May 31, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Comments on Proposed Rules on Incentive-Based Compensation Arrangements
File Number S7-12-11

Dear Ms. Murphy:

The Center On Executive Compensation ("Center") is pleased to submit comments to the U.S. Securities and Exchange Commission ("Commission") providing its perspective on the rules on incentive-based compensation arrangements that have been jointly proposed with the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration and the Federal Housing Finance Agency (collectively, the "Agencies"). Our comments focus on our concerns that the proposed regulations are exceedingly broad and would unnecessarily transfer Board authority to the government with respect to the strategy, compensation and oversight of financial institutions. Moreover, because of the breadth of information that the agencies have proposed to collect, the Center believes that agency review is likely to take a one-size-fits-all approach to implementation and enforcement that would not allow for discretion to reflect the unique structure, business strategy and other characteristics that distinguish one company from another. We are concerned that this rigid approach will ultimately hurt shareholders and other stakeholders.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 325 large companies, and the Center's more than 80 Subscribing Companies are HR Policy members that represent a broad cross-section of industries. Because senior human resource officers play a unique role in supporting the compensation committee as well as establishing and operating incentive-based compensation programs for employees below the executive level, we believe our views can be particularly helpful in understanding the important role that carefully constructed executive compensation packages play in ensuring a strong link between pay and performance and mitigating risks that could lead to material loss.

I. Executive Summary

The Board of Directors is elected by the company's shareholders and is responsible for structuring incentive arrangements to attract, retain and motivate employees to manage the company with care and to produce sustained creation of shareholder value. The proposed incentive-based compensation regulations implementing Section 956 of the Dodd-Frank Act are extremely broad and the Center believes that they will lead to the Agencies taking a one-size-fits-all approach to enforcing them, thereby reducing the role that the Board plays in setting compensation. Compensation is a unique tool as it effectuates company strategy, reflects market forces and allows companies to distinguish themselves from other employers in the market for talent. The following summarize the Center's primary concerns with respect to the proposed regulations:

- Section 956 of the Dodd-Frank Act should be implemented in a Board-centric manner which draws on the informed judgment of the Board. Equipped with intimate knowledge of the company's business and talent strategy, the Board, is supported by the advice and council of independent expert advisors and is uniquely qualified to design and monitor incentive arrangements that are in the best long term interests of shareholders. Failing to maintain and reinforce the Board's unique role in managing compensation will create disjointed programs that are likely to negatively affect company performance without fulfilling the purpose of this rule – to improve the safety of financial institutions and mitigate unnecessary and excessive risk. This is especially the case with respect to executive compensation.
- Consistent with the duty to manage incentive arrangements in an informed and careful manner, Boards should continue to have responsibility for risk mitigation. Since the beginning of the economic downturn, companies took steps to minimize risk prior to government intervention. Accordingly, companies with strong corporate governance have involved the risk management function in discussions regarding compensation. The Center believes that the proposed regulations should recognize the initiatives Boards have undertaken to manage risk and adopt a flexible approach which allows Boards to adopt the most appropriate risk mitigation strategies for a company.
- Most companies seek to minimize risk in incentive compensation through multiple levels of review -- an appropriate and reasonable approach consistent with sound governance. These best practices should be recognized and accommodated in the rules. Requiring all companies to adopt a one-size-fits-all approach to risk mitigation is an overly broad reaction as most institutions already have in place a well-defined governance structure to assess risk in incentives. Additionally, companies should be free to allocate responsibility for risk management as appropriate for their business structure. The proposed regulations contemplate dictating a governance structure with respect to the compensation committee's responsibilities in reviewing, assessing and approving compensation for all individuals that have the ability to expose the institution to loss. Consistent with the oversight role of the Board, the responsibility for mitigation of risk in incentives

below the executive level should be company management, and the Board should have responsibility to ensure processes are in place, and monitor such processes, to ensure risk mitigation is appropriate.

- The mandatory deferral provision in the proposed regulations exceeds the Agencies' statutory mandate and is contrary to a Board-centric approach to compensation. The Center is concerned that this requirement will lead to a "cookie-cutter" approach to executive compensation among large financial institutions. Moreover, the requirement raises a number of questions with respect to how it will be interpreted and implemented, because it is drafted in such vague and ambiguous terms.

- The determination of what constitutes excessive compensation is best left to the judgment of the Board of directors. The Center believes that the Agencies should take a principles-based approach that would allow companies to develop compensation programs that are appropriately structured for the company and to discourage executives from taking excessive risk. Incorporating flexibility in these rules ensures that Boards can tailor the compensation programs – especially with respect to the competition for talent -- to reflect the unique company-specific facts and circumstances that surround each compensation decision.

- To the extent that the proposed regulations are duplicative of existing regulations, the Center requests that the Agencies consider removing the duplicative provisions. The annual report requirement is excessive, unclear and is redundant with many provisions that are already required to be filed under existing SEC disclosure rules and existing financial regulatory agency guidelines.

- As the proposed regulations are currently drafted, it is not always easy to determine which of the seven Agencies would be the appropriate regulating agency. This could lead to confusion in the future as each agency is permitted by the regulations to establish additional guidance. It is common for financial institutions to have two or more divisions that fall under a single corporate entity; therefore, it is possible that separate divisions could fall under the purview of different regulating Agencies with potentially inconsistent or contradictory requirements. The Center seeks clarification regarding the appropriate regulating agency rules.

The Center's detailed comments on these issues follow.

II. Section 956 Should be Implemented in a Board-Centric Manner

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Agencies to promulgate regulations that prohibit incentive-based compensation that may encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. The Center is extremely concerned that the proposed rules are so prescriptive that they will effectively undermine the ability of covered financial institutions, especially those that are publicly held companies, to appropriately tailor compensation to performance for executives and other employees. The Center urges the Agencies to reconsider the prescriptive nature of these rules and to reshape these rules as guidelines to give the boards of directors of covered financial institutions the leeway and authority to govern a company effectively while accomplishing the statutory mandate of section 956. Allocating decision-making authority between the board, shareholders and the government as proposed will create disjointed programs that are likely to negatively affect company performance without adding measurably to the safety and soundness of the institutions.

A. The Authority to Determine Senior Executive Compensation Should Rest With the Board.

Boards of directors are required to manage the company in the best interests of the company and its shareholders and to undertake such responsibility consistent with their duty of care and good faith. A critical component of managing a company involves setting the compensation for the company's senior executives and monitoring the compensation programs established for the company's other employees. The proposed rules prohibit companies from establishing or maintaining any type of incentive-based compensation arrangement that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation.[1] Although this prohibition may appear logical on its face, the Center is concerned that the vague standards in the proposed regulations, combined with the agencies' relative inexperience in assessing and understanding the business reasons underlying compensation decisions will leave every Board compensation decision subject to second guessing. For example, it is not clear what the Agencies mean specifically with respect to certain phrases, such as "inappropriate risks" and "excessive compensation." Yet, the proposed regulations enumerate a list of factors that must be considered, and the Center is concerned that these guidelines will result in a one-size-fits all approach to compensation and the nuances that are so critical in setting compensation will be lost.

In determining executive compensation, Boards are required to act not only in the best interests of shareholders and the company, but to uphold statutory requirements such as maintaining the safety and soundness of the institution. Within the framework of section 956, Boards need the flexibility to tailor compensation to the specific business needs of the company while complying with such requirements. Compensation arrangements may differ between similarly sized organizations due to factors such as entering new markets or starting a new business, bringing in an executive to run a business that has not done well or to reinvigorate a mature product line. In addition, financial institutions face competition for talent from other industries that are not subject to these rules. By advocating flexibility and a Board-centric approach, we are asking the SEC and the other agencies to recognize that such circumstances may require unique but prudent compensation approaches that may not be understood following a cursory review of the covered institutions' reports or pay disclosures.

---

[1] Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (proposed Apr. 14, 2011) (SEC regulation to be codified at 17 C.F.R. § 248.205(a)(1)).

B. Broad Interpretation Risks Substituting Government Decisions for the Judgment of the Board.

The Center is concerned that broad interpretation of the proposed rules will ultimately substitute government decisions for the business judgment of the Board and thus undermine the board's role of developing company-specific compensation.[2] As proposed, the regulations would effectively require the Agencies to take on the role of shadow compensation committees to review, assess and compare compensation at each covered institution for those employees who engage in transactions that may impact the company as a whole. Boards spend hours reviewing the company's operations, strategy and talent to develop a company-specific approach to developing compensation programs that best serve the interests of shareholders. It would be nearly impossible, and inappropriate, for the Agencies to develop the time and effort to gain this depth of understanding and therefore we are concerned that the Agencies will take a one-size-fits-all approach that may have the effect of standardizing compensation structures for an industry without respect to the business strategy that a Board would implement on its own.

The Center believes that the final regulations should be narrowly tailored to focus on addressing incentive compensation arrangements that provide excessive compensation and incentive compensation arrangements that could lead to the material financial loss to the institution. While the proposed regulations purport to accomplish these goals, the Center urges the Agencies revise these rules in such a way to accommodate the variability and differences among firms and business models. A company's board is in the best position to understand the institution's desired business strategy, industry and needs. The proposed regulations should provide a framework that is flexible enough to allow the board to exercise its judgment in determining what is best and appropriate for the institution it manages.

C. Provide More Flexibility By Implementing Section 956 Through Guidelines Rather Than Regulations

The plain language of Section 956 gives the agencies the flexibility to implement the section through regulations or guidelines.[3] The Center believes that the proposed rule should be issued as guidelines, rather than rules so that boards will ultimately have the final

[2] The business judgment rule "recognizes both the primacy of the board's role in corporate decision-making and the significant risks that are inherent in making entrepreneurial decisions. Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities 10 (Aug. 1, 2009). This rule was established so that the Board will not suffer legal action because they made a bad decision. *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, §956(a)(1).

authority to determine appropriate pay practices for its company.[4] Corporate compensation has been increasingly scrutinized and there are many checks to balance compensation programs. For example, not only are the actions of boards subject to fiduciary duties, but they are also now subject to the approval of shareholders through the periodic say on pay process.[5] Given the increased engagement of shareholders, a natural dynamic between the boards and shareholders will continue to develop and this new system of checks and balances is more appropriate for setting a particular company's compensation as opposed to government intervention through mandatory compensation standards.

III. Prohibition on Inappropriate Risks Leading to Material Financial Loss Should Build on Existing Best Practices

Section 956(b)(2) of the Dodd-Frank Act requires the Agencies to adopt regulations that prohibit any incentive-based pay arrangement, or any feature of any such arrangement, that the Agencies determine encourages inappropriate risks by a covered financial institution that could lead to material financial loss to the covered institution. While there are some existing concepts in banking law regarding excessive compensation, the Agencies do not have a long history of evaluating compensation arrangements may encourage excessive-risk taking. For this reason, in the final regulations, the SEC and other Agencies should adopt a board-centric approach that incorporates a wide range of risk mitigating practices already in place at various levels of the organization, rather than a prescriptive approach, especially the proposed regulations' mandatory deferral requirement for larger institutions.

A. Responsibility for Risk Mitigation Should Be Overseen by the Board of Directors But Implemented by a Larger Team

Because the Board of Directors has responsibility for establishing executive compensation programs to drive the financial institution's broader business strategy, the Board is in the best position to assess, in conjunction with input from the audit, compensation committees and independent external advisors, as well as the organization's risk management division, whether such programs encourage the existence of inappropriate risk and to determine appropriate risk mitigation strategies. The Center believes that a flexible approach is best, and on their face, the proposed regulations appear to provide

[4] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,173 (noting that "[t]he Agencies have elected to propose rules, rather than guidelines, in order to establish general requirements applicable to the incentive-based compensation arrangements of all covered financial institutions.").

[5] Say on pay was another provision implemented by the Dodd-Frank Act. It became effective for annual meetings that occurred on or after January 21, 2011. The votes that have occurred during these first two quarters indicate that shareholders are actively engaged in the process and are not automatically approving compensation programs.

covered institutions some flexibility in determining how to mitigate risk, how internal controls are maintained and the governance structure that oversees the risk program.[6]

Despite some flexibility, the Center is concerned that the proposed regulations will be interpreted so as to require compensation committee approval of all incentive compensation for all covered persons, rather than just for executive officers. This is neither an effective approach to risk management, nor does it encompass developing best practices among the financial industry. The Center believes that the compensation committee should be focused on senior executives and provide oversight of the processes within the institution performing similar functions for other covered employees.

A current practice at many financial institutions is to have a separate management committee that focuses on the compensation of employees below the senior executive level. The compensation committee oversees the compensation decisions made by the risk committee on a general level. By mandating that compensation committees become involved in risk mitigation for employees far below the executive level, their role is expanded significantly, thereby diluting the committee's ability to oversee compensation and effectively executive its traditional roles. The proposed rule should incorporate flexibility in terms of establishing a governance structure that is appropriate and workable for a particular company. The proposed rules should be revised to incorporate a safe harbor that would allow companies with such a structure to continue permitting the compensation committee to oversee the process by which compensation decisions are made with respect to employees below the senior executive level.

To assist Boards in their assessment and oversight of risk and incentives, the Center has developed a checklist that aggregates best practices for compensation committees as they structure incentives to mitigate the potential for excessive risk. Although this checklist focuses on executive compensation issues, the concepts can apply equally to highly leveraged individuals and groups of individuals in the financial services sector. The checklist raises questions to guide Board discussions so that the Board can determine and assess the extent to which the design and administration of their executive compensation program encourages or reinforces excessive risk-taking by management. The Center's checklist is attached to these comments as Appendix A. The Center believes that adopting guidelines that encourage companies to balance incentives and risk is a more effective approach than mandating specific requirements since it allows companies to tailor their risk mitigation specifically to the needs and strategy of their company.

---

[6] Incentive compensation arrangements must do one of the following: (1) balance risk and financial rewards; (2) be compatible with effective controls and risk management; or (3) be supported by strong corporate governance. Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,178.

B. Most Institutions Have a Well-Defined Governance Structure in Place for Assessing Risk in Incentives.

Most large financial institutions already have clear and effective structures in place for setting and reviewing compensation and risk, and these best practices should be incorporated into the final rule. Typically, under the terms of its charter, the Board Compensation Committee is responsible for overseeing risks in incentives for executive officers and above. The institution's risk management function participates in briefing the committee or consults with the compensation committee chair to ensure that appropriate risk mitigation measures are being implemented. Below the senior executive level, compensation is set by management and risk is assessed by a multi-disciplinary management committee assigned to assess risk that may include risk management, accounting, and human resources. For example, a company may designate a sales incentive risk committee to assess the risk in incentive programs applicable to sales employees who can structure transactions on behalf of the company. For these employees, the compensation committee is responsible only for overseeing the decisions made by management because of the large number of employees involved and the greater knowledge of the positions of management that oversee the employees.

As discussed further below under Section IV. C., the final rules should make clear that under Section __.5(b), the Board's or compensation committee's responsibility for "active and effective oversight" should not be mandated to include primary responsibility for reviewing compensation arrangements for employees below the senior executive level. Compensation committees would not have sufficient time or resources to carefully review and apply reasoned judgment to the compensation arrangement for executives or traders several levels below senior executives. In addition to being bad corporate governance, such a mandate could expose compensation committee members to significant personal liability and make it more difficult for public institutions to recruit qualified directors to sit on the committee. By overseeing the process undertaken at lower management levels, the compensation committee can ensure that a risk process is in place and management officials with greater knowledge of the positions are actively assessing risk. Sound approaches, such as the use of a multidisciplinary team, will help ensure that effective controls are being implemented.

C. The Business Judgment of the Board is to be Respected Unless There is Evidence of Action in Bad Faith or Without Due Care.

In addition, the proposed regulations make it appear that agencies will not be able to review their incentive compensation arrangements until long after they have been approved and paid. The Center believes that neither directors, nor covered persons should be at risk of an after-the-fact determination by an agency that compensation that has already been paid was excessive unless there is evidence that the Board acted in bad faith or without due care.

IV. Mandatory Deferral of Compensation for Executive Officers of Larger Institutions Exceeds Statutory Mandate

The proposed regulations impose a three-year deferral requirement for 50 percent of the incentive-based compensation granted to all executive officers at larger covered financial institutions, which are covered financial institutions with over $50 billion in consolidated assets.[7] The Center believes that this requirement goes beyond Dodd-Frank's statutory mandate[8] and is clearly contrary to a Board-centric approach to compensation. The proposed rule takes one of the suggested risk mitigation methods – deferral of payment – and imposes it on larger financial institutions thereby removing a Board's discretion to shape its compensation policy to its particular business model.

A. Deferral Requirement Goes Beyond Statutory Authority

The Center disagrees with the mandatory deferral requirement because it goes far beyond the statutory requirements, is ambiguous and removes the Board's discretion to mitigate risk in incentives in the best interest of the financial institution and its stakeholders. This is particularly true in the case of institutions that are public corporations. Generally, the compensation committee of a board is responsible for overseeing the development of compensation for the executive officers and with the additional reporting and oversight requirements, the financial regulators already have the ability to monitor how the companies are implementing the regulation. The Center is very concerned that these regulations will lead to a "cookie-cutter" approach to executive officer compensation among larger financial institutions.

B. The Deferral Requirement Is Ambiguous and Creates Uncertainty Regarding Adjustments

The Center stresses that the deferral requirement oversteps Dodd-Frank's mandate and is not appropriate for larger financial institutions. If the Agencies are unwilling to remove the mandatory deferral requirement, the Center believes the following revisions must be made:

- Compensation Covered by Deferral Rule. The proposed regulation states that an incentive-based compensation arrangement for any executive officer must provide for the deferral of "at least 50 percent of the *annual incentive-based compensation* of the executive officer."[9] This requirement causes some confusion as to whether the deferral applies to only annual incentives or to all incentive-based compensation granted annually. The language of the Preamble refers to incentive

---

[7] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,216.

[8] Dodd-Frank Wall Street Reform and Consumer Protection Act § 956.

[9] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,216.

compensation, not annual incentive compensation. The footnote in the Preamble provides an example in which the deferral requirement applies to an annual incentive.[10] Moreover, the annual incentive-based compensation requirement raises questions about what constitutes annual incentive-based compensation. Is it based on when the incentive compensation is granted or when it was paid? The Center recommends that if the deferral requirement is retained, the language of this provision should be changed to provide clarity and should read "50 percent of the incentive-based compensation granted annually." Rather than creating a mandatory deferral of the annual bonus, this would encourage those in the financial services industry to put more compensation into long-term incentives, consistent with best practice compensation design.

- Valuation Questions. The proposed rules require 50 percent of incentive-based compensation to be deferred; however, the regulations do not contain a method to determine the value of the incentive-based compensation. The Center believes that the summary compensation table valuation would be preferable as most institutions that would be subject to the disclosure are already required to value incentive compensation that way for SEC disclosure purposes. Under this approach, companies that grant a significant portion of awards annually in the form of long-term incentives would have a greater opportunity to satisfy the deferral requirement while not significantly changing the structure of compensation the Board has determined to be in the best interests of shareholders.

- Deferral Requirement. There are several questions raised by the deferral requirement, which was proposed to allow for flexibility for a company to administer its specific deferral program. First, as discussed above, it is unclear what counts as deferrals. For example, would long-term incentive programs (*i.e.,* stock options and performance shares) with a three-year vesting period count as deferrals? These vehicles achieve the goal for mandating deferral, which is to allow time to recognize and assess risks for the larger financial organization as a whole and have compensation adjusted automatically with the performance of the institution. This would concentrate the deferral provision to covered employees below the executive officer level, as many executive officers already receive more than 50 percent of their annual compensation through long-term incentives.

  Moreover, the proposed rule should distinguish between performance-based compensation under Section 162(m) of the Internal Revenue Code

[10] *Id.* at 21,180.

and incentive-based compensation as defined under the proposed rule. Restricted stock should be considered incentive-based compensation under the proposal, but it would not be considered performance-based compensation under the Code.

- Adjustment of Deferred Amounts. The proposed rule includes a provision that deferred amounts must be adjusted for actual losses or other measures of performance that are realized or become known during the deferral period. It is unclear how companies are to make this adjustment, e.g., the percentage by which the deferred amounts should be adjusted. The Center believes that the agencies should give companies flexibility in making such adjustments, provided a company's implementation is reasonable. There are many questions as to the implementation of this adjustment, including:
    - How much discretion is involved in the adjustment of the deferred amount and what is the measure of these adjustments?
    - When and how are companies expected to execute this adjustment?
    - Should the adjustment process impact equity compensation that vests before the adjustment is known and made (if applicable)?

  The Center urges the agencies to interpret this section so that once the restrictions lapse, the compensation should not be subject to adjustment. Further, the Center would urge the Agencies to adopt as flexible a process as possible to allow the Board discretion to make adjustments as they deem appropriate given the structure of their deferred compensation programs. The Center recommends that the agencies base the adjustment on a company's stock price because it is an easy, objective way to accomplish the adjustment.

- Complications with Existing Rules. The adjustment requirement raises interesting questions with respect to rules under Section 409A of the Internal Revenue Code, which contains significant limitations on the changes to the form and timing of payments under an incentive plan. The Center requests that the Agencies provide clarification with respect to this existing rule. In particular, should the word, "deferral" be used as it implicates the timing of a payment with respect to tax law (i.e., Section 409A) or are the proposed regulations simply contemplating a deferral as a vesting mechanism? If the mandatory deferral were phrased as a vesting requirement, it is possible that section 409A issues may be minimized. For example, if an employee were awarded an incentive-based bonus, but it was subject to the mandatory deferral, since the employee would not have access to the deferred amounts or know what the actual amount of the bonus until it was paid (due to the required adjustments under the proposed regulations), the employee would not technically be deferring the bonus as the term, deferral, is traditionally used. As drafted, the proposed regulation is likely to lead to confusion between concepts in banking law and tax law.

C. Limit Board Responsibility Over Compensation to Senior Executives, Rather Than Extending it to All Covered employee

The proposed rule contains a requirement that the Board of Directors or appropriate committee thereof must identify the covered persons that are not executives who individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance.[11] The Board or committee must then approve the incentive-based compensation of those individuals and maintain documentation of such approval. The Board or committee may not approve the incentive-based compensation unless it effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered person's activities.

The Center believes that a Board or committee should only be required to monitor that appropriate risk mitigation procedures and controls are in place for employees that fall below the executive officer level or the executives covered by the Committee's charter. This would limit the Board's role to one of oversight and monitoring for non-senior executive employees.

It would be extremely difficult, if not impossible for a Board to fulfill this requirement while properly executing its fiduciary duties. Boards have a duty of care, which requires directors to inform themselves "of all material information reasonably available to them concerning a given decision prior to acting on that decision."[12] Under the proposed rules, Boards would be required to spend an inordinate amount of time in order to identify, review and approve the compensation of any employee that may have the ability to expose the financial institution to loss in a deliberative and fully informed manner. This would divert a Board's time and resources away from ensuring the company is managed and operated in a manner consistent with increasing the long-term performance of the company. The intent behind the proposed rule can be accomplished by limiting the Board or committee's role to monitoring and approving processes and controls rather than the compensations received by each employee below the executive level.

Finally, in response to the Agencies' request regarding whether a different formulation of the deferral requirement should be required, the Center urges the Agencies not to extend the deferral rule to the top 25 earners of incentive compensation or any similar extension. By including the top 25 earners as suggested by the Preamble to the proposed

---

[11] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,216.

[12] Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities at 9 (citing *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985)).

regulations, a number of new questions would be raised. For example, how would the compensation for the top 25 earners be calculated since that is a number that fluctuates throughout the year and can be calculated in a number of ways. The Center believes the proposed regulations should be kept as narrow as possible, because the broader the application, the less it covers employees who truly have the ability to expose the financial institution to possible losses that impact the company as a whole.

D. Section 956 Does Not Give Agencies Unlimited Authority to Prohibit Excessive Compensation.

Section 956 of the Dodd-Frank Act gives the Agencies authority to jointly prescribe rules requiring enhanced disclosure of incentive compensation as well as reviewing and prohibiting types of incentive-based compensation that the Agencies deemed to encourage inappropriate risks through excessive compensation or that could lead to material financial loss to the financial institution. The Act does not contain any authority for the Agencies to mandate the deferral of incentive-based compensation. The agencies justify the deferral requirement by arguing that "[r]equiring deferral is consistent with international standards," but the Agencies have not otherwise explained their rationale for requiring mandatory deferrals.[13] Generally, U.S. executive compensation is more heavily oriented toward long-term equity-based incentives so the comparison to international standards may not be appropriate given the differences in the structure of compensation arrangements. The Agencies articulate that they "believe that incentive-based compensation arrangements are likely to be better balanced if they involve the deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance."[14]

The Center believes that the Agencies are mandating a particular approach to mitigating risk without sufficient proof that this requirement will have the intended effect. Absent an informed assessment by the Board that a particular approach to risk mitigation is best for a given company it is likely there will be unintended consequences, such as talent drain from larger covered financial institutions that are required to defer a considerable percentage of an executive's compensation as well as a shift in compensation practices away from incentive-based compensation arrangements to cash compensation, which is contrary to the intention of section 956.

V. Boards Should Have Discretion to Determine What Constitutes Excessive Compensation

The proposed rules prohibit a covered financial institution form maintaining any incentive-based compensation arrangement that would encourage inappropriate risk-taking by the covered institution by providing a covered person with excessive compensation that could encourage that individual to take inappropriate risks for the covered financial

[13] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,180.

[14] *Id.*

institution or that could lead to a material loss for the institution. This standard is nearly identical to existing banking rules under which Boards retain significant discretion to determine what constitutes excessive compensation.

Under the proposed rule, excessive compensation will be determined by a comprehensive review performed by the appropriate regulating Agency. The regulating agency must review certain factors to determine whether incentive-based compensation meets standards regarding excessive compensation. Given the subjective nature of the factors, it will be difficult for companies to determine whether compensation will be considered excessive. The Agencies should take a principles-based approach that would allow companies to develop compensation programs that are appropriately structured for the company and discourage executives and other employees from taking excessive risk. These requirements already exist under the SEC proxy disclosure regulations.[15]

As with risk mitigation, the Center believes that a Board-centric approach to compensation is preferable since compensation programs are developed and approved by a majority of independent directors or a compensation committee and the actions of boards should be given deference under the business judgment rule provided the Board did not act in good faith or without due care in approving the compensation program. Lastly, the Center believes that if a Board acts in good faith and with due care, the regulating Agency should not second guess the Board, and its compensation determinations should be upheld as neither directors, nor covered persons should be at risk for an after-the-fact determination by the regulating Agency that compensation that has already been paid was excessive. Given that this requirement is limited to the financial services industry, it may drive talent to other industries that allow the company to properly align performance with pay without limits.

A. Definition of Incentive-Based Compensation Requires Clarification

The proposed rules broadly define incentive-based compensation to include "any variable compensation that serves as incentive for performance."[16] The Center believes that, at a minimum, the Agencies should provide illustrations of the types of compensation included and excluded from the definition of incentive-based compensation in the proposed rules. For example, certain discretionary bonuses may not meet the definition of incentive-based compensation, depending on how the incentive arrangement is structured. While the definition of incentive compensation leaves some unanswered questions for companies, what constitutes excessive compensation under the proposed regulations also needs clarification.

---

[15] Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334 (Dec. 23, 2009) (to be codified at 17 C.F.R. §§ 229, 239, 240, 249, 274).

[16] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,215.

B. Boards Should Have Authority to Determine What Constitutes Excessive Compensation

Most financial institutions are already prohibited from providing excessive compensation; however, under the proposed rules, whether compensation is excessive will now be determined by the appropriate Agency. Regulators will make this determination based on factors that are listed in the proposed regulation.[17] The Center is concerned that the list of factors will not take into account specific business situations. For example, if a covered financial institution is not in a strong financial position and needs to hire an executive from another company as part of its restructuring, the covered institution may need to pay a recruiting premium to attract the courted executive, but there is concern that regulators could determine that that pay is excessive given the list of factors in the proposed regulations. The final regulations should clarify that competition for attracting and retaining talent is a factor in determining whether compensation is excessive, as well as the importance of the Board's disclosures regarding the rationale for such payments. A board-centric approach would provide companies the flexibility to ensure that compensation is reasonable and appropriate for the particular facts and circumstances that are unique to the compensation for each executive.

C. The Proposed Regulation Creates the Potential for Significant Unintended Consequences

The proposed regulations may result in the unintended consequence of companies shifting compensation strategies so avoid the potential post-payment determination that compensation was excessive. By eliminating incentive compensation, executives will receive stability and predictability in their pay and Boards will have the discretion to tailor compensation to reflect a company's business strategy. However, converting a significant portion of pay to fixed rather than variable incentive pay is inconsistent with best practices in pay design.

VI. Proposed Regulations Contain Many Duplicative Provisions

A. Annual Report Requires Excessive, Unclear and Duplicative Disclosures

Section 956(a)(1) of the Dodd-Frank Act requires that a covered financial institution submit an annual report to its appropriate regulating agency that would disclose the structure of the company's incentive-based compensation arrangements. The Center is concerned with the volume of the information and the precise level of detail[18] that must be filed on an

---

[17] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,216.

[18] *Id.* at 21,177 (requiring a report "that describes the structure of the covered financial institution's incentive-based compensation arrangements for covered persons and that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees or

annual basis under the annual report requirement. The Center is concerned with the burden that preparation would impose on a covered financial institution. For example, global companies maintain separate programs all over the world and it would take a considerable amount of time, education and other resources to know the details of every program and when, if any, changes are made to those programs.

Further, this requirement seems excessive given the broad SEC proxy disclosure requirements that apply to many institutions and that provide detailed descriptions regarding the company's mix of compensation and how those decisions were made. To the extent that this information is already disclosed in a company's Compensation Discussion & Analysis ("CD&A"), the Center would urge the Agencies to allow companies to incorporate their CD&A by reference in this annual report. Alternatively, since these companies already provide this information, the Agencies should consider eliminating this duplicative disclosure requirement for publicly traded companies. The Center is further concerned with the requirement that companies provide a "succinct description" of their practices and policies. Despite the proposed regulatory language, this disclosure is likely to become as long as voluminous as CD&A requirements, which were intended to be "concise."[19] The Center urges the Agencies to keep these descriptions short, because there has been a 25 percent expansion of pay disclosures in proxy statements among the largest 50 companies since 2008.[20]

The proposed rule notes that the Agencies are seeking simpler and less burdensome methods of reporting that would be sufficiently robust to help the agencies assess a company's incentive compensation arrangements.[21] It is our understanding that the Agencies are already required to review much of this information as part of ongoing safety and soundness reviews. If that is the case, then requiring additional disclosures from companies as proposed would be an excessive requirement.

In addition to requiring duplicative disclosures, the annual report requirement raises other serious questions:

- Confidentiality. It is unclear what information that is submitted to the Agencies will be publicly available. If public, the Center is concerned about the impact that these disclosures may have on a company's overall compensation strategy.

---

benefits to covered persons or could lead to material financial loss to the covered financial institution." The proposed regulation mandates the inclusion of five minimum standards.).

[19] *See* Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,076 (proposed July 17, 2009).

[20] Based on Center research data (Mar. 2011).

[21] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,177.

- Significant Implementation Costs. Though the SEC has anticipated that it will take companies approximately 100 hours to prepare the annual report, the estimate does not include the time, if any, that it would take a company to draft relevant policies and procedures that are also required by the proposed rules.[22] The Center is also concerned that the estimated external recordkeeping costs of $987,500 and up to $3,357,500 for covered entities with more than $50 billion in assets and covered non-bank companies having between $1 and $50 billion in assets, respectively, is far below what the actual costs would entail.

B. To Extent Duplicative of Other Requirements, Proposed Rule Should be Revised

In January 2011, President Obama issued an executive order that would eliminate burdensome and costly regulations and he noted that agencies must consider ways to reduce burdens for U.S. businesses because "[t]he administration believes firmly that regulations can both be more effective and consistent with American competitiveness."[23] Given the duplicative nature of the reporting requirements and the significant estimated costs of implementation, the annual report provision of the proposed regulations is contradictory to President Obama's executive order. The Center believes this requirement should be revised to reflect the duplicative nature with respect to required filings for publicly traded companies or eliminated altogether.

VII. Revisit the Appropriate Regulating Agency

As drafted, the proposed regulations provide that each regulating agency may establish additional guidance covering its regulated financial institutions in the future. The Center's Subscribers have described that it is common for financial institutions to have two or more divisions that fall under a single corporate entity, such as a depository holding company with broker-dealer and investment-advisor subsidiaries. Accordingly, it is possible that separate divisions fall under the purview of different regulating agencies (*e.g.*, the holding company regulated by the FDIC and the broker-dealers regulated by the SEC), thus requiring a holding company to make multiple filings under the proposed regulations.

There is, however, one exception to this rule. Under the definition of "covered financial institution," the proposed rules provide that a subsidiary of a bank holding company regulated by the Federal Reserve includes the subsidiaries of the institution.[24] We are concerned that without extending a similar approach to other regulatory agencies, the proposed rule may lead to contradictory or competing regulatory requirements with which a

---

[22] *See id.* at 21,188-89.

[23] John McArdle & Gabriel Nelson, "*Regulations: Obama issues executive order to cut red tape*," E&E PUBLISHING, LLC (Jan. 18, 2011).

[24] Incentive-Based Compensation Arrangements, 76 Fed. Reg. at 21,174.

single financial institution must comply since the proposed regulations provide that each regulating agency may establish additional guidance covering its regulated financial institutions.[25] The Center also believes that in instances where a holding company has subsidiaries that may also be covered financial institutions, the Agencies should appoint a lead regulator that would be responsible for all covered financial institutions under a single holding company with the nature of the holding company determining which regulating agency would have jurisdiction.

Although the Center is seeking a uniform rule, we believe that the rules for all agencies should provide for flexibility where logic dictates a different result based on the totality of the circumstances. For example, if a subsidiary would be regulated by one agency and the subsidiary is larger than the parent company that would be regulated by a different agency, the logical lead regulator would be that governing the subsidiary rather than the parent in this example.

VIII. Conclusion

The Center On Executive Compensation appreciates the opportunity to provide comments regarding the proposed rules for incentive-based compensation arrangements. If you have any questions about these comments, please contact me at tbartl@execcomp.org.

Sincerely,

Timothy J. Bartl
Senior Vice President and General Counsel

cc: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System
Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation

[25] *Id.* at 21,173-74.

Appendix A

Compensation Committee Checklist for Assessing Incentives and Risk

As Board Compensation Committees consider and finalize executive compensation arrangements for 2010, they will seek to confirm that the company's incentive programs are appropriately structured for the company and discourage executives from taking "excessive risk." Many Committees will also voluntarily disclose how their compensation programs address the subject of risk. The Center On Executive Compensation, a research and advocacy organization that provides a principles-based perspective on executive compensation matters, has created the following checklist to help guide Compensation Committees on these issues. The questions that form the basis of the checklist are provided below and in greater detail on the subsequent pages.

1. **Do the performance criteria and corresponding objectives represent a balance of performance and the quality and sustainability of such performance?**
2. **Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities?**
3. **When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?**
4. **Is there a relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?**
5. **Are the long-term incentive performance measures or equity devices overly leveraged and thereby potentially encourage excessively risky behavior?**
6. **Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?**
7. **Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?**
8. **Does the Compensation Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts? Are such discussions recorded in the minutes of the Committee meeting? Does the Compensation Discussion and Analysis articulate how the company's incentive plans mitigate risk?**

Role of the Compensation Committee in Assessing Excessive Risk

The Center On Executive Compensation believes that the Compensation Committee is in the best position to assess the appropriate relationship between the risk inherent in compensation arrangements and how that level of risk corresponds to the overall business strategy and competitive environment of the company. The Compensation Committee is responsible for establishing company-specific performance goals and potential incentive payouts that will motivate and reward performance supporting the long-term success of the company. The following checklist is offered to aid Compensation Committees in assessing the extent to which the design and administration of executive compensation encourages or reinforces excessive risk-taking by management.

1. **Do the performance criteria and corresponding objectives represent a balance of performance and the quality of such performance?**
    - The committee should evaluate whether performance criteria under annual and long-term incentive plans include measures of performance (such as financial or managerial goals) and measures of the quality of that performance (such as return measures or measures of sustainability of performance).
        - For example, incentive plans may focus on performance such as revenue, market share or other growth measures, and profitability, return on invested capital, or other measures of efficiency and return.
    - This dual approach mitigates the potential that executives will aim to achieve increases in measures such as sales or growth while not focusing on the ultimate value creation or sustainability of such performance.

2. **Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities?**
    - Does the annual incentive make up more than 50 percent of the total compensation opportunity?
        - To avoid placing too much focus on achieving short-term results, the annual incentive should not comprise a disproportionate share of the total annual executive compensation opportunity (base salary, annual incentive, estimated value of long-term incentive).
            - Too much emphasis on short-term results may jeopardize long-term performance

2. **Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities? (Continued)**

    - Recognizing that each company will be slightly different, the median division among the elements of compensation for Fortune 500 companies are
        - Salary ≈ 15-20 percent
        - Annual Incentive ≈ 15-20 percent
        - Long-Term Incentive ≈ 60-70 percent
    - Annual incentive in excess of 50 percent of annual compensation opportunity should trigger additional Compensation Committee scrutiny and potentially re-allocation of the annual pay opportunity to other components of the pay package.

- Does the annual incentive plan have unlimited payout potential?
    - The annual incentive plan should limit total payouts and the range of payouts should be set at a reasonable level, as determined by the Compensation Committee, to avoid encouraging decisions that maximize short-term earnings opportunities (swinging for the fences) at the expense of long-term viability.
- Do the annual incentive plan criteria and administration mitigate excessive risk?
    - It may be advisable to provide the Compensation Committee discretion in the incentive plan to adjust above-target payouts downward in the face of excessively risky behavior and discuss why this discretion was exercised in the proxy statement.

3. **When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?**

    - The range of performance, and corresponding payouts, should be within a realistic range of results as compared to the performance of the company's peer group.

4. **Is there a relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?**
    - While the annual and long-term incentive plans play different roles in the compensation plan, it is important that annual and long-term incentive plan objectives, metrics and targets are aligned to ensure that both types of awards encourage consistent behaviors and sustainable performance results.

5. **Do the long-term incentive performance measures or equity devices potentially encourage excessively risky behavior?**
    - Do the long-term incentive performance measures require excessively risky behavior to realize target or above target payouts? (e.g., do the targets require performance at so high a level that executives would take improper risks to achieve them?)
    - Do the performance criteria and vesting periods of long-term incentive awards overlap and thereby reduce the incentive to maximize performance in any one period?
        - With overlapping awards, an attempt to increase short-term performance may jeopardize company performance in future years and thus payouts under other outstanding awards.
    - Does the mix of long-term incentive awards meet the Committee's pay for performance objectives?
        - The Compensation Committee should determine the specific mix of long-term incentive awards that serve the best interests of the shareholders and the company, and may include:
            - performance-vested performance shares or units (which reward the attainment of key financial objectives)
            - time-vested or performance-vested restricted stock or restricted stock units (which may aid in the retention of key talent)
            - stock options or stock appreciation rights (which provide value only if share price appreciates thereby producing direct gains to shareholders).

6. Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?

- Require meaningful stock ownership requirements to link executives' interests to shareholders' interests
- In the Compensation Committee's discretion, require executives to hold a percentage of net equity received as a continuing link between shareholder and management interests.
- The level of share ownership should build over the executive's career
  - As the executive approaches a targeted retirement date the compensation committee may determine it advisable to approve a phased-diversification plan.
  - If the Compensation Committee determines appropriate, ownership may be also be required for some period after retirement
    - consistent with Internal Revenue Code Section 409A, which requires "key executives" to delay payout of deferred compensation for six months' after departure.
  - Holding requirements should not be so great as to potentially encourage overly conservative management decisions that would harm shareholder value.

7. Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?

- Adopt a strong clawback provision to provide for recoupment in the event of a material restatement.
- The Compensation Committee, in its discretion, should determine when the need for a clawback is triggered, to whom the clawback should apply and the mechanism for recouping incentive payments.

8. Does the Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts? Are such discussions recorded in the minutes of a Committee meeting? Does the Compensation Discussion and Analysis articulate how the company's incentive plans mitigate risk?

- In addition to competitiveness and the linkage of pay and business strategy, the relationship between business risk and incentive compensation should be a key consideration in setting performance criteria, the corresponding mix of awards and the range of incentive plan opportunities.

- The Compensation Committee should meet with the company's principal financial officer and/or corporate risk officer prior to approving financial incentive criteria and meet with him/her periodically to facilitate a complete understanding of how the company's financial performance interacts with its strategy and compensation programs.

- Company proxy disclosures should briefly explain how incentive designs mitigate risk to help demonstrate how risk is considered and addressed by the Committee in approving incentive plans.