities, operations, risk profile, and compensation practices (similar to the horizontal review). The Covered Institution would share the results of this review with its regulator and jointly determine whether to apply additional safeguards. Among the factors the Covered Institution and its regulator could consider would be: (i) significant levels of off-balance sheet activities, such as derivatives that may entail complexities of operations and greater risk than balance sheet measures; (ii) particular high-risk business lines, such as lending to distressed borrowers or investing or trading in illiquid assets; (iii) whether the Covered Institution is part of a complex organizational structure, such as operating with multiple legal entities in multiple foreign jurisdictions; and (iv) significant use of incentive-based compensation to reward risk-takers.

2. The asset thresholds in the Proposal are not appropriate (§_.2(v), (w) and (x)).[16]

FSR strongly believes that in the absence of major changes, the Proposal will be ill suited to meet the statutory objectives of Section 956 and that the Proposal will be improved to the extent it reduces its focus on asset thresholds.

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[14] The Proposal's request for comments covered in this section: 1.1, 1.2, 2.1-2.13, 2.44-2.46, 3.1-3.6, 6.1-6.5, 7.5 and 9.1.

[15] The Proposal's request for comments covered in this section: 2.4, 2.7, 2.8 and 9.1.

[16] The Proposal's request for comments covered in this section: 2.6, 2.7, 2.8, 2.44, 6.5 and 7.5.

As it stands, the three-level structure of the Proposal is anticompetitive and should be replaced with a regulatory approach applicable to all Covered Institutions, which avoids placing certain institutions at a significant disadvantage when competing for talent. Large diversified financial institutions compete with many unregulated businesses every day for talent. For example, in hiring cybersecurity expertise, Covered Institutions will compete with technology companies, such as Google or Apple. Under the Proposal, the definition of a significant risk-taker could easily pick up a highly skilled and well-compensated member of a Covered Institution's cybersecurity team, whose responsibility is to protect the institution's proprietary information and its customers' confidential personal data. This individual has no role in risk-taking at the Covered Institution but instead is employed to mitigate and prevent risks associated with cyber threats. It will be difficult for Covered Institutions to compete for the talent they need if Covered Institutions must impose the enhanced incentive-based compensation restrictions imposed by the three-level structure of the Proposal.

If the Agencies maintain the prescriptive level approach in the final rules, FSR believes that there should only be two levels and that no institution should be subject to the requirements currently detailed under "Level 1" of the Proposal. The resulting two-level approach would be similar to the 2011 Proposal. Under the two-level approach, the requirements currently proposed for Level 2 Covered Institutions would be applied under a principles-based approach to Covered Institutions that, based on their size, funding structure, and business activities, pose greater risks for the broader economy and financial system. The remaining lower Level would compress into a single tier those Covered Institutions that were formerly defined as being Level 2 or Level 3 Covered Institutions and would also apply the 2010 Guidance to the extent applicable. We believe that a two-level structure will significantly reduce the burdens imposed by the Proposal and reduce the possibility that certain Covered Institutions may receive a competitive advantage simply due to their organizational structure and U.S.-based assets.

As explained above, FSR believes the Proposal will be improved to the extent it reduces its focus on asset thresholds. However, if the final rules fail to adopt a principles-based approach, and retains three levels of differentiation between Covered Institutions, FSR believes that the Agencies must carefully reevaluate the appropriateness of the asset thresholds in the Proposal, to ensure they accurately reflect meaningful differences among Covered Institutions.

3. <u>The requirements applicable to subsidiaries that are Covered Institutions generally should be based on the average total consolidated assets of the subsidiary, not the holding company parent (§_.2(b)).[17]</u>

The Proposal would apply the more specific provisions of the Proposal to smaller institutions based on the consolidated assets of the parent holding company. As the Proposal recognizes, this approach would create significant disadvantages for smaller subsidiaries of larger Covered Institutions.

Requiring the smaller subsidiaries of larger Covered Institutions to apply the more restrictive provisions of the Proposal to their employees would substantially impair the ability of

[17] The Proposal's request for comments covered in this section: 2.3, 2.4, 2.5, 2.6, 2.7, 2.8, 2.9, 2.11, 2.12, 2.44 and 4.7.

those subsidiaries to compete for talent against entities in the same business that are not part of a larger Covered Institution.

Additionally, it simply does not follow that, because a smaller bank or thrift institution is a subsidiary of a larger Covered Institution, it is taking more risk than the same size entity that is standing alone (or is part of a smaller institution).

Importantly, the burdens and competitive disadvantage imposed on smaller subsidiaries of larger Covered Institutions would hinder the efforts of, and possibly dissuade, those larger institutions from diversifying their business as a way of reducing their overall risk profile, which would be contrary to the Agencies' long-standing policy. The Proposal would discourage, and even prevent, Covered Institutions from diversifying into businesses and offering new services, because a Covered Institution, if subjected to the proposed prescriptive rules, would be severely hampered in its ability to compete with a less regulated business entity. Discouraging diversification is not good for the soundness of the financial services industry.

For example, an asset management subsidiary within a Covered Institution competes for talent with hedge funds. If an asset management subsidiary is owned by a Level 1 or Level 2 Covered Institution, the deferral (and other) requirements of the Proposal would place it at a significant disadvantage in terms of its compensation program as compared to an asset manager owned by a smaller Covered Institution or not being bank-owned at all.

Covered Institutions that operate globally also would be placed at a significant disadvantage in competing with business entities in a country that does not have the deferral (and other) requirements of the Proposal.

FSR appreciates the Agencies' efforts to reduce the compliance burden on smaller subsidiaries of larger institutions. The Proposal would permit holding company subsidiaries to satisfy the Proposal's requirements if the parent causes compliance by the subsidiary. However, this element of the Proposal would not reduce the burden of complying with the requirements; it would only push the burden up the ownership chain to the parent Covered Institution. The same onerous deferral (and other) requirements would still apply to the smaller subsidiary. In particular, based on a survey of our members, more than 35% do not design and administer their incentive based compensation arrangements at the holding company level. Additionally, the business nature, workforce, and compensation structure (including incentive-based compensation) of the parent Covered Institution will often be very different from that of the subsidiary Covered Institution. For example, the business nature, workforce, and compensation structure of a relatively small broker-dealer within the structure of a larger commercial bank are dramatically different from those of the parent Covered Institution.

The operations, services and products of a broker-dealer or investment adviser—even those that exist as subsidiaries of a larger commercial bank—are substantially different from the operations, services and products of a bank. Incentive-based compensation arrangements of the broker-dealer/investment adviser will be derived from the activities of the broker-dealer/investment adviser, not the parent commercial bank. Thus, any inappropriate risks that could be encouraged by the incentive-based compensation programs at the broker-dealer/investment adviser, would be localized, and the management of these risks would reside at the broker-dealer/investment adviser.

Similarly, the business nature, workforce, and compensation structure of a bank or thrift institution within the structure of an insurance company are generally different from those of the insurance company, and the operations, services and products of a bank or thrift institution within the structure of an insurance company are substantially different from those of the parent Covered Institution.

FSR believes that the approach taken in the SEC's Proposal,[18] which would *not* make a Covered Institution that is a subsidiary of another Covered Institution subject to the same requirements as those applicable to the parent Covered Institution, is the correct one. The SEC's proposal in this area should be extended to non-SEC regulated institutions.

Additionally, FSR requests clarification of the definition of "consolidation" so as to allow a national bank or state nonmember bank to be covered by the consolidation provision in Section _.3(c) of the OCC and FDIC rules in the same way that the FRB rules allow a state member bank to take advantage of parent holding company programs to comply with the governance and policy and procedure requirements of the Proposal to avoid differential treatment for one charter-type over others.

4. The definition of "control" is inappropriately broad (§_.2(g)[19]

Under the Proposal, the definition of "control" is similar to the definition of the same term in the Bank Holding Company Act.[20] Any company would have "control" over a bank or any company if: (1) the company directly or indirectly or acting through one or more other persons owns, "controls", or has power to vote 25% or more of any class of voting securities of the bank or company; (2) the company "controls" in any manner the election of a majority of the directors or trustees of the bank or company; or (3) the appropriate Federal regulator determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

Covered Institutions participate in joint ventures or other business endeavors in which the Covered Institution owns 50% or less of the voting equity and, therefore, has no practical or legal control. They do not have the ability to manage compensation at these entities or impose requirements on incentive-based compensation or governance. The Covered Institution cannot renegotiate its management or control right with the other parties to the joint venture. The Proposal would sweep in joint ventures, which would not be appropriate. These entities should not be governed by the Proposal or be included in the assets or other tests and measurements applicable to the Covered Institution. Considering that a survey of our members indicated that nearly half of them have at least one affiliated entity in which the respective member owns less than 50%, it is vitally important that the Agencies reconsider the definition of "control."

FSR believes that the final rule should use a definition of "control" that is consistent with the test used for consolidated reporting required under generally accepted accounting principles

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[18] Incentive-Based Compensation Arrangements, 18 Fed. Reg. 37,669, 37,832 (proposed June 10, 2016) (§ 303.2(b)).

[19] The Proposal's request for comments covered in this section: 2.3, 2.5, 2.7, 2.8, 2.9 and 2.44.

[20] 12 U.S.C. § 1841.

("GAAP"). We believe that proposing a definition of "control" similar to GAAP would encourage Covered Institutions to reduce risk in their operations, as is the intent of the Statute. If a Covered Institution does not have a controlling interest in a joint venture, the Covered Institution cannot dictate the terms of the compensation arrangements to the joint venture or the joint venture's employees. The Proposal, in its current form, would prevent Covered Institutions from properly diversifying their capital as small investments in joint ventures; instead, in order to control the compensation practices of the joint venture, a Covered Institution would have to invest substantially more capital, a proposition that could antithetically increase risk to the institution.

Additionally, some Covered Institutions maintain qualified retirement plans that own 25% or more of the voting equity (or have an interest in a hedge fund that has a 25% or more ownership interest) in another entity. FSR believes that the final rule should clarify that, with respect to an entity in which a Covered Institution or its qualified retirement plan has a minority passive ownership interest, such ownership interest does not constitute control or require consolidation of the entities for purposes of (i) the Covered Institution's responsibility for the incentive-based compensation or governance of the investment entity or (ii) if the investment entity is itself a regulated institution, determining the extent to which the incentive-based compensation requirements apply to the investment entity.

5. <u>The determination of average total consolidated assets should be revised (*e.g.*, investment advisers should exclude non-proprietary assets, etc.) (§_.2(b)).</u>[21]

As the SEC's Proposal[22] recognizes, certain non-proprietary assets under management by an investment adviser are included on the investment adviser's balance sheet under accounting rules. Considering that a survey of our members indicated that more than 72% of our members have broker-dealer and/or investment advisor subsidiaries, failure to exclude such non-proprietary assets may have dramatic unintended consequences. Non-proprietary assets, such as certain types of client assets under management, are not owned by the Covered Institution. The Agencies should extend the SEC's Proposal in this regard to all Covered Institutions. These assets are subject to separate legal requirements and protections. Therefore, the determination of average total consolidated assets for investment advisers and other Covered Institutions should exclude non-proprietary assets, such as certain types of client assets under management. Funds that a Covered Institution holds on account of others or in trust for others, including insurance company separate accounts and free credit balances, should not be counted. Additionally, intangible assets like goodwill bear very little relation to a Covered Institution's proxy for risk, so they should be excluded. Finally, excluding non-banking subsidiary assets may help to filter out institutions that the Statute did not intend to capture.

[21] The Proposal's request for comments covered in this section: 2.4, 2.5, 2.8, 2.9, 2.10, 2.11, 2.12, 2.13 and 2.44.

[22] Proposal at § 303.2(b)

6. Agency definitions of "Covered Institution" and "regulated institution" should be clarified with regards to the provision of insurance services (§§372.2(i), 42.2(i), 236.2(i), 236.2(dd), 303.2(i) and 303.2(dd)).[23]

FSR believes that the definitions of "Covered Institution" and "regulated institution" in some of the Agencies' Proposals need to clarified, to avoid including non-bank subsidiaries that pose little to no risk to the safety and soundness of the Covered Institution. For example, some Covered Institutions provide insurance brokerage services through a subsidiary. Certain of the Agencies' definitions of "Covered Institution" specifically exclude a "person providing insurance." We believe that Agencies should clarify this language to make clear that insurance brokerage operations are included within the definition of "persons providing insurance."[24]

Specifically, subpart (2) of the FDIC's definition of Covered Institution (372.2(i)) should be clarified to read as follows: "(2) A subsidiary of a state nonmember bank, state savings association, or a state insured branch of a foreign bank, as such terms are defined in Section 3 of the FDIA, 12 U.S.C. 1813, that: (i) Is not a broker, dealer, person providing insurance or insurance services, investment company, or investment adviser; and . . ."

Subpart (1) of the OCC's definition of Covered Institution (42.2(i)) should be clarified to read as follows: "(1) A national bank, Federal savings association, or Federal branch or agency of a foreign bank with average total consolidated assets greater than or equal to $1 billion; and (i) A subsidiary of a national bank, Federal savings association, or Federal branch or agency of a foreign bank that: (ii) Is not a broker, dealer, person providing insurance or insurance services, investment company, or investment adviser; and . . ."

Additionally, the Federal Reserve Board's definition of regulated institution (236.2(dd)) should be clarified to read as follows: "(dd) Regulated institution means: (1) A state member bank, as defined in 12 CFR 208.2(g); (2) A bank holding company, as defined in 12 CFR 225.2(c), that is not a foreign banking organization, as defined in 12 CFR 211.21(o), and a subsidiary of such a bank holding company that is not a depository institution, broker-dealer, person providing insurance or insurance services, or investment adviser; (3) A savings and loan holding company, as defined in 12 CFR 238.2(m), and a subsidiary of a savings and loan holding company that is not a depository institution, broker-dealer, person providing insurance or insurance services, or investment adviser; . . ."

7. The reservation of authority as to Level 3 Covered Institutions is not appropriate (§_.6).[25]

FSR respectfully requests that the reservation of authority as to Level 3 Covered Institutions be removed from the Proposal. As discussed above, FSR believes that the asset thresholds and the prescriptive provisions of the Proposal are not appropriate. While not optimal, FSR also believes that a simpler two-tiered system that dispenses with Level 1 requirements in

[23] The Proposal's request for comments covered in this section: 2.3, 2.4, 2.8 and 2.44.

[24] Addendum B to this comment letter describes FSR's view that the Proposal should not apply to an operating insurance company that is a parent company to a bank or thrift institution.

[25] The Proposal's request for comments covered in this section: 2.6, 2.7, 2.8, 6.1, 6.2, 6.3, 6.4 and 6.5.

their entirety would be easier to administer and mitigate some of the negative consequences of the rule.

The reservation of authority indicates that the Agencies are concerned that asset size alone may not be an accurate indicator of the complexity of an organization's operations and compensation practices indicating a strong need for a risk consideration. If the Agencies decide to include the reservation of authority in the final rule, the floor should be set no lower than $50 billion. Covered Institutions with average consolidated assets below $50 billion are not likely to affect adversely the broader economy.

If the Agencies decide to include in the final rule a reservation of the authority to apply any of the provisions of §§ __.5 and __.7 through __.11 to a Level 3 Covered Institution, FSR believes that the final rule must be augmented with more procedural standards to provide institutions with fair notice:

- Make explicit the criteria that the applicable Agency would apply to make the determination;

- Provide that, when the total consolidated assets of a Covered Institution decrease, an Agency cannot use this discretion to maintain the Covered Institution at a significantly higher level, contrary to the applicability/transition rules;

- Require the applicable Agency to provide advance written notice to the Covered Institution and at least 120 days for the Covered Institution to respond;

- Include a transition period following the applicable Agency's final decision to apply any of these provisions to the Covered Institution similar to that in _.3(a);

- Require the applicable Agency to review and, if appropriate, renew its decision to apply any of these provisions to the Covered Institution at least annually; and

- Provide that, if the applicable Agency determines that some or all of the provisions of §§ __.5 and __.7 through __.11 should no longer apply to the Covered Institution, the applicability of the provisions will lapse immediately.

Finally, if the Agencies retain the concept of multiples asset-based levels in the final rule, they should add a reservation of authority to move a Level 1 organization to a Level 2 organization and a Level 2 organization to a Level 3 organization, if the Covered Institution's activities, operations, risk profile, and compensation practices are consistent with those of a lower level Covered Institution.

8. <u>The applicability/transition rules should be clarified (§§ _.1(c) and _.3).</u>[26]

As indicated, FSR believes that the Agencies should continue to use and refine a holistic and principles-based approach to assessing compensation risk, similar to that followed since the 2010 Guidance. However, if the Agencies proceed with the prescriptive rules of the Proposal,

[26] The Proposal's request for comments covered in this section: 1.1, 1.2, 2.11, 2.12, 2.44, 2.45, 2.46, 3.1, 3.2, 3.3, 3.4, 3.5, 3.6 and 6.5.

we respectfully request recognition of the substantial, complex and unprecedented changes being imposed on the financial industry. FSR believes that the requirement should not apply until the beginning of the first fiscal year of the Covered Institution that begins at least 730 days (two years) after a final rule is published in the Federal Register. Because nearly all incentive-based compensation plans and programs operate on a fiscal year basis, it would not make sense to begin applying the new requirements as of a calendar quarter that is not the beginning of a calendar or fiscal year.

FSR believes that 540 days should be the minimum amount of time provided to a Covered Institution to adjust incentive-based compensation programs to comply with any additional requirements under the Proposal. FSR believes that any increasingly burdensome requirements should not apply until the first performance period that begins at least 540 days after the date on which the regulated institution becomes a Level 1, Level 2 or Level 3 Covered Institution in order to provide the Covered Institution sufficient time to undertake the complete redesign of its compensation programs that the provisions of §§ __.5 and __.7 through __.11 would require.

For purposes of determining when a Covered Institution would move from one level to the next to account for growth, FSR recommends using a rolling average total consolidated asset measurement determined as of a Covered Institution's fiscal year-end in determining a Covered Institution's level.

FSR believes that the determination of total consolidated assets for Covered Institutions that are investment advisers should be determined by reference to a periodic report or similar concept under rules that already apply, instead of requiring new and additional reports.

FSR believes that the final rule should provide a transition period for an institution that changes levels or becomes a Covered Institution due to a merger or acquisition. That period should be similar to the period that applies to an institution that changes levels or becomes a Covered Institution without a change in corporate structure.

Finally, if the final regulation retains a multi-level structure, FSR believes that a Covered Institution that is transitioning from one set of requirements to another should be permitted to modify incentive-based compensation plans with performance periods that began prior to their transition as long as the institution does not qualify as "troubled."

B. The Proposal's Method for Determining Which Covered Persons Are Subject to its Requirements, Prohibitions and Limitations Is Arbitrary, Overly Broad and Unnecessarily Complicated (§_.2(j))[27]

FSR believes that the Proposal's method for determining which covered persons are subject to the deferral (and other) requirements is arbitrary, overly broad and unnecessarily complicated.

As previously discussed, the 2010 Guidance clearly has helped to manage and reduce institutional risks related to incentive-based compensation programs. Covered Institutions

[27] The Proposal's request for comments covered in this section: 2.4, 2.8, 2.14 – 2.35, 2.37, 2.38, 2.44 and 7.34.

subject to the 2010 Guidance have modified incentive compensation programs, enhanced corporate risk management and controls and formalized active and effective board oversight of all aspects of incentive compensation, including risk. During the ensuing six years, banking organizations have substantially improved their incentive compensation practices and aligned them with risk. As part of their examination process, the Agencies have reviewed and gained substantial experience in assessing risk in Covered Institutions incentive compensation plans and arrangements. Much of this work, however, will be obsolete if the Agencies' final rule retains the Sections _.5 through _.11 as requirements.

The multi-step approach suggested by the Proposal would capture substantially more employees than the 2011 Proposal and is far more complicated than the methods the regulators have been focusing on to date, *e.g.*, in the horizontal review. In addition, many of the employees who are needlessly swept into the definitions could easily move to other industries or smaller institutions to avoid the requirements, prohibitions, and limitations of the Proposal.

FSR believes that this 2010 Guidance, which seems to be retained only as a fallback in §_.2(hh)(2), is much more effective than the complicated alternatives in the Proposal.

Specifically, FSR believes that any effort to identify the "covered persons" population solely based on whether the employee receives any incentive compensation unnecessarily includes individuals who are not capable of placing the safety and soundness of the institution at risk and needs to be refined. The 2010 Guidance instead focused on the specific employees who individually or in the aggregate can expose the Covered Institution to a material risk that could jeopardize the safety and soundness of the institution. Again, the focus is specific not only to the institution but also to the risk the employee can take. The Proposal would have negative impacts on Covered Institutions that provide any form of variable compensation, including smaller incentives for lower level employees. FSR requests that the Agencies consider adding a minimum threshold for employees earning incentive compensation before they are included in the covered employee population. For example, the scope of covered employee could exclude employees earning $100,000 or less in incentive compensation per year.

Additionally, the more complicated and prescriptive three-part test for determining significant risk-takers under the Proposal would be extraordinarily burdensome to Covered Institutions. This complicated test will require the creation of complex administrative systems, processes, and records to identify and maintain compensation information on a large number of employees who receive any variable compensation in order to identify significant risk-takers. As previously discussed, compensation practices have evolved to favor variable compensation. Certain Covered Institutions use variable compensation to incent and reward outstanding customer service and compliance to consumer-facing employees. The Proposal would sweep in employees with no authority to expose the Covered Institution to material risk who receive modest compensation and penalize Covered Institutions who have not outsourced customer service. Additionally, the significant risk-taker population will likely vary from year to year further adding to the complexity of administering and maintaining records on outstanding deferrals, forfeitures, and downward adjustments, triggering events, investigations, clawbacks and board oversight on a variable population. The complexity of administering such a program across a variable population with different requirements over variable periods unnecessarily introduces risk into Covered Institutions incentive compensation programs. FSR urges the Agencies to reconsider the requirement to identify significant risk-takers to eliminate unnecessary administration and instead focus on covered employee responsibilities within the Covered Institution. The three-part test in the Proposal may not identify the right individuals, would be too costly to administer and delivers too little benefit.

Adding the time and expense of calculating the multi-part test costs to the substantial financial, recruiting and retention costs of applying the deferral, forfeiture, clawback and other provisions of the Proposal would place all Level 1 and Level 2 Covered Institutions at a significant competitive disadvantage even against other Covered Institutions.

In addition to being overbroad and inefficient for the goals the Agencies are trying to achieve, the complicated multi-part test would be redundant of work the Covered Institutions already have done over the last six years in implementing the 2010 Guidance identifying covered employees and in working with the regulators to refine the covered population.

FSR's survey of its members reveals that there would be too many roles that fall into the category of senior executive officer and significant risk-taker, rendering it overbroad for intended coverage. This is particularly difficult as these are individuals who are important officers and managers of Covered Institutions who are talented and sought-after individuals who could easily move to other industries or smaller companies to avoid coverage under the Proposal.

Raising the thresholds under the three-part test for significant risk-takers would help reduce the burden on Covered Institutions in terms of time, expense and anti-competitive effect. However, this solution would still be less effective than the efforts under the 2010 Guidance that the Banking Agencies and the Covered Institutions subject to the 2010 Guidance have implemented to identify covered employees who have the ability to expose the institution to material risk. FSR asks that the Agencies revise the rules to be used to identify significant risk-takers under the Proposal to leverage the covered employee identification process used in the 2010 Guidance. This could include Agency authority to designate a covered person as a significant risk-taker, using Agency guidelines, including guidelines on "material financial loss" and/or "overall risk tolerance" based on the role of the individual and the nature of the Covered Institution. However, dictating a specific standard for what would constitute "material financial loss" and/or "overall risk tolerance" would only compound the overly prescriptive nature of the Proposal with no offsetting benefit.

Finally, if the Agencies include a formulaic test in the final rule, they also should incorporate procedures for Covered Institutions to request waivers from the appropriate regulators for certain employees or groups of employees.

1. The definition of "senior executive officer" is overly broad (§_.2(gg)).[28]

As noted above, FSR believes that the types of positions identified in the Proposal's definition of "senior executive officer" may be overbroad, as a covered employee's title is not a reliable method of determining whether the individual is in a position to place the safety and soundness of the institution at risk. For example, in a survey of our members, five (5) members indicated that the definition of "senior executive officer" would capture more than 50 employees. However, if the Agencies determine to include the senior executive officer test in the final rule,

[28] The Proposal's request for comments covered in this section: 2.15, 2.16, 2.17, 2.23, 2.37, 2.38 and 2.44.

(i) the specified list should include fewer titles and (ii) the definition should include a dollar threshold (*i.e.,* $1 million) and/or a higher percentage of total compensation that is incentive-based test (*i.e.,* at least 60% of the covered employee's compensation must be incentive-based compensation). The experience of FSR members indicates that individuals earning less than $1 million are rarely in a position to place the safety and soundness of the institution at risk and never in a position to create risk to the U.S. financial system.

Specifically, FSR believes that the roles of chief compliance officer and chief audit executive should not automatically be designated as senior executive officers and should not be classified as significant risk-takers. At most Covered Institutions, the chief compliance officer, chief audit executive and the chief risk officer, are in positions to help identify, quantify and control risk. At FSR member companies, generally, the chief compliance officer and chief audit executive report directly to the audit committee of the board of directors, rather than management or, when serving on a management committee, do so in an ex-officio capacity. Both types of officers, the chief compliance officer, and the chief audit executive, typically do not have policy-making functions and are not considered an ”officer” for purposes of Section 16 or an ”executive officer” for other securities law purposes.

The term "major business line" does not provide enough information to allow a Covered Institution to identify individuals who are heads of major business lines. Larger Covered Institutions may have many business lines of different sizes, product lines, and risk profiles. To better harmonize the rule with regulatory standards that are already in use, the final rule instead should refer to a "principal business unit, division or function," as described in SEC definitions of the term "executive officer,"[29] which is widely understood.

Rules proposed by the SEC in July 2015, under Section 954 of the Dodd-Frank Act, titled "Listing Standards for Recovery of Erroneously Awarded Compensation Policy,"[30] limit their application to current or former executive officers, a term for which the SEC proposes a definition that is modeled on the definition of "officer" under Section 16 of the Securities Exchange Act of 1934, which is widely understood. We believe that such a definition more accurately captures the intent of the Statute.

2. The definition of "significant risk-taker" is overly broad, overly complex and not effective in identifying all significant risk-takers (§_.2(hh)).[31]

As noted above, FSR believes that this blanket, one-size fits all approach to identifying risk-takers is an unnecessary and inappropriate shift away from the 2010 Guidance under which each employee in the organization is assessed by function to determine the employee's ability to expose the Covered Institution to risk. Instead, FSR continues to believe the process started under the 2010 Guidance, where examiners review institutions holistically for the manner in which the institution takes and manages risk and applies that assessment to the compensation process, is far preferable to that of the Proposal.

[29] 17 CFR 240.3b-7.

[30] 80 FR 41143 (July 14, 2015).

[31] The Proposal's request for comments covered in this section: 2.15, 2.18-2.35, 2.38 and 2.44.

The complicated three-part test under the Proposal would be inappropriately burdensome to Covered Institutions. The three-part test would result in too many individuals being designated as significant risk-takers, triggering significant costs and reporting for the institution and problematic consequences for the employees, while not necessarily capturing all of the individuals who actually could put the institution at risk. The three-part test in the Proposal would be too costly to administer, for too little benefit. As previously discussed, FSR suggests the Agencies modify the Proposal to allow Covered Institutions and Agencies to leverage the mature covered employee identification process which has been used by Covered Institutions subject to the 2010 Guidance for six years and which is specifically designed to identify the employees who can expose the Covered Institution to material risk.

Additionally, the effective date of the Proposal would require a retroactive application to certain incentive compensation awarded prior to the effective date of the final rule for purposes of identifying the population of significant risk-takers due the look-back requirement. The Proposal provides for phased-in implementation for Covered Institutions moving from Level 3 to 2 specifically to avoid the application of the prescriptive rules to previously granted compensation. The same phased-in approach should be used for the initial identification of significant risk-takers. We also propose that the final rule allow institutions at least two years to determine those employees that might qualify as significant risk-takers.

a. The one-third test

FSR believes that using the percentage of total compensation that is incentive-based compensation is a poor proxy for determining which employees can influence risk-taking behavior and will result in including far too many employees in this category. At a minimum, for this test to have any meaning, it would have to be combined with a significant dollar threshold. If the Agencies use a percentage threshold as a part of the test for designating significant risk-takers, the Agencies should instead use 50% as the percentage of total compensation that is incentive-based compensation and a dollar threshold of total compensation that is equal to at least $1 million.

b. The relative compensation test

The relative compensation test would arbitrarily sweep into the definition of significant risk-taker many employees who are not in a position to take risks or influence risk-taking behavior. Several members of FSR that would be classified as Level 1 Covered Institutions under the Proposal employ more than 100,000 people and provide incentive compensation to most of them, which means that as many as 5,000 employees (not including senior executive officers) would be subject to the requirements, prohibitions and limitations of the Proposal. It is likely the case that only a small fraction of these employees are actually in positions that could create a risk to the safety and soundness of the Covered Institution. In addition to being overly broad, any standard that applies to a fixed percentage of a Covered Institution's employees is arbitrary by its very nature. Defining significant risk-takers as the top 5% or the top 2% of all employees who receive incentive compensation is arbitrary.

FSR also does not understand the gap between the percentage used under the test as applied to Level 1 and Level 2 Covered Institutions. This gap is anti-competitive. To avoid unfairly penalizing specific companies due to differences in asset size, we propose that, if retained, a 2% test be used for all companies subject to the "significant risk-taker" rules.

c. The exposure test

FSR believes that the Proposal's exposure test is burdensome, inefficient and much too variable to be administered successfully. As noted above, the likely additional costs of the exposure test in terms of time and expense would far outweigh the possible benefits of the test, especially as compared to the current system.

FSR believes that the Agencies should utilize a dollar threshold test as an enhancement to both the relative compensation test and the exposure test in the definition of significant risk-taker. The exposure test would be costly and difficult to apply and would likely sweep in far too many individuals who are not in a position to put the safety and soundness of the Covered Institution at risk.

The exposure test would often pick up individuals within a Covered Institution who have little, if any, role in the Covered Institution's risk-taking activities. For example, an employment lawyer at a Covered Institution would likely have technical authority to approve settlements of employment-related claims against the Covered Institution. Such individual's technical authority to sign a settlement of a potential claim could exceed the exposure test, thereby causing the individual to be considered a significant risk-taker under the Proposal. This result is plainly antithetical to the Proposal's objective to limit the inappropriate risk-taking that compensation programs may induce. Moreover, Covered Institutions have not historically tracked each of their employees' potential to commit capital, especially measured on a per-Covered Institution basis. The complexity and cost required to do so would be substantial. The sheer volume of calculations potentially required would likely result in inadvertent errors and would certainly require Covered Institutions to pour a significant amount of resources into running and checking the results of each year's exposure test. This expense, time and effort would be better spent elsewhere. Lastly, the exposure test requirements, as drafted, are unworkable and unclear. For example, it remains to be seen how capital should be calculated, what types of risk should be included, and whether hedging or insurance products used to reduce risk should be considered. This could lead to great variations in how the exposure test is applied and cause inconsistent application and enforcement issues for the Agencies.

d. A dollar threshold test

As noted above, the addition of an annual compensation dollar threshold of at least $1 million and an increase in the percentage of an individual's total compensation that must be incentive-based compensation under the significant risk-taker designation would help pinpoint individuals who are capable of taking significant risks. A dollar threshold test also would be simple and less costly to apply and monitor.

The potential costs of the exposure test in terms of time and expense are likely to be extraordinarily high, while the potential benefits to the exposure test over the process started by the 2010 Guidance are highly questionable.

FSR believes that $1 million (assuming a mechanism for inflation adjustment) would be the lowest amount appropriate for a dollar threshold test. Any lower threshold would sweep in too many individuals who are not in a position to materially affect the financial position of the Covered Institution, let alone put the U.S. economy, at risk. The advantages of a dollar threshold test compared to the proposed relative compensation test, include simplicity of calculation and certainty of application. Covered Institutions would not be required to perform complicated, expensive and time-consuming calculations each year.

C. The Proposal's Deferral, Forfeiture, Downward Adjustment and Clawback Requirements Are Unnecessary, Overreaching and Extend Over Too Long a Period (§_.7)[32]

FSR would advise the Agencies to adopt portions of Section .__7 of the Proposal as guidelines rather than a final rule. FSR believes that the Proposal's deferral, forfeiture, downward adjustment and clawback requirements are too prescriptive and exceed the mandate of the Statute.

FSR also believes that the Proposal's established period of time, for which incentive-based compensation amounts must be deferred and must remain subject to forfeiture or clawback requirements, is unnecessarily long. Finally, the Proposal establishes an entire group of new definitions of terms that are inconsistent with the way in which those terms have been used by compensation professionals, applied to compensation plans, represented to employees and disclosed to shareholders. The layers of complexity and confusion that these changes cause may actually have a negative effect on a Covered Institution's risk governance procedures.

Covered Institutions and the Banking Agencies have been operating under the 2010 Guidance without these complicated and prescriptive requirements for six years. The system has worked well, and all parties have become accustomed to it. In addition to enhancing controls, corporate risk management, and board oversight, Covered Institutions have undertaken training of covered employee populations and incorporated risk into individual and institution performance metrics creating a risk-sensitive culture. FSR does not believe that the significant costs and potential risk associated with increased complexity that these new rules would impose in terms of time, expense and disruption even come close to outweighing the uncertain potential benefits the rules may provide. Moreover, the Proposal unnecessarily creates complexity by mandating a rigid structure for all Covered Institutions when the 2010 Guidance offers a viable framework for principles-based regulations.

The Proposal's parameters for forfeiture and downward adjustment review are far too prescriptive. The Agencies should allow Covered Institutions the flexibility to leverage existing procedures designed to meet the institutional risks and affected employees in designing an appropriate governance framework for making forfeiture decisions. Additionally, the Proposal should permit Covered Institutions to use discretion and take into account specific facts and circumstances when making determinations related to a wide variety of possible outcomes, including the relation of risks taken to the Covered Institution's risk appetite.

[32] The Proposal's request for comments covered in this section: 1.1, 2.7, 2.15, 2.36-2.46, 6.5, 7.1-7.36, 9.1, 11.1 and 13.1.

1. The periods of time for which incentive-based compensation amounts must be deferred and must remain subject to forfeiture or clawback requirements are unnecessary and unrealistic (§_.7).[33]

Under the Proposal, for many employees, a portion of the typical stock award grant vesting on the third anniversary of the grant date would remain subject to forfeiture for up to five years from the grant date and subject to clawback for up to nine years after the grant date. The typical annual incentive bonus established for a year would remain subject to forfeiture for up to four years after it is earned and subject to clawback for up to *eleven* years after it is earned. These lengthy periods go significantly beyond what is necessary to achieve the purpose of the deferral and clawback requirements. At a minimum, FSR believes that the clawback period should run concurrent with the deferral period so that the maximum period of time that any incentive-based compensation would remain at risk would be seven years from the end of the performance period. This would still be at least ten years from the beginning of the performance period for long-term incentive plan awards. It seems reasonable that any evidence confirming significant misconduct, misrepresentation or fraud would be discovered within seven years from the end of a performance period.

Additionally, the lengthy clawback period would hinder the Proposal's purpose of enhancing the safety and soundness of Covered Institutions by making it nearly impossible for a Covered Institution to recruit and retain seasoned employees with substantial and valuable experience critical for complex financial institutions. A Covered Institution trying to hire an experienced employee at age 61 in February 2020 will not be able to pay an annual bonus for that year until after the employee's 65th birthday – and even then a portion of such annual bonus would remain subject to clawback until the executive is 72 years old, more than a decade after such compensation was earned.

Finally, as a practical matter, the clawback requirement would become increasingly difficult to enforce with the passage of time. The proposed period is so long that, depending on the individual's financial circumstances at the time of attempted clawback, an attempt to clawback such compensation may be either unworkable or unenforceable.

2. The Deferral, Forfeiture, Downward Adjustment and Clawback requirements for Level 1 and Level 2 Covered Institutions would have a variety of unintended impacts (§_.7).[34]

FSR believes that the proposed minimum required deferral amount in §_.7(a)(1)(i) is excessive and that the proposed minimum required deferral period in §_.7(a)(1)(ii) will provide little appreciable benefit.

To our knowledge, no studies have shown that deferral is effective or appropriate to promote the alignment of employees' incentives with the risk undertaken by such covered persons. However, as a result of working with bank regulators, the deferral of a portion of the

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[33] The Proposal's request for comments covered in this section: 2.38-2.43, 2.44, 2.45, 2.46, 7.1, 7.2, 7.3, 7.9, 7.13, 7.14, 7.30 and 7.31.

[34] The Proposal's request for comments covered in this section: 2.15, 2.38, 2.43, 2.45, 2.46, 6.5, 7.1, 7.2, 7.3, 7.4, 7.5, 7.6, 7.7, 7.16, 7.17 and 7.19.

incentive-based compensation payable to employees who are in a position to place the safety and soundness of the Covered Institution at risk has become more commonplace. More than 70% of our members already impose deferral or post-vest holding requirements. FSR agrees that deferrals can be an important tool for certain Covered Institutions and certain employees, but strongly suggest that the Proposal be revised to eliminate the mandatory deferrals and instead provide guidelines for using deferrals in a manner consistent with the principles-based approach of the 2010 Guidance.

The required minimum deferral provisions are certain to have an adverse effect on the ability of Level 1 and Level 2 Covered Institutions to attract skilled employees and retain critical talent at every position to which they apply. The definitions of senior executive officer and significant risk-taker would include numerous individuals who could easily move to other industries or different sized Covered Institutions to avoid the prescriptive rules that make significant portions of their compensation packages subject to long-term risk of forfeiture. This could deprive Covered Institutions of the precise skill and experience necessary to avoid risks that could pose a threat to the Covered Institution or to the U.S. economy as a whole.

Applying a prescriptive deferral (and other requirements of the Proposal) would clearly make it more difficult for Covered Institutions to attract and retain key employees in comparison to the ability of organizations not subject to such requirements to recruit and retain the same employees. If finalized, the Proposal would have enormous implications on the competitive enviroment between Covered Institutions and non-Covered Institutions.

Additionally, larger Covered Institutions that are subject to stricter deferral (and other) requirements could be forced to *increase* total compensation to remain competitive with firms subject to different and lesser restrictions. The requirement in the Proposal will unquestionably result in Covered Institutions paying more fixed compensation and less incentive-based compensation. However, given that the deferral and other requirements of the Proposal apply both to qualified incentive-based compensation and long-term incentive plans, the mix as between those two types of arrangements is unlikely to be significantly altered.

To address concerns with the complexity of the mandatory deferrals and given the breadth of the definition of "incentive compensation," FSR respectfully requests the Agencies consider a threshold for mandating incentive compensation deferrals. For example, the first $200,000 of incentive compensation could be excluded from mandatory deferral requirements.

The following will address some of the specific requests for comment made in the Proposal:

- Longer performance periods, such as those under long-term incentive plans, provide risk-balancing benefits similar to those provided by deferral. Therefore, a shorter deferral period for incentive-based compensation awarded under long-term incentive plans is appropriate.

- The proposed distinction between the deferral requirements for qualifying incentive-based compensation and incentive-based compensation awarded under a long-term incentive plan generally would not pose practical difficulties for

Covered Institutions or increase compliance burdens since Covered Institutions already treat those types of compensation differently.

- The adjustments and limits to deferred qualifying incentive-based compensation and deferred long-term incentive plan compensation amounts requirement of §__.7(a)(3) are inappropriate and do not take into account desired changes that may occur during the deferral period.

- The Proposal should not single out stock options for separate and special limits. The use of stock options by Covered Institutions has declined dramatically in recent years due to market practices and changes in accounting rules.

- The Proposal should not include a requirement that a certain portion of incentive-based compensation be structured with debt-like attributes (request for comment 7.16). Nothing in the current compensation practices of Covered Institutions even remotely resembles debt instruments. Any such requirement by the Agencies would disrupt the current policies and best practices used by Covered Institutions.

3. <u>Mandating deferrals in cash and stock is overly prescriptive and unreasonable (§_.7(a)(4)(i)).</u>[35]

The Proposal's requirement in Section ___.7(a)(4)(i) that any deferred qualifying incentive-based compensation or deferred long-term incentive plan amounts must include substantial portions of both deferred cash and equity-like instruments throughout the deferral period is unnecessary, overly prescriptive and misguided for several reasons.

- Deferral of cash is not consistent with current (or historic) industry or general market practices. Therefore, this new requirement would disrupt the long-standing compensation practices in the financial industry, causing uncertainty.

- For decades, the world's most sophisticated investors have uniformly encouraged both public and private institutions to pay a greater percentage of compensation in the form of equity-like instruments in order to better align the interests of management with those of stockholders. A requirement that deferrals must include substantial portions of both cash and equity-like instruments throughout the deferral period would run contrary to this recognized objective.

- The requirements would cause the compensation practices of Covered Institutions to be different from, and not competitive with, the practices of the general market.

- Creating a competitive imbalance or uneven playing field also may result in overall higher levels of total compensation, as larger Covered Institutions, with less flexibility as to the mix of incentive award vehicles, could be forced to increase total compensation to remain competitive with firms subject to different and lesser restrictions.

[35] The Proposal's request for comments covered in this section: 2.7, 2.38, 2.46, 7.5, 7.13 and 7.14.

- Requiring a change to the character of the award, *e.g.*, from a stock award to a cash deferral, would be difficult to administer and confusing to the covered person.

- A Covered Institution on the lower end of the Level 1 or Level 2 range likely will have a relatively smaller portion of common stock outstanding and available for awards. Mandating that a substantial amount of deferral be in stock could put those institutions at a severe disadvantage (compared both to larger firms in the same Level and to firms in a lower Level) in gaining the required stockholder approval of stock incentive plan shares and plan changes given current burn rate and dilution restrictions sought by institutional investors and stockholder advisory groups.

- As discussed further below, requiring a change to the character of a stock award to a cash deferral would have very negative accounting consequences for the institution.

Even though the Proposal does not include a specific definition of "substantial" for the purposes of this requirement, it will not give Covered Institutions sufficient flexibility in designing their incentive-based compensation arrangements.

As an alternative, the final rule should simply provide that incentive-based compensation that is settled in stock should remain in stock during the deferral period, and incentive-based compensation that is settled in cash should remain in cash. Each Covered Institution then would be able to design its incentive-based compensation program in the manner that its board of directors deems appropriate for its circumstances.

If the Agencies nonetheless decide to require deferred qualifying incentive-based compensation and deferred long-term incentive plan amounts to include substantial portions of both deferred cash and equity-like instruments throughout the deferral period, FSR suggests at a minimum all incentive compensation should be aggregated for purposes of satisfying the requirement to have a substantial portion of deferred compensation in both cash and equity

4. <u>The Proposal's clawback requirement would be more effective if modified (§_.7(c)).</u>[36]

FSR believes that the Agencies should revise the clawback requirements of the Proposal. First, the Agencies should assess the length of the clawback in relation to ordinary business cycles. The National Bureau of Economic Research has indicated that the average business cycle is 5.5 years. FSR believes that the clawback period in the Proposal would exceed the ordinary business cycle and should be reduced to five years.

At a minimum, as discussed above, FSR believes that the clawback period should run concurrently with the deferral period so that the maximum period of time that any incentive-based compensation would remain at risk would be seven years from the end of the performance

[36] The Proposal's request for comments covered in this section: 2.38, 2.43, 2.46, 7.27, 7.30, 7.31, 7.32, 7.33, 7.34, 7.35, 7.36 and 11.1.

period. (This would still be at least ten years from the beginning of the performance period for long-term incentive plan awards.)

Rules proposed by the SEC in July 2015, under Section 954 of the Dodd-Frank Act, titled "Recovery of Erroneously Awarded Compensation Policy," (the "SEC Section 954 Clawback Rule") recognize several of the difficulties of imposing a clawback provision on compensation that already has been paid to an employee or former employee. Many of the Covered Institutions affected by the Proposal also will be subject to the clawback provisions of Section 954. The SEC Section 954 Clawback Rule could serve as a useful guide for the Agencies in developing the final rule. Additionally, the final rule should provide a method for coordinating with this overlapping federal requirement, by carving-out incentive-based compensation that has been subject to a Section 954 clawback.

a. A seven-year clawback period tacked on to the applicable deferral period is unreasonably long and would be difficult to enforce.

Under the Proposal, for many employees, a portion of the typical stock award grant vesting on the third anniversary of the grant date would remain subject to forfeiture for up to five years from the grant date and subject to clawback for up to nine years after the grant date. The typical annual incentive bonus established for a year would remain subject to forfeiture for up to four years after it is earned and subject to clawback for up to eleven years after it is earned. These lengthy periods go beyond what is necessary to achieve the purpose of the clawback requirements. It seems highly unlikely that any significant misconduct, misrepresentation or fraud would be discovered within seven years from the end of a performance period.

Notably, under Section 954 of the Dodd-Frank Act, only incentive compensation received during the three-year period preceding the date on which the corporation is required to prepare an accounting restatement is subject to clawback. The SEC Section 954 Clawback Rule treats compensation as "received" in the fiscal period during which the applicable financial reporting measure for the incentive-based compensation was attained so that the clawback period does not begin until after the end of the performance period. The Proposal's clawback periods should conform to the clawback provisions in the SEC Section 954 Clawback Rule.

The length of these clawback periods seems particularly unreasonable when compared to the length of time that the government has determined is appropriate to bring criminal and/or civil charges against individuals in cases of extreme misconduct. For example, 28 U.S.C. §1658 provides that a private right of action that involves a claim of fraud, deceit, manipulation or contrivance in contravention of a regulatory requirement concerning the securities laws must be brought not later than the earlier of two years after the discovery of the facts constituting the violation or five years after such violation. We also note that 18 U.S.C. § 3293 only provides for a ten year statute of limitation in the case of theft, embezzlement or misapplication by a bank officer or employee. The Proposal suggests that incentive compensation that has been lawfully awarded to senior executive officers and other covered individuals is subject to a private right of action—due to risks that were determined, in hindsight, to be greater than expected—for a period that is more than twice as long as the statute of limitation available in the case of serious violations of the securities laws and longer even than the period for which such person would have been subject to criminal sanctions for theft or embezzlement. Forcing Covered Institutions and their employees to face uncertainty as a result of properly exercised business decisions for such a long period is significantly disproportionate to the potential benefit envisioned or harm avoided and seems clearly at odds with implicit Congressional intent.

b. Allowances should be made where recovery is impracticable.

FSR believes that the final rule should take into account situations when recovery is impracticable. Under the SEC Section 954 Clawback Rule, a company must recover erroneously awarded compensation in compliance with its recovery policy except to the extent that it would be impracticable to do so. The SEC Section 954 Clawback Rule provides that recovery would be impracticable "only if the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered, or if recovery would violate home country law."[37] This provision is meant to account for the difficulties that a corporation will encounter under state contract, employment and wage payment laws and foreign laws in attempting to clawback compensation previously paid. The laws in some states will make recovery more difficult or even forbid recovery, particularly for employees and former employees other than outside the senior executive officers.

The SEC Section 954 Clawback Rule requires the compensation committee of the corporation's board of directors to make the determination that recovery would be impracticable. The compensation committee would be required to document its reasonable attempts to recover and, if applicable, may be required to provide that documentation to its stock exchange. Before concluding that it would be impracticable to recover any amount of erroneously awarded compensation based on the expense of enforcement, the corporation must first make a reasonable attempt to recover that erroneously awarded compensation.

In order to avoid conflicting regulatory mandates, the Proposal should be revised to excuse clawback requirements when it is impracticable, incorporating the common-sense provisions of the SEC Section 954 Clawback Rule. FSR believes that the SEC's approach to clawbacks is far more practicable and appropriate than that in the Proposal.

The Proposal also should clarify that the board of directors of a Covered Institution may enforce a clawback against the current compensation of a covered person.

c. Certain provisions of the Proposal need clarification.

FSR believes that §_.7(c)(3) should be modified to read as follows: "(3) Intentional misrepresentation of **<u>material</u>** information used to determine the senior executive officer or significant risk-taker's incentive-based compensation." Due to the harshness of the clawback requirement, a covered person needs to understand when his or her non-financial performance could be used as a reason to clawback compensation earned previously.

d. Comments on estimates.

The final rule should allow a Covered Institution to use reasonable estimates of the amount of incentive-based compensation that it must recover in certain circumstances. The

[37] The SEC Section 954 Clawback Rule would require a corporation to obtain an opinion of home country counsel before it may conclude that it would be impracticable to recover any amount of erroneously awarded compensation based on violation of home country law.

SEC's Section 954 Clawback Rule provides that for incentive-based compensation based on stock price or total shareholder return, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the amount must be based on a reasonable estimate of the effect of the accounting restatement on the stock price or total shareholder return upon which the incentive-based compensation was received. The corporation must maintain documentation of its determination of this reasonable estimate and, if applicable, may be required to provide the documentation to the stock exchange. The Proposal should be revised to adopt this approach.

e. The clawback rule should not be made more prescriptive than necessary.

FSR does not believe that the final rule should include a presumption of some amount of clawback for particularly severe adverse outcomes. The Proposal's parameters for clawback are sufficient to provide guidelines for making clawback decisions while still permitting adequate discretion for Covered Institutions to take into account specific facts and circumstances when making determinations related to a wide variety of possible outcomes. The Agencies should provide additional guidance on the types of behavior that would constitute misconduct for purposes of Section __.7(c)(1).

5. <u>The deferral, forfeiture and downward adjustment and clawback requirements for Level 1 and Level 2 would have adverse tax, accounting and other effects on Covered Institutions and Covered Persons (§_.7).</u>[38]

Absent specific action by Congress, the Internal Revenue Service and the Financial Accounting Standards Board, the deferral, forfeiture, downward adjustment and clawback requirements could have dramatic and adverse tax and accounting effects on Covered Institutions. Key areas of overlap include Sections 409A ("Section 409A") and 162(m) of the Internal Revenue Code of 1986, (as amended), and liability accounting treatment under the relevant generally accepted accounting principles for compensation subject to clawback and/or adjustment.

a. Unintended accounting consequences

The discretionary deferrals, similar to other clawback programs, could lead to more income statement variability as all equity awards could be subject to liability accounting. Many stock-based awards made by Covered Institutions would no longer qualify for equity classification accounting treatment if the Proposal was adopted in its current form, which would require the Covered Institutions to re-measure all such outstanding stock awards at the awards' fair value each reporting period and produce artificial earnings volatility.

b. Unintended tax consequences

Under the Proposal, the deferred portion of an incentive-based compensation award must remain subject to forfeiture and clawback. However, these contingencies alone likely would not constitute a "substantial risk of forfeiture" under Code Section 409A. Because the Proposal requires a delay in payment beyond the date the substantial risk of forfeiture lapses, most of the

[38] The Proposal's request for comments covered in this section: 2.38, 2.46, 7.9 and 7.14.

deferred incentive-based compensation would be subject to the complex requirements, including restrictions on the time and form of payment, and potential penalties of Section 409A.

In addition, the multiple unintended and unanticipated consequences to covered persons cannot be overstated. For example, how will such circumstances of death, divorce or long-term disability of the covered Person be treated? How should advisors guide covered Persons on issues such as estate planning? These issues will need to be resolved before implementation can be accomplished.

6. The definition of "incentive-based compensation" and "performance period" should be clarified (§_3.2(r) and _.2(aa)).[39]

FSR believes that the definition of incentive-based compensation should be clarified in three specific respects (i) to exclude explicitly cash and equity awards that vest solely based on continued employment, (ii) to exclude explicitly contributions to retirement plans, and (iii) to distinguish between variable compensation plans and arrangements that reward specific individuals (and therefore arguably reward specific risk taking) and variable compensation plans that reward a broad class of employees based on enterprise or company-wide performance metrics that no single individual within the organization could meaningfully impact.

a. Exclude explicitly cash and equity awards that vest solely based on continued employment.

Many Covered Institutions pay compensation in the form of equity-like instruments that become vested based solely on continued employment, including restricted stock, restricted stock units and stock options, with no performance-based criteria. The Section-by-Section Description of the Proposal unequivocally states that "compensation, fees or benefits that are awarded solely for, and the payment of which is solely tied to, continued employment (*e.g.*, salary or a retention award that is conditioned solely on continued employment) would not be considered incentive-based compensation." However, because of the prevalence of these equity-like awards, the final rule should make this exclusion explicit.

Some institutions pay compensation in the form of equity-like instruments with two-stage vesting provisions, (*i.e.*, a performance-period that determines the size or amount of the award, followed by a time period during which the compensation becomes vested based solely on continued employment). The final rule should provide that these types of awards are included in definition of incentive-based compensation, but this compensation would be "awarded" at the end of the initial period during which performance criteria are applied to determine the size or amount of the award (which would be the "performance period") and the subsequent time-based vesting period will run concurrently with any deferral period required by the final rule.

b. Exclude contributions to retirement plans.

The definition of incentive-based compensation also should be modified to exclude specifically all contributions made (by the employer or the employee) and benefits accrued under a retirement plan qualified under Internal Revenue Code Section 401(a) (including both "401(k)"

[39] The Proposal's request for comments covered in this section: 2.38, 2.39, 2.40, 2.41, 2.42, 2.43, 2.44, 2.45, 2.46, 7.14, 7.17, 7.19 and 11.1.

and pension plans). Because of the broad-based nature of these plans and the existing authority under which the Internal Revenue Service regulates these plans, this blanket exclusion should apply even if the amount of contribution or benefit is based on the profitability or performance of the Covered Institution. Additionally, any non-qualified or supplemental benefits plans that provide restoration benefits or contributions that would have been contributed or accrued by an employee under a qualified retirement plan, but for the limitations of the Internal Revenue Code, should be excluded.

c. Distinguish between incentive compensation that rewards specific individuals and incentive compensation that rewards employees based on enterprise or company-wide performance metrics.

The definition of incentive-based compensation in the Proposal is too broad, as it would capture virtually any variable compensation. The definition fails to distinguish between variable compensation plans and arrangements that reward specific individuals (and therefore arguably reward specific risk taking) versus variable compensation plans that reward a broad class of employees based on enterprise or company-wide performance metrics that a single individual within the organization would have no meaningful ability to impact. Further, there is an implicit and unsupported assumption that any form of variable compensation increases risk. The mere fact that compensation can vary, without more, is insufficient under Section 956 to warrant restriction in an effort to limit unnecessary risk. The Agencies should attempt to identify compensation factors that are related to increased risk. The failure to establish a nexus between the compensation program and increased risk potentially renders the rule arbitrary and capricious.[40]

d. Distinguish between incentive-based compensation and commissions.

Typically, a commission-based employee does not receive a salary, or they receive a modest salary that is really a draw against commissions. At FSR member institutions, commissions are often the only compensation that a person receives and often take the place of a traditional salary. Therefore, deferring compensation at the level suggested by the Proposal would affect commission-based employees more significantly than other employees receiving traditional incentive compensation with a fairly large salary.

Finally, FSR believes that the Proposal's definition of "performance period" should provide maximum flexibility to Covered Institutions. Most of the incentive-based compensation awards made by Covered Institutions are based on calendar year performance period. However, Covered Institutions need flexibility in determining the length and start and end dates of performance periods to account for special situations, including employees hired or promoted mid-year.

e. Exclude earnings from equity-like instruments.

Under the Proposal, "dividends paid or appreciation realized on stock or other equity-like instruments" are excluded from the definition of incentive-based compensation once they are

[40] Had there been more analysis of compensation systems prevalent in other types of businesses covered by the Proposal (such as insurers who own depository institutions), these factors might have been considered.

owned outright (that is, not subject to any vesting or deferral arrangement). The Agencies should clarify that this exclusion applies to earning from other equity-like instruments owned outright by covered persons at Covered Institutions that are not corporations. For example, such Covered Institutions include partnerships that cannot pay dividends. In order for this rule to apply consistently across all legal organizations, the Agencies should make this clarification.

7. <u>The Proposal's definitions of "award," "deferral" and "vesting" change the meanings of such terms that have been used for decades (§_.2(c), (k) and (jj).</u>[41]

The Proposal's definitions of "award date," "vesting date" and "deferral period" are inconsistent with the meanings of such terms that have been uniformly used over the last several decades. For decades, professionals involved with compensation, corporate governance, accounting or tax and SEC reporting have generally understood these terms to mean as follows:

> "Award date" means the date on which the company, usually through its board of directors or compensation committee, completed all action necessary to make a cash or equity-like grant of compensation to an employee. The compensation awards generally were subject to vesting criteria based on continued employment or performance, but the "award" was made upon adoption of the resolution.
>
> "Vesting date" means the date on which the employee has satisfied criteria based on continued employment or performance criteria and, therefore, the cash or equity compensation underlying the award is delivered to the employee and is no longer subject to a risk of forfeiture. Some companies have adopted a so-called post-vest holding period during which the shares of stock distributed to them upon vesting are not transferable.
>
> "Deferral period" means a period of time during which an employee voluntarily elects to defer receipt, generally for tax or retirement purposes, to delay the receipt of cash or equity compensation that has vested and otherwise would be taxable.

To adopt the Proposal with these substantially different terms would require each Covered Institution to not only (1) potentially rewrite their current programs in order to account for these new terms, but (2) potentially maintain two programs on a going forward basis—one program for individuals subject to the Proposal and one program for individuals exempt from the Proposal. This creates not only a significant amount of complexity, upfront and ongoing costs for each institution in terms of a legal, human resources and accounting perspective, but also raises serious concerns about ongoing compliance issues associated with the proper administration of such programs.

8. <u>The Proposal's limits on accelerated vesting are too restrictive, impractical and inconsistent with market practices (§_.7(a)(iii)(B)).</u>[42]

The Proposal would only allow the accelerated vesting and payout of deferred amounts in the event of the covered person's death or disability. FSR recognizes there are complex policy

[41] The Proposal's request for comments covered in this section: 2.36, 2.38, 2.44, 2.45, 2.46 and 7.9.

[42] The Proposal's request for comments covered in this section: 2.7, 2.46, 7.5, 7.10, 7.11 and 11.1.

considerations for circumstances under which acceleration of vesting and payment should be permitted.

FSR believes that, in defining the events that would permit an acceleration of the payment of deferred amounts, the Agencies should look to the rules promulgated by Congress, and carefully developed in regulations by the Treasury Department, in connection with deferred compensation under Section 409A.

a. Code Section 409A(a)(2)

Code Section 409A(a)(2)(A) permits distribution of deferred compensation amounts only upon six specified events. These events include, in addition to the employee's death or disability and two events not relevant to the purposes of the Proposal,[43] (i) a change in the ownership or effective control of the corporation or a substantial portion of the assets of the corporation, and (ii) the occurrence of an unforeseeable emergency. These events have been meticulously defined and circumscribed by regulations promulgated by the Secretary of the Treasury in 2008 and are now widely understood.

At a minimum, the final rule should allow accelerated vesting and payment of both cash and equity-like awards where a covered person is terminated without cause following a change of control. It would not be appropriate for a covered person whose employment was terminated in connection with a change in control to have the future vesting of his or her awards tied to a company for which the covered person never worked. The final rule also should allow accelerated vesting and payment of equity-like awards where the acquirer in a change of control fails or refuses to exchange and continue the equity awards.

b. Code Section 409A(a)(3)

Code Section 409A(a)(3) provides that its requirements "are met if the plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary." The Secretary of the Treasury carefully defined the specific and narrow circumstances under which deferred compensation could be accelerated in Treasury Regulation §1.409A-3(j)(4), under the following circumstances (excluding circumstances not appropriate for the Agencies' Proposal or final rule):

- Payment necessary for any Federal officer or employee in the executive branch to comply with an ethics agreement with the Federal government or any Federal, state, local, or foreign ethics law or conflicts of interest law.
- A payment made to the employee to pay the Federal Insurance Contributions Act (FICA) tax on the compensation deferred.
- A payment to reflect the payment of state, local, or foreign tax obligations that apply to an amount deferred before the amount is paid or made available to the employee.

[43] "(i) [S]eparation from service as determined by the Secretary . . . (iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation."

- Payment at any time if the plan fails to meet the requirements of Code Section 409A, in the amount required to be included in income as a result of the failure to comply.

- Payment to an individual other than the employee to the extent necessary to fulfill a domestic relations order (as defined in Code Section 414(p)(1)(B)).

- The lump sum cash-out of the entirety of an employee's interest under all agreements, programs, or other arrangements with respect to which deferrals of compensation are treated as having been deferred under a single nonqualified deferred compensation plan, if the employee's interest is not greater than the applicable dollar amount under Code Section 402(g)(1)(B) ($17,500 in 2016).

- A payment made as satisfaction of a debt of the employee to the employer, where such debt is incurred in the ordinary course of the employment relationship, the entire amount of reduction in any of the employee's taxable years does not exceed $5,000, and the reduction is made at the same time and in the same amount as the debt otherwise would have been due and collected from the employee.

At a minimum, in circumstances under which a deferred amount becomes subject to income tax, the final rule should allow for the accelerated vesting and payment of a portion of the deferred amount necessary to pay all applicable taxes due.

9. <u>Other Suggestions (§_.7)</u>[44]

As noted above, FSR believes that the Proposal's deferral, forfeiture, downward adjustment and clawback requirements are too prescriptive, exceed the requirements of the Statute and should be promulgated as guidelines or omitted in the Agencies' final rule. However, if the Agencies decide to include these requirements or guidelines in the final rule, FSR believes, in addition to the items listed above, that the final rule should:

- Not place amounts voluntarily deferred by Level 1 and Level 2 Covered Institutions, senior executive officers or significant risk-takers at risk of forfeiture; only the unvested deferred incentive-based compensation that is required to be deferred under Section ___.7(a) should be at risk of forfeiture. Anything broader would make the percentage requirements meaningless and would strongly discourage voluntary deferrals for retirement;

- Not add "repeated supervisory actions" as a forfeiture or downward adjustment review trigger. The events triggering a review that are identified in Section ___.7(b)(2) are comprehensive enough to cover applicable supervisory actions;

- Allow Covered Institutions more discretion in determining risk events triggering a review under existing risk governance activities, monitoring, limits and risk appetite;

[44] The Proposal's request for comments covered in this section: 2.7, 2.15, 2.36-2.46, 6.5, 7.1-7.36, 9.1, 11.1 and 13.1.

- Not include additional factors that a Level 1 or Level 2 Covered Institution must consider in determining the amount of incentive-based compensation to be forfeited or downward adjusted by a Covered Institution;
- Limit the events that require a Level 1 or Level 2 Covered Institution to consider forfeiture and downward adjustment to adverse outcomes that occurred within a three-year period;
- Clarify that forfeiture and downward adjustment reviews only reduce the incentive-based compensation that is related to the performance period in which the triggering event(s) occurred;
- Not subject unvested or unawarded incentive-based compensation to the risk of forfeiture or downward adjustment if the incentive-based compensation does not specifically relate to the performance in the period in which the relevant event occurred or manifested;
- Replace the proposed "enforcement or legal action" with "**final** enforcement or legal action" to avoid imposing a forfeiture or downward adjustment that later may need to be reversed;
- Eliminate the presumption of some amount of forfeiture for particularly severe adverse outcomes, as that would eliminate the board of director's ability to take into account all of the facts relating to the adverse outcome, including operations undertaken in a manner consistent with the Covered Institution's risk appetite;
- Not require Covered Institutions to establish formal review committees including representatives of control functions and a specific timetable for reviews as part of the forfeiture and downward adjustment review process;
- Not require Covered Institutions to employ any specific protections when making forfeiture and downward adjustment determinations; and
- Not require a formal process that looks for the occurrence of trigger events.

D. **Other Prohibitions and Limitations (§_.8)**[45]

FSR would advise the Agencies to adopt portions of Section .__8 of the Proposal as guidelines rather than a final rule. The limitations imposed by §_.8 are unnecessary in light of the Proposal's extensive deferral, forfeiture, downward adjustment and clawback requirements.

Unless the Agencies eliminate the deferral, forfeiture, downward adjustment and clawback requirements from the final rule, they should eliminate each of the limitations of this Section of the Proposal.

[45] The Proposal's request for comments covered in this section: 2.7, 2.18, 2.46, 4.1 and 8.1-8.11.

1. The Proposal's prohibition on hedging is unnecessary and inappropriate (§_.8(a)).[46]

The Proposal would prohibit all covered persons at a Level 1 or Level 2 Covered Institution—not just senior executive officers and significant risk-takers—from purchasing hedging instruments or similar instruments to hedge or offset any decrease in the value of the covered person's incentive-based compensation. Nowhere does the language of the Statute mention hedging or any similar requirement. Section 955 of the Dodd-Frank Act requires each publicly traded company to "disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer whether any employee or member of the board of directors of the issuer, or any designee of such employee or member, is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities." Section 955, therefore, implicitly recognizes and allows hedging so long as it is disclosed. Most Covered Institutions currently maintain a policy that strictly limits or even prohibits hedging of company stock. However, while some institutions voluntarily choose to limit or prohibit this activity, FSR does not believe that the mandating of such a restriction is supported by the Statute or appropriate to implement in the context of the Proposal.

If Congress had intended for additional or separate anti-hedging rules to apply to financial institutions, it presumably would have included such rules in the section of the Dodd-Frank Act immediately following the hedging rules applicable to all corporations. This feature of the Proposal is duplicative of and inconsistent with Section 955.

2. The Proposal's maximum incentive-based compensation opportunity is unnecessary and unreasonably restrictive (§_.8(b)).[47]

The Proposal's limit on performance upside (leverage) is unnecessary, inappropriate and unrealistic. The Proposal would limit the amount of actual incentive-based compensation that could exceed the target amounts for performance measurement goals established at the beginning of the performance period to 125% of the target amount for a senior executive officer and 150% of the target amount for a significant risk-taker. Like many other provisions of the Proposal, these limitations are too prescriptive and inconsistent with current (and historic) market practices. As noted above, these limitations are also unnecessary in light of the Proposal's extensive deferral, forfeiture, downward adjustment and clawback requirements.

These limitations would force Covered Institutions to increase the target levels in their compensation plans in order to compete for talent. Additionally, lower leverages would dissuade Covered Institutions from setting any targets at all, which would be a difficult cultural shift if undertaken.

As noted above, FSR believes that the Agencies should eliminate these caps on performance upside (leverage) from the final rule. However, if the Agencies decide to include caps on performance upside, a uniform target of at least 200% should be permitted for all covered personnel at all Covered Institutions. Historically, the Agencies seem to have viewed

[46] The Proposal's request for comments covered in this section: 8.1, 8.2 and 8.3.

[47] The Proposal's request for comments covered in this section: 2.7, 2.46, 4.1, 8.4, 8.5, 8.6 and 8.7.

200% leverage as acceptable for all but the biggest and most complex institutions. This change would create a significant re-design obstacle for many of our members. This leverage limit would have even more of an adverse effect on the ability of Covered Institutions that are not publicly traded to attract and retain talent, because non-public entities cannot use company stock (which has the ability to incent performance based on the rise or fall share value) when it comes to attracting and retaining talent.

3. The Proposal's limitations on relative performance measures are unnecessary and unreasonably restrictive (§_.8(c)).[48]

FSR does not believe that the prohibition against using incentive-based compensation performance measures for any covered person based solely on industry peer performance comparisons would help to deter behavior that could put the Covered Institution at risk of material financial loss and otherwise further the Agencies' goals.

As noted above, these limitations are also unnecessary if the final rule retains the Proposal's extensive deferral, forfeiture, downward adjustment and clawback requirements.

4. The Proposal's limitations on volume-driven incentive-based compensation are unnecessary and unreasonable restrictive (§_.8(d)).[49]

For many employees of Covered Institutions who are not either senior executive officers or significant risk-takers, a substantial portion of their compensation is based on commissions or similar performance. In addition to being overly prescriptive, these limitations are simply unnecessary in light of the Proposal's extensive deferral, forfeiture, downward adjustment and clawback requirements, as noted above.

E. The Requirements and Prohibitions Applicable to All Covered Institutions Need Improvement (§_.4)[50]

1. Rules should establish principles that allow consideration of all relevant factors but leave decisions to the judgment of the board of directors (§ .4). [51]

The final rule should leave the judgment as to whether an incentive-based compensation arrangement encourages inappropriate risks to the Covered Institution and its board of directors.

FSR believes that the rule should create a safe harbor or apply a standard similar to the business judgment rule so that the board of directors, or compensation committee thereof, cannot be second-guessed if they (1) made a compensation decision not involving direct self-interest or self-dealing, and (2) acted on an informed basis, in good faith, and in the honest belief that their actions are in the Covered Institution's best interest.

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[48] The Proposal's request for comments covered in this section: 2.18, 4.1, 8.8 and 8.9.

[49] The Proposal's request for comments covered in this section: 8.10 and 8.11.

[50] The Proposal's request for comments covered in this section: 4.1, 4.2, 7.26, 10.1, 10.2 and 11.1.

[51] The Proposal's request for comments covered in this section: 4.1, 4.2, 7.26, 10.1, 10.2 and 11.1.

The decision on what level of total compensation a financial institution provides to its officers, employees and directors should be made by the institution. Subsection (b) of the Statute requires the Agencies to promulgate regulations or guidance that prohibits any incentive-based payment arrangement, or any feature of any such arrangement, that encourages inappropriate risks by a Covered Institution by providing a covered person with excessive compensation, fees or benefits. What constitutes an arrangement that encourages inappropriate risks or provides a covered person with excessive compensation is unique and varies widely according to the specific needs and risk appetite of a particular institution. FSR believes that the Agencies should not attempt to define this concept, but should only attempt to provide guidance that if properly followed by a Covered Institution's board of directors (or a committee of the board) under standards similar to the business judgment rule, is not subject to being second-guessed by federal regulators or a court.

FSR believes that §__ .4(a) could be revised by adding the following paragraph immediately after clause (2) thereof:

> A Covered Institution's board of directors (or a committee thereof) shall determine whether an incentive-based compensation arrangement or any feature of any such arrangement, encourages inappropriate risks by the Covered Institution by providing covered persons with excessive compensation in accordance with the business judgment rule. For example, an incentive-based compensation arrangement might encourage inappropriate risks by the Covered Institution by providing a covered person with excessive compensation when the arrangement provides outsized increases in the covered person's compensation for achieving unprecedented, short-term performance goals without mitigating factors such as compliance or oversight goals.

FSR believes that the Agencies' final rule should not set compensation amounts or label an amount of compensation as "excessive." No connection necessarily exists between total compensation and the amount of risk an employee brings to an institution. The decision on what level of total compensation an employee receives should be up to the Covered Institution considering the employee's experience, skills, and talent. Covered Institutions should be given the discretion to award a compensation package within the Covered Institution's applicable risk framework balancing risk and rewards. The Dodd-Frank Act requires that any regulation of "excessive" compensation should be connected to risk and FSR believes that the Agencies' final rule should not exceed that authority.

FSR believes that the Agencies' final rule should provide that the incentive compensation awarded to a covered person will be presumed not to provide "excessive" compensation if the Covered Institution otherwise complies with the requirements of the final rule and there is appropriate documentation of the deliberative process that was followed by management and/or the compensation committee of the institution's board of directors in determining the amount of incentive compensation awarded to the covered employee.

Finally, because of the complexity and ambiguity of the excessive compensation requirement, FSR believe that the Agencies' final rule should apply the §__ .4 restrictions to senior executive officers only.

2. <u>Rules should provide flexibility as to which board of directors approves and adopts plans (§ .4(e)).</u> [52]

The final rule should clarify that the parent of a Covered Institution may approve incentive-based compensation arrangements for senior executive officers of its Covered Institution subsidiary. Existing statutory requirements could preclude subsidiary institutions that are not "issuers" from awarding equity compensation. The board approval requirements in the Proposal could be read to restrict non-issuer subsidiary institutions from awarding equity compensation.

F. <u>The Requirements Applicable to Covered Persons Engaged in Control Functions at Level 1 and Level 2 Covered Institutions Need Improvement (§_.9(b))</u>[53]

FSR would advise the Agencies to adopt portions of Section .__9 of the Proposal as guidelines rather than a final rule.

The Agencies should revise the Proposal's requirement that covered persons engaged in "control functions" (which the Proposal broadly defines) at Level 1 and Level 2 Covered Institutions must be compensated in accordance with the achievement of performance objectives linked to their control functions *and independent of those business areas*. Covered Institutions often maintain an enterprise-wide incentive-based compensation program that factors in risk management and effectively mitigates the risk of small groups of employees trying to drive pay by taking inappropriate risks, as well as mitigating the potential conflict issue on which this added requirement is focused. The final rule should allow covered persons engaged in control functions to participate in enterprise-wide incentive-based compensation plans and programs.

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[52] The Proposal's request for comments covered in this section: 4.1, 4.2, 7.26, 10.1, 10.2 and 11.1.

[53] The Proposal's request for comments covered in this section: 2.37.

ADDENDUM B[54]

Insurance Company Issues

FSR strongly believes, consistent with the intent of Congress, that it is inappropriate to apply the Proposal to operating insurance companies that are parent companies of a bank or thrift institution within their structure. As Federal Reserve Governor Daniel K. Tarullo recognized in his recent address to the National Association of Insurance Commissioners International Insurance Forum on May 20, 2016, the Federal Reserve Board's oversight role complements the role that insurance regulators play, and while the Dodd-Frank Act broadened the Federal Reserve Board's statutory mandate, it also preserved functional regulation. He added that the Federal Reserve Board has no role in regulating the manner in which insurance is provided as that is the province of State insurance regulators. Indeed, insurance companies are inherently different from banks in their business operations, systemic risk profiles and how they are supervised and regulated. Compensation methods of the insurance industry also vary greatly from other types of financial services firms. Applying the Proposal to the discrete number of insurance companies regulated as Covered Institutions would harm their ability to retain and attract high quality employees and, thereby potentially reduce the strength and success of these companies. The negative impacts of the Proposal would be exacerbated by the exorbitant compliance costs that would be incurred by these institutions. FSR discusses each of these issues in greater detail below.

1. Insurance companies are inherently different from banks.

Parts of the Proposal seem to have been developed based on the Agencies' experience supervising banks. The overly prescriptive standards are intended to curtail financial stability risk, which is not presented by insurance companies. Insurance companies and the business of insurance are vastly different from banks, bank or thrift holding companies or the business of banking. Insurance companies compensate and incent their employees differently than banks and bank holding companies compensate and incent their employees. Thus, it is inappropriate for the Agencies to apply this rule to insurance companies and the compensation programs of the insurance companies.

Due to the uniqueness of the insurance business model as compared to banking and the fact that insurance company savings and loan holding companies ("SLHCs") take on a variety of structures and risks (stock, mutual, life, property and casualty), the Agencies' would be better served utilizing principles-based guidance to carry out their safety and soundness mandate because a prescriptive rule designed for banks does not accurately capture the unique needs of the insurance industry.

[54] The Proposal's request for comments covered in this section: 1.1, 2.3, 2.4, 2.5, 2.7, 2.8, 2.9, 2.10, 2.25, 2.37, 2.38, 2.44, 3.1, 6.3 and 7.33.

2. Applying the Proposal to operating insurance companies that own depository institutions is inconsistent with the letter and the spirit of the McCarran-Ferguson Act.[55]

Section 956(d) of the Dodd-Frank Act expressly provides that Section 956 and regulations issued under it are to be enforced under Section 505 of the Gramm-Leach-Bliley Act. An analysis of this provision evidences Congressional intent to exempt insurance companies from the Agencies' enforcement of Section 956 and quite possibly to reserve incentive compensation risk regulation to State insurance authorities.

Section 505(a)(6) of the Gramm-Leach-Bliley Act expressly provides that Subtitle A (Disclosure of Nonpublic Information) of Title V (Privacy) and regulations prescribed thereunder are to be enforced as to insurance companies by State insurance authorities, subject to Section 104 of the Act, not by the banking agencies. Section 104(a) of the Gramm-Leach-Bliley Act expressly provides that the McCarran-Ferguson Act remains the law of the United States.

With this Proposal, as it would relate to insurance companies that own banks or thrifts, the Federal Reserve Board is proposing to commence, for the first time and without certain legal authority or jurisdiction, the direct regulation of the insurance industry.

Applying the Proposal to operating insurance companies that own depository institutions is inconsistent with the letter and the spirit of the McCarran-Ferguson Act. That statute largely reserves regulation of the business of insurance to the States. It expressly provides that "[n]o Act of Congress shall be construed to … impair … any law enacted by any State for the purpose of regulating the business of insurance …."[56] Thus, Section 956 of the Dodd-Frank Act ought not to be construed to impair any state law enacted for the purpose of regulating insurance. A primary focus of state regulation and oversight of insurance companies is solvency, which depends on insurers' ability to operate profitably and maintain appropriate capital and reserves. Since compensation costs are part of the operational costs of insurance products, state regulation of insurance companies would be adversely affected by limits the Agencies would impose on the ability of insurance companies to offer competitive and appropriate compensation to their executives and other employees. To the extent that the Proposal would limit such compensation, insurance companies may find it increasingly difficult to retain and recruit experienced qualified executives to sell their products, supervise their employees, and manage their companies in ways that meet all regulatory requirements and satisfy the concerns of state insurance regulators. Notably, these regulations would apply to a very discrete number of insurance companies, thus placing them at a competitive disadvantage—in both their banking and insurance activities vis-a-vis their competitors. That disparate treatment of one sector of the insurance industry would impair the effectiveness of state insurance regulation and violate the letter and spirit of the McCarran-Ferguson Act.

A fundamental part of the business of insurance is the sale of insurance products often through a network of licensed and trained insurance agents. A primary objective of state regulation of insurance companies is to regulate the industry in a way to monitor institutions and

[55] 15 U.S.C. § 1011-1015.

[56] 15 U.S.C. § 1012(b).

licensed individuals, and to correct market failures that would otherwise cause insurers to incur an excessive risk of insolvency.[57] Significant state insurance department regulatory resources are employed to monitor market behaviors, compliance, and solvency.[58] Each State, the District of Columbia and the U.S. Territories are responsible for regulating the insurance business within their own jurisdictions, and each maintains its own insurance department operating under the supervision of an elected or appointed commissioner, director or superintendent. Insurance companies are chartered by individual jurisdictions and receive a license (certificate of authority) to conduct business from each jurisdiction in which the company wishes to underwrite insurance.[59] Those licenses may be revoked if insurance commissioners determine that the companies are not operating in a safe and sound manner. Since 1792, States have required insurance companies to limit their activities and investments and to file financial statements.[60] State insurance regulators monitor insurance company financial health by requiring extensive financial reporting based on conservative statutory accounting principles that do not permit the inclusion of certain assets in calculating an insurer's surplus. State regulators use that reporting and many other information sources to screen for solvency,[61] such as on-site examinations. Using these tools, state insurance regulators historically have done an excellent job of limiting risk at insurance companies. Between 1980 and 2010, insurance companies had a lower failure rate (0.40%) than either banks (0.49%) or thrift institutions (2.07%).[62]

For the Federal Reserve Board to commence regulation of the business of insurance through the backdoor mechanism of proposed regulation of incentive compensation is neither appropriate nor on sound legal footing. In addition, the Proposal would not regulate the entire industry, thus creating a level playing field. Instead, the Proposal would proscribe compensation paid by one set of insurance companies, selected only on the basis of ownership of an insured depository institution, subjecting them to regulation unlike any others in the industry. This can only have the effect of making it more difficult for such insurance companies to retain and recruit qualified executives thereby creating unnecessary challenges for state regulation and regulators.

To the extent that compensation of insurance employees is of concern to state insurance regulators, under our federal system and in accordance with Congressional intent reflected in the McCarran-Ferguson Act, it should be entirely within the purview of the state regulators to address any such concerns. For the Federal Reserve Board to assert direct regulatory authority over insurance industry compensation and take authority out of the hands of state insurance regulators is on an unsound legal footing and will weaken the ability of state insurance regulators

[57] Report of the National Association of Insurance Commissioners ("NAIC") and the Federal Reserve System Joint Troubled Company Working Subgroup: A Comparison of the Insurance and Banking Regulatory Frameworks for Identifying and Supervising Companies in Weakened Financial Condition (April 19, 2005) at 5.

[58] *Ibid.*

[59] *Ibid.*

[60] *Ibid*. at 6.

[61] *Ibid*. at 11.

[62] Comparative Failure Experience in the U.S. and Canadian Life Insurance and Banking Industries From 1980 To 2010 (March 2013) at 33.

to carry out their responsibilities and effectively do their jobs in the regulation and supervision of firms and individuals in the insurance business.

Congress implicitly recognized in the Collins Amendment to the Dodd-Frank Act[63] and explicitly in its subsequent amendment of the Collins Amendment[64] that insurance companies are not like traditional holding companies regulated by the Federal Reserve Board. The amendment to the Collins Amendment expressly recognized that insurance company capital needs are different from bank holding company capital and that insurance company accounting needs to be different from bank holding company accounting. Similarly, Congress directed that the Financial Stability Oversight Council's Volcker Rule recommendations should appropriately accommodate the business of insurance, further evidencing the desire of Congress that any regulation of the insurance industry in the implementation of the Dodd-Frank Act must take into account the nature of the insurance business and insurance risk-taking and risk management. The same is true for insurance company compensation.[65]

3. <u>By possibly applying its regulation to "Persons Providing Insurance" the Federal Reserve Board's regulation is inconsistent with the proposals of other Agencies.</u>

Neither the OCC nor the FDIC propose to apply the requirements of the Proposal to "persons providing insurance," only the Federal Reserve Board does so. Thus, the Federal Reserve Board's action is inconsistent with the statutory directive that the agencies develop the rule jointly. The other Agencies excluded persons providing insurance because, under the terms of the Gramm-Leach-Bliley Act, which governs enforcement of the rule, the banking agencies have no power over persons providing insurance. That power rests with state insurance regulators. In other words, the Federal Reserve Board has proposed to apply the Proposal to persons providing insurance, yet lacks the authority to enforce such a rule.

4. <u>The possible benefits of applying the Proposal to insurance companies would be greatly outweighed by the expense and administrative burdens that the Proposal would place on such insurance companies.</u>

Any theoretical benefit from the Proposal as it relates to these institutions would be greatly outweighed by the expense and administrative burdens that the Proposal would place on such insurance companies. Creating the level and type of prohibitions, disclosures, recordkeeping, monitoring, controls, governance and policies and procedures that would be necessitated by the Proposal would present a considerable expense and impact on the business of the organization in a fundamental way. Likewise, any benefits from subjecting a subsidiary bank or thrift institution to Level 1 or 2 obligations, based on the consolidated assets of the large parent insurance company, would be greatly outweighed by the expense and administrative burdens the Proposal would place on such institutions.

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[63] § 171(b)(4)(D).

[64] The Insurance Capital Standards Clarification Act of 2014, resulting in 12 U.S.C. 5371.

[65] As discussed above, FSR believes that the Proposal should not apply to insurance companies. However, if the Agencies decide to apply the final rule to insurance companies, the definition of the term "significant risk-taker" should not apply to the ability of an employee to initiate or structure proposed insurance product offerings, because the design and approval of such products is subject to extensive regulation and scrutiny by state insurance regulators.

Even if there were perceived policy concerns that might on their surface appear to justify applying the Proposal to insurance organizations in order to protect their banking operations, those concerns do not withstand scrutiny.

FSR's member insurance companies do not engage in complex banking operations. Problems in these institutions would not threaten other subsidiaries within the company or have any discernible impact on the financial stability of the United States.

Of importance in considering the risk profile of these institutions, thrift institutions that are subsidiaries of existing unitary SLHCs have statutorily limited powers; their activities are limited by law to those enumerated by the qualified thrift lender ("QTL") test.[66] Under that test, generally at least 65% of the thrift institution's assets must be comprised of qualified thrift investments (*i.e.*, residential housing or manufactured housing loans, home equity loans, securities back by such loans, Federal Home Loan Bank stock, student loans, small business loans and credit card loans and, subject to limits, low- and moderate-income residential real estate development loans, church loans, school loans, nursing home loans and hospital loans, consumer loans and shares of stock of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association). This limited list of activities precludes insurance SLHCs from investments in more complex assets such as commercial real estate, corporate loans, structured financings, complex derivatives-based transactions and other types of transactions that carry higher levels of risk and that, when not properly managed, may threaten the financial stability of the organization.

The Proposal would permit holding company subsidiaries to satisfy the Proposal's requirements if the parent ensures compliance by the subsidiary. However, this element of the Proposal would not reduce the burden of complying with the requirements for covered insurance companies; it would only push the burden up the ownership chain to the parent Covered Institution. For example, where the parent is an insurance company with a bank or thrift institution subsidiary, the insurance company would bear the compliance expense of its downstream subsidiary having to comply with the Level 1 and Level 2 standards. This is despite the fact that the business nature, workforce, and compensation structure (including incentive-based compensation) of the insurance company will be very different from that of the bank or thrift institution subsidiary.

5. The application of the Proposal to insurance companies is premature until other Federal Reserve Board rulemaking processes are completed.

It is difficult to see how it would be appropriate for the Federal Reserve Board to propose a rule on how to compensate employees in insurance companies based on the risk that such employees pose to the safety and soundness of the holding company or the underlying depository institution at a point in time when the Federal Reserve Board has not yet adopted final rules to set forth the basis on which it will assess risk for the insurance companies it regulates. On June 3, 2016, the Federal Reserve Board issued an advance notice of proposed rulemaking ("ANPR") regarding various potential approaches to regulatory capital requirements for depository institution holding companies significantly engaged in insurance activities. Comments are due on that ANPR by August 17, 2016, and eventually the Federal Reserve Board may propose a rule

[66] 12 U.S.C. § 1467a(m).

to reflect how it will consider the adequacy of the capital of such firms. At some indefinite later date, the Federal Reserve Board may adopt a final rule and subsequently that rule may become effective at which time it will become clear what capital levels the Federal Reserve Board will expect such insurance companies to maintain and, by extension, apply portions of the incentive-based compensation rule that rely on regulatory capital.[67] Therefore, it is at the very least premature to issue rules regulating the compensation of insurance company employees whose conduct theoretically could put the capital of the insurance company at risk.

Finally, we note that the Federal Reserve Board already exercises supervisory oversight over insurance SLHCs, which includes the ability to review corporate governance and risk management activities. Such efforts allow appropriate oversight without the need for a full-scale application of the Proposal.

6. The asset thresholds established by the Proposal are not appropriate for insurance companies.

For purposes of measuring presumed risk in relation to incentive compensation, the amounts and types of assets held by a bank, an insurer or an asset manager are not directly comparable. In the development of the Proposal, the Agencies appear to have used asset thresholds as familiar measures taken solely from the banking industry. Insurance company assets, however, are not a readily comparable or an appropriate factor in determining whether and how a regulation should apply to insurers who own thrifts. This is due not only the unique nature of many insurance assets, but also to the liability structure of the insurance industry, which is completely dissimilar from the deposit taking model used by banks.

The goal of the Proposal is to reduce the risk that inappropriate incentive-based compensation programs will increase systemic risk to the financial system. However, even large insurance organizations with a bank or thrift institution in their structure do not pose significant systemic risk merely by virtue of owning the bank or thrift, particularly in light of their limited size and less complex business operations. This low risk profile was explicitly acknowledged several times by the Federal Reserve Board in its recent ANPR on insurance savings and loan holding company capital.[68] Therefore, it would be inappropriate to apply what are arguably enhanced prudential standards targeted to larger bank holding companies to a separate sector of the financial industry.

FSR members believe that insurance companies that own bank or thrift institutions should be excluded entirely from the Proposal. This would enable the Federal Reserve Board to give effect to one of the policy goals of the Dodd-Frank Act, as articulated in the Volcker Rule (Section 619), to "appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which the insurance company is affiliated and of the United States financial system . . ."[69]

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[67] Such standards would be necessary, for example, should the final definition of "significant risk -taker" continue to integrate using a capital exposure test.

[68] 81 FR 38361 (June 14, 2016).

[69] 12 U.S.C. § 1851(b)(1)(F).

Further, some of the insurance companies affected by the Proposal are mutual or reciprocal in form and are owned by their policyholders. Such mutual (or reciprocal) companies encounter special issues on how to incent employee performance because they are unable to use stock or stock-related components in compensation plans for their employees. Unlike public companies, mutual companies do not have the legal ability to issue stock. Thus, mutual institutions are not able to issue restricted stock, stock appreciation rights or stock options as incentive compensation in the same manner as public company financial services organizations. Since the consolidated asset size of several of these mutual insurance SLHCs is large, the Proposal would treat many of them as Level 2 institutions imposing many of the most complex and onerous requirements of the Proposal, substantially compounding the existing incentive compensation challenges that arise from their mutual form.

FSR respectfully requests, for the reasons above, that insurance companies be exempted from coverage under the Proposal.