September 4, 2024

Chief Counsel's Office
Attention: Comment Processing
Docket ID OCC-2011-0001
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, DC 20219

Melane Conyers-Ausbrooks
Secretary of the Board
Docket Number: 2024-0038
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

James P. Sheesley
Assistant Executive Secretary
Attention: Comments, RIN 3064–AD86
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Clinton Jones, General Counsel
Attention: Comments / RIN 2590–AB30
Federal Housing Finance Agency
400 Seventh Street SW
Washington, DC 20219

Re: Incentive-Based Compensation Arrangements; OCC Docket ID OCC-2011-0001; RIN 1557-AD39; RIN 3064–AD86; RIN-2590-AA42; RIN 3133-AE48 (May 3, 2024)

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the above-captioned notice of proposed rulemaking ("Proposal")[2] to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[3]

It has become all too common for financial executives and traders to pocket million-dollar bonuses and other compensation in a single year.[4] That prospect of unimaginable, immediate riches causes too many bankers to take outsized and unjustified risks. Worse, while those bankers

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2] Incentive-Based Compensation Arrangements; Docket ID OCC-2011-0001; RIN 1557-AD39; RIN 3064–AD86; RIN-2590-AA42; RIN 3133-AE48 (May 3, 2024); https://www.fdic.gov/sites/default/files/2024-05/2024-05-03-fed-reg-incentive-based-compensation-agreements_0.pdf.

[3] Public Law 111–203, 124 Stat. 1376 (2010), codified at 12 U.S.C. 5641.

[4] *See e.g.*, Kevin Wack, *Which Big Bank CEOs Got Hefty Pay Raises In 2023*?, AM. BANKER (Feb. 13, 2024), https://www.americanbanker.com/list/which-big-bank-ceos-got-hefty-pay-raises-in-2023; Arpita Banerjee & Umer Khan, *JPMorgan's Dimon Retains Position as Highest-Paid US Bank CEO in 2021*, S&P GLOBAL (Aug. 17, 2022), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/jpmorgan-s-dimon-retains-position-as-highest-paid-us-bank-ceo-in-2021-71558542.

benefit if their unreasonable and unconstrained risk taking pays off, the bank is left with the downside when they lose, or worse, other banks and taxpayers end up holding the bag if the losses are so big that the financial institution fails. This is exactly what happened in the 2008 financial crisis ("2008 Crash") and again with the regional bank failures in 2023[5] and is the reason that rulemaking to govern incentive-based compensation arrangements must be prioritized.

Section 956 of the Dodd-Frank Act directs a group of federal agencies—the Federal Reserve ("Fed"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of Thrift Supervision ("OTS"), the National Credit Union Administration ("NCUA"), the Securities and Exchange Commission ("SEC"), and the Federal Housing Finance Agency ("FHFA")—to ***jointly*** implement regulations or guidelines that prohibit any types of incentive-based pay arrangements that the regulators determine encourage inappropriate risk within 9 months of the July 10, 2010 enactment of the Dodd-Frank Act—or by April 2011. However, ***more than 14 years have now passed*** since the enactment of the Dodd-Frank Act and Section 956 has not been implemented. As a result, financial institution executives continue to take inappropriate risks, earn excessive compensation, cause material financial losses that lead to taxpayer-funded bailouts, and endanger financial stability. ***There is absolutely no excuse for the regulators' failure to act and they must implement Section 956 as soon as practicable to protect Main Street Americans and financial stability.***

This Proposal reflects the efforts of ***only four*** of the federal regulators named in Section 956—OCC, FDIC, FHFA, and NCUA (collectively "the Agencies")—to move forward with implementing rules that appropriately govern incentive-based compensation. We applaud the Agencies' action but also emphasize that the incentive-based compensation rulemaking that is mandated by Section 956 cannot be finalized, implemented, or enforced until the Fed and SEC join in the effort.[6]

As detailed in the Proposal as well as in other studies,[7] flawed incentive-based compensation arrangements contributed to the 2008 Crash, as these arrangements:

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[5] Incentive-Based Compensation Arrangements, *supra* note 2 at 27-28.

[6] *See e.g.*, Federal Deposit Insurance Corporation, *Statement by Martin J. Gruenberg Chairman, Federal Deposit Insurance Corporation Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements* (May 6, 2024), https://www.fdic.gov/news/speeches/2024/statement-martin-j-gruenberg-chairman-federal-deposit-insurance-corporation-4; Press Release, Office of the Comptroller of the Currency, *Acting Comptroller Issues Statement on Notice of Proposed Rulemaking on Incentive Compensation* (May 6, 2024), https://www.occ.gov/news-issuances/news-releases/2024/nr-occ-2024-48.html.

[7] *See e.g.*, Dennis Kelleher, *Ten Actions Necessary to Prevent Large Bank Failures, Strengthen the Financial System, and Protect Main Street Families* 3-4, Better Markets (May 9, 2023), https://bettermarkets.org/wp-content/uploads/2023/05/Better_Markets_Policy_Brief_SVB_Banking_Crisis_Responses_5-9-2023.pdf; BETTER MARKETS, COST OF THE CRISIS 71 (July 2015), https://bettermarkets.org/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf; Better Markets, *Dodd-Frank and Deregulation: Some Lessons from History* (Nov. 17, 2017), https://bettermarkets.org/newsroom/dodd-frank-and-deregulation-some-lessons-history/.

> [R]ewarded employees—including non-executive personnel such as traders, underwriters, and loan officers—for increasing an institution's revenue or short-term profit without sufficient recognition of the risks the employees' activities posed to the institutions, their customers, and to the broader financial system.[8]

The Proposal includes several examples of financial institutions' compensation structures—particularly non-salary compensation—that reward employees and executives for increasing short-term financial gains for the bank without regard for the broader, longer-term financial and consumer protection risks that such incentives bring. For example, loan officers at Washington Mutual, which still ranks as the largest bank failure in American history,[9] were compensated based on loan origination volume, not quality, and were paid more for issuing high-risk loans.[10] Additionally, incentive-based compensation structures at Wells Fargo rewarded sales volume, without controls and oversight to protect consumers from harm and illegal activities.[11]

More recently, in its review of the Silicon Valley Bank failure, the Fed detailed serious deficiencies in the bank's incentive-based compensation program, which focused on short-term financial results and had no reductions for the known weaknesses in the bank's risk management programs.[12] In fact, just two months before Silicon Valley Bank's failure:

> In January 2023, the Compensation Committee of [Silicon Valley Bank Financial Group] SVBFG's and [Silicon Valley Bank] SVB's boards of directors approved stock incentive bonuses to executives and employees for 2022 performance. The Compensation Committee also approved cash incentive bonuses to senior executives for their 2022 performance. ***Despite SVBFG's deteriorating condition and SVBFG's negative cash balance, cash bonuses were paid to several SVBFG executives and staff for their 2022 performance on March 10, 2023, despite the failure of SVB that day***.[13]

Moreover, Silicon Valley Bank CEO Greg Becker is reported to have cashed out $3.57 million in stock in the weeks before the bank failed, after selling nearly $30 million in stock during

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[8] Incentive-Based Compensation Arrangements, *supra* note 2 at 27.

[9] FEDERAL DEPOSIT INSURANCE CORPORATION, BANK FAILURES IN BRIEF – SUMMARY, https://www.fdic.gov/resources/resolutions/bank-failures/in-brief/index (last accessed Aug. 22, 2024).

[10] Incentive-Based Compensation Arrangements, *supra* note 2 at 27.

[11] *Id*. at 28.

[12] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK 75 (Apr. 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

[13] *Id* (emphasis added).

the prior two years.[14] It is completely unacceptable for a bank executive to personally profit like this, at the expense of financial stability while leaving taxpayers and other banks to pick up the pieces.

These examples are important for two reasons: first, they show why incentive-based compensation reform was identified as a problem when the Dodd-Frank Act was written, and second, they prove that problems with incentive-based compensation persist, continuing to threaten financial stability and Main Street Americans. This is not an unknown or undefined problem, as Fed Chair Jerome Powell suggested in recent congressional testimony.[15] It has been known for well over a decade, but regulators have still failed to complete the rulemakings that are statutorily required by Dodd-Frank.

We applaud the efforts of the Agencies to implement an incentive-based compensation rule, but unfortunately, such a rule cannot be implemented or enforced until all six agencies are working together. In other words, the Agencies cannot move forward with a formal rulemaking effort until the Fed and SEC are on board. Moreover, the fact that capital rules and resolution planning frameworks remain weak further bolsters the need to prioritize and finalize Section 956 rulemaking to protect Main Street Americans from the greed and negligence of Wall Street banks. The bottom line is that appropriately strong and enforceable standards are needed to ensure that incentive-based compensation arrangements are not excessive and do not lead to material loss.[16]

BACKGROUND

Executive compensation policies that encouraged short-sighted and high-risk corporate behavior were unquestionably major contributors to the 2008 Crash and the regional bank failures of 2023. The House Financial Services Committee report on the "Corporate and Financial Institution Compensation Fairness Act of 2009," which was a precursor to the executive compensation provisions in the Dodd-Frank Act, observed that as the 2008 Crash unfolded, "a broad consensus has developed that executive and financial institution compensation structures relate directly to both the safety and soundness of individual financial institutions and the health of the broader financial system."[17]

Another analysis of the 2008 Crash described the harmful impact of poorly designed compensation systems in these terms:

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[14] *See e.g.*, Ruth Styles, *Aloha Suckers! Silicon Valley Bank's Failed CEO Gregory Becker Escapes to His $3.1million Hawaiian Hideaway Days After Being Fired, Leaving the Chaos of the Collapse in the Dust*, DAILY MAIL (Mar. 16, 2023), https://www.dailymail.co.uk/news/article-11864495/Silicon-Valley-Banks-failed-CEO-Gregory-Becker-escapes-3-1-million-Hawaiian-hideaway.html.

[15] House Financial Services Committee, *The Federal Reserve's Semi-Annual Monetary Policy Report* (Mar. 6, 2024), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=409159.

[16] Incentive-Based Compensation Arrangements, *supra* note 2 at 29.

[17] H.R. REP. NO. 111-236, 111th Cong., 1st Sess., at 6 (2009).

> Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.[18]

The Proposal confirms that flawed incentive-based compensation policies can pose a threat not only to the long-term health of individual financial institutions but also to the long-term health of the U.S. financial system.[19] It also highlights the reality that such compensation arrangements are a concern among major financial institutions worldwide, not only in the U.S. In 2009, the Financial Stability Board's Financial Stability Forum published principles for sound compensation practices, based on the fact that ***compensation is more than a market wage, it is a system of incentives***.[20] The report also cited multiple international surveys which found that more than 80 percent of market participants believe that compensation practices led to the accumulation of risks that resulted in the 2008 Crash.[21]

Even before the 2008 Crash, regulators had begun to promulgate rules substantially improving the disclosure regime for executive compensation.[22] After the 2008 Crash, calls for more fundamental reform in the area of executive compensation were widespread, and they culminated in Title IX, Subtitle E of the Dodd-Frank Act.

In the Dodd-Frank Act, Congress passed a broad series of measures aimed at correcting the structural flaws in our traditional approach to executive compensation. Those measures include shareholder votes on executive compensation, new listing standards to ensure that compensation committees and their consultants at public companies are independent from management, mandatory disclosure of executive compensation in relation to corporate performance, and recovery of erroneously awarded compensation.[23]

Section 956 of the Dodd-Frank Act is one of the most important components of the new regulatory framework governing executive compensation. It requires the imposition of new

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18 FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT at xix (Jan. 2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

19 Incentive-Based Compensation Arrangements, *supra* note 2 at 27.

20 FINANCIAL STABILITY FORUM, FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES (Apr. 2, 2009), https://www.fsb.org/wp-content/uploads/r_0904b.pdf.

21 *Id*. at 4.

22 *See e.g.*, Executive Compensation and Related Person Disclosure, Document Number 06-6968, 71 FED. REG. 53158 (Sept. 8, 2006), https://www.federalregister.gov/documents/2006/09/08/06-6968/executive-compensation-and-related-person-disclosure.

23 Dodd-Frank Act §§ 951-957.

disclosure requirements and prohibitions relating to incentive-based compensation arrangements offered by banks, broker-dealers, and other financial institutions. Specifically, Section 956:

- Requires each covered financial institution to disclose to its appropriate federal regulator the structure of all incentive-based compensation arrangements offered by the institution to determine whether the compensation structure:
  - provides any executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits; or
  - could lead to material financial loss to the institution; and
- Prohibits any type of incentive-based compensation arrangement that the appropriate regulator determines encourages inappropriate risks by covered financial institutions:
  - by providing an employee with excessive compensation, fees, or benefits; or
  - that could lead to material financial loss to the institution.[24]

SUMMARY OF THE PROPOSAL

The Fed, FDIC, OCC, SEC, FHFA, and NCUA, jointly issued the original proposal to implement Section 956 in 2011.[25] Better Markets commented on this proposal, detailing several ways that it needed to be strengthened.[26] These six financial regulators received more than 10,000 comments on the 2011 proposal but failed to finalize a rule, so they jointly proposed a new version of the rule in 2016.[27] The 2016 proposal reflected changes made in response to comments received from the 2011 proposal as well as supervisory experience related to incentive-based compensation. Better Markets also commented on the 2016 rule, detailing its beneficial new provisions as well as its substantial gaps and weaknesses.[28] Unfortunately, the six financial regulators also failed to

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[24] Public Law 111–203, *supra* note 3.

[25] Incentive-Based Compensation Arrangements, Document Number 2011-7937, 76 FED. REG. 21170 (Apr. 11, 2011), https://www.federalregister.gov/documents/2011/04/14/2011-7937/incentive-based-compensation-arrangements.

[26] Better Markets Comment Letter, *Incentive-Based Compensation Arrangements* (May 31, 2011), https://www.bettermarkets.org/sites/default/files/SEC-%20Comment%20Letter-%20Incentive-based%20comp%205-31-11.pdf.

[27] Incentive-Based Compensation Arrangements, Document Number 2016-11788, 81 FED. REG. 37670 (June 10, 2016), https://www.federalregister.gov/documents/2016/06/10/2016-11788/incentive-based-compensation-arrangements.

[28] Better Markets Comment Letter, *Incentive-Based Compensation Arrangements* (July 22, 2016), https://www.bettermarkets.org/sites/default/files/FRS%20NCUA%20FDIC%20OCC%20SEC%20FHFA%20-%20CL%20-%20Incentive-Based%20Compensation%20Arrangements%20-7-22-2016.pdf.

finalize a rule following the 2016 proposal. The Proposal that is currently being considered contains the regulatory text of the 2016 proposal without change.

As Better Markets noted in its 2016 comment letter,[29] the Proposal includes some beneficial new provisions, including:

- broadening the scope of the initial proposal beyond just senior executive officers to include "significant risk-takers" who "are in a position to put large covered institutions at risk of material financial loss;"[30]

- adding a clawback provision to provide for the recovery of incentive-based compensation under certain circumstances;[31] and

- prohibiting hedging by covered institutions on behalf of their covered employees against decreases in the value of a person's incentive-based compensation.[32]

However, as Better Markets also noted in 2016, the Proposal suffers from multiple flaws, which are addressed in the comments below.

SUMMARY OF COMMENTS

To achieve the statutory purposes of the Dodd-Frank Act, the Proposal must be strengthened in several ways.

First and most importantly, all six federal regulators—the Fed, FDIC, OCC, SEC, FHFA, and NCUA—must jointly finalize the same incentive-based compensation rule.

Second, since this Proposal has not changed from the 2016 version, our prior comments are all still relevant:

- CLAWBACKS: The type of conduct that triggers clawbacks should be expanded beyond culpable behavior. In addition, covered institutions should be required to exercise their clawback remedies, not simply be allowed to do so.

- VESTING PERIODS: The deferral periods should be extended and pro rata vesting should be abandoned in favor of cliff vesting.

- STOCK OPTIONS: Stock options should be banned as a form of incentive-based

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29 *Id*. at 4.

30 Incentive-Based Compensation Arrangements, *supra* note 2 at 20-21.

31 *Id*. at 17-18.

32 *Id*. at 18.

compensation, including as a form of deferred incentive-based compensation.

- HEDGING: The prohibition on hedging should cover individuals, not only the institutions acting on their behalf.

Third, the period for compliance with a final rule should be shortened. As noted earlier in this letter, a final rule to protect the American people and financial stability from unsafe and flawed incentive-compensation arrangements is now more than 13 years overdue. The financial institutions that would be subject to a rule have had plenty of time to prepare and providing a full year after a rule is finalized is more than enough time for complete compliance.

COMMENTS

I. JOINT PROPOSAL: ALL SIX FEDERAL REGULATORS—THE FED, FDIC, OCC, SEC, FHFA, AND NCUA—MUST JOINTLY FINALIZE AN INCENTIVE-BASED COMPENSATION RULE.

We applaud the actions of the FDIC, OCC, FHFA, and NCUA with this Proposal. It is a step in the right direction but it is not enough.

Currently, both the Fed and the SEC have not joined in the rulemaking process, even though both were part of the 2011 and 2016 proposals.

In recent congressional testimony, Fed Chair Powell has provided myriad excuses for the Fed's inaction. For example:

- In a hearing at the House Financial Services Committee on March 6, 2024, Powell said that he agrees that incentive-based compensation contributed to the failure of Silicon Valley bank, but that it was not a major factor and "at best a tertiary factor."[33] Powell continued by saying, "I would like to understand the problem we're solving and then I would like to see a proposal that addresses that problem."[34] This answer is incomprehensible, irresponsible, and inconsistent with the Fed's own reports that identify incentive-based compensation as a cause of the SVB failure.[35]

  At the same hearing, Powell said "Everything we do is in service to our public mission." The Fed's mission ***includes*** following the law and maintaining the stability of the financial system as well as supervising and regulating banks to ensure the safety and

[33] House Financial Services Committee, *supra* note 15.

[34] *Id*.

[35] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 12.

soundness of the banking system.[36] The fact that the Fed has refused to join in this Proposal is indefensible. The fact that all six agencies are not working together also continues to enable bank executives to personally benefit by taking excessive risks that endanger banks and the banking system.

- In a hearing at the House Financial Services Committee on July 10, 2024, Powell's answer as to why he does not support rulemaking on incentive-based compensation was different than his answer a few months earlier. At this hearing, he said that the existing prior guidance from the Fed on incentive-based compensation from 2010 is sufficient.[37] This is not true or appropriate and is fraught with legal risk.

  First, relying on incentive-based compensation guidance from 2010 as a substitute for a Dodd-Frank Act statutory mandate is not acceptable. The Dodd-Frank Act directed all six financial regulators to jointly prescribe regulations or guidelines. Refusing to act because prior guidance exists on the same topic is not acceptable and does not meet the statutory direction.

  Second, the 2010 guidance is structurally inadequate ***because it is guidance*** and not "regulations or guidelines" as the Dodd-Frank Act directed. Furthermore, the Fed determined in 2011 that guidance is not enforceable,[38] which further proves that Powell's statement that the 2010 guidance meets the Dodd-Frank Act's directive is wrong.

Moreover, the Fed's own investigation into the failure of Silicon Valley Bank and report on the topic[39] details the inadequacy of the bank's incentive-based compensation arrangements, so it does not make sense that Powell does not understand the problem or the urgent need for a solution.

The fact that the SEC has not joined in the Proposal is also unacceptable, but the reasons for the SEC's inaction are not as clear as the Fed's reasons. Incentive-based compensation remains

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36 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FAQS: WHAT IS THE PURPOSE OF THE FEDERAL RESERVE SYSTEM?, https://www.federalreserve.gov/faqs/about_12594.htm (last accessed Aug. 22, 2024).

37 House Financial Services Committee, *The Federal Reserve's Semi-Annual Monetary Policy Report* (July 10, 2024), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=409311.

38 *See, e.g.*, Press Release, Board of Governors of the Federal Reserve System, *Federal Reserve Board Adopts Final Rule Outlining and Confirming the Use of Supervisory Guidance for Regulated Institutions* (Mar. 31, 2021), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210331a.htm; Better Markets Comment Letter, *Role of Supervisory Guidance, Notice of Proposed Rulemaking* (Jan. 4, 2021), https://bettermarkets.org/sites/default/files/Better%20Markets%20Comment%20Letter%20on%20Notice%20of%20Proposed%20Rulemaking%20-%20Role%20of%20Supervisory%20Guidance.pdf.

39 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 12.

on the SEC's Regulatory Agenda. As of the spring 2024 agenda,[40] the SEC said that it was considering participation in the joint Proposal, but it did not join and the reason for this decision is unknown.

II. CLAWBACKS: THE TYPES OF CONDUCT THAT TRIGGER CLAWBACKS SHOULD BE EXPANDED BEYOND CULPABLE BEHAVIOR. IN ADDITION, COVERED INSTITUTIONS SHOULD BE REQUIRED TO EXERCISE THEIR CLAWBACK REMEDIES, NOT SIMPLY BE ALLOWED TO DO SO.

A. *The triggers for clawbacks should not be limited to misconduct.*

The clawback provision in the Proposal is flawed in two important respects. First, it is too narrow, as it applies only in the event of "misconduct" or other types of culpable behavior. The Proposal would provide for institutions to recover incentive-based compensation if the institution determines that the executive officer or significant risk-taker engaged in:

1. **Misconduct** that resulted in significant financial or reputational harm to the covered institution;

2. **Fraud**; or

3. **Intentional misrepresentation** of information used to determine the senior executive officer or significant risk taker's incentive-based compensation.[41]

All three of these elements incorporate some measure of fault. However, this narrow approach is inconsistent with the purposes of Section 956, the approach reflected in other statutes, and even the increasingly common practices among financial institutions.

A fundamental goal of Section 956 is to discourage excessively risky behaviors at large financial institutions whether or not those behaviors rise to the level of illegal, fraudulent, or otherwise blameworthy "misconduct." Nothing in Section 956 on its face or in its intended purposes suggests that it was aimed only at that narrow band of blameworthy behavior. Thus, limiting clawback provisions to instances of such conduct conflicts with the basic purpose of the statute.

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[40] OFFICE OF INFORMATION AND REGULATORY AFFAIRS, SEC: INCENTIVE-BASED COMPENSATION ARRANGEMENTS, https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202404&RIN=3235-AL06 (last visited Aug. 22, 2024).

[41] Incentive-Based Compensation Arrangements, *supra* note 2 at 113-14.

Other regulatory measures are not so limited. For example, under Section 954 of the Dodd-Frank Act, the SEC's rules must require issuers to recover excessive incentive-based compensation resulting from noncompliance with financial reporting requirements, without regard to culpability. Common practices in the industry also depart from this narrow approach. The 2016 Proposal noted that "clawback provisions are now increasingly common at the largest financial institutions."[42] It went on to explain the types of factors that serve as triggers:

> Over the past several years, many financial institutions have further refined such mechanisms. Most often, clawbacks allow banking institutions to recoup incentive-based compensation in cases of financial restatement, misconduct, ***or poor financial outcomes***. A number of covered institutions have gone beyond these minimum parameters to include situations where ***poor risk management*** has led to financial or reputational damage to the firm.[43]

This confirms that the predominant focus of common clawback provisions is on conduct that leads to "poor financial outcomes" or "financial damage," irrespective of whether it constitutes what is normally meant by "misconduct."

Finally, repeatedly in the Proposal, the rationale for the Proposal is described broadly in terms of addressing both "inappropriate risk-taking" and "misconduct," two distinct forms of behavior.[44] Yet, without explanation, the Proposal establishes the narrow band of only misconduct as the trigger for clawbacks.

For all these reasons, the Proposal should be amended to expand the triggers for clawbacks beyond scenarios involving misconduct.

B. *Application of the clawback remedy should be mandatory, not discretionary*.

The second major problem is that while the Proposal would require the inclusion of a clawback provision in incentive-based compensation arrangements, it would not require that covered institutions exercise the clawback provision.[45] That decision would remain entirely at the discretion of the institution, and the Proposal would not even prescribe the process that the institution should follow to recover vested incentive-based compensation under the clawback provision.

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42 Incentive-Based Compensation Arrangements, *supra* note 27 at 37732.

43 *Id*.

44 Incentive-Based Compensation Arrangements, *supra* note 2.

45 Incentive-Based Compensation Arrangements, *supra* note 2 at 113.

Leaving the use of clawbacks completely to the discretion of the regulated industry, without even specifying required procedures or guidelines, severely weakens the clawback provision in the Proposal. Without question, the result will be cases where executives are able to retain incentive-based compensation even though it leads to a material financial loss for the firm. It is easy to imagine circumstances where the Board yields to the myriad intra-corporate political pressures that a high-level executive or top-producing risk-taker could apply to fend off the discretionary application of a clawback provision and to protect his or her incentive-based compensation. Such outcomes are precisely the ones that the Proposal should be designed to prevent.

As an apparent justification for this lax approach, the 2016 Proposal explained that "facts, circumstances, and all relevant information should determine whether and to what extent it is reasonable for a Level 1 or Level 2 covered institution to seek recovery of any or all vested incentive-based compensation."[46] But this is simply a truism, not a convincing rationale for leaving the exercise of a core reform in the hands of the regulated institutions. A mandatory clawback clause could take several forms, all of which would address the stated concern about facts and circumstances. For example, the financial regulators could require the use of the clawback mechanism and then (1) couple that requirement with a list of factors the firm must consider; (2) require the adoption of policies and procedures that establish guidelines for the use of the clawback provision; or (3) simply issue separate guidance regarding the application of the clawback provision. But abandoning a mandatory provision altogether is unacceptable.

It is especially difficult to reconcile the hands-off approach in the Proposal with the severity of the three criteria for the application of the clawback provision in the first instance. Clearly, if an executive officer or significant risk-taker engages in fraud, intentional misrepresentation, or misconduct—the predicates for clawback set forth in the Proposal—then it would be unquestionably appropriate to mandate the application of a clawback provision.

As with the standards of conduct that trigger clawbacks, other statutory provisions exemplify the mandatory approach to the exercise of the clawback remedy. For example, under Section 304 of the Sarbanes-Oxley Act and Section 954 of the Dodd-Frank Act, the recovery of incentive-based compensation is mandatory whenever an issuer is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements.

In light of all these considerations, the financial regulators must require the application of the clawback provision if the triggers, as amended in accordance with part II.A. above, are met.

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[46] *Id*. at 71.

III. VESTING PERIODS: THE DEFERRAL PERIODS SHOULD BE EXTENDED AND PRO RATA VESTING SHOULD BE ABANDONED IN FAVOR OF CLIFF VESTING.

A. *The vesting periods are too short*.

One of the core provisions in the Proposal is the time period over which executive officers and significant risk-takers must defer their incentive-based compensation. Under the Proposal, those time periods vary depending on the size of the institution, the position of the actor (senior executive officer or significant risk-taker), and the type of compensation plan. But even at the largest institutions, and even in cases where the most senior executive officer is responsible, the Proposal only provides for a minimum mandatory deferral period of four years.

These deferral periods are too short in light of both theory and practice. The 2016 Proposal aptly described the need, in principle, for significant deferral periods to achieve the risk-mitigating purposes embodied in Section 956:

> The deferral period allows for amounts of incentive-based compensation to be adjusted for actual losses to the covered institution or for other aspects of performance that become clear during the deferral period before those amounts vest or are paid. . . . Deferral periods that are sufficiently long to allow for a substantial portion of the risks from the covered person's activities to manifest are likely to be most effective in ensuring that risks and rewards are adequately balanced.[47]

The 2016 Proposal also noted that "this approach may be particularly relevant, for example, where performance is difficult to measure because performance results and risks take time to observe," as is often the case in financial transactions such as loans.[48]

Together, these observations make clear that the longer the deferral period, the more accurate the assessment of the risks that an executive or significant risk-taker may have created for the institution and that take time to incubate. Academic research bears this out. Empirical studies indicate that longer deferral periods correlate with better firm value and performance, lower risk exposure, and less frequent manipulation of earnings.[49]

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[47] Incentive-Based Compensation Arrangements, *supra* note 27 at 37720.

[48] *Id*. at 37716.

[49] *Id*. at 37721 n.151.

Thus, to better serve the underlying purposes of Section 956, the Proposal should be revised to extend the minimum deferral period. Six years would be more consistent with the average life span of the business cycle in the U.S., which is estimated to be 5.7 years.[50] Some other regulators have imposed deferral periods of as much as seven years for senior managers.[51] The 2016 Proposal came close to endorsing a "business cycle" metric, stating that the three-to-four-year minimum deferral period was chosen because, coupled with the typical one-year performance period, it would allow institutions four to five years, "or the ***majority of a traditional business cycle***," to identify outcomes associated with the activities of a senior executive officer or significant risk-taker.[52]

However, it offered no convincing explanation for the decision to tailor the minimum deferral period to only a fraction of a business cycle. It simply notes, without elaboration or citation to data, that "deferral periods that are inordinately long may reduce the effectiveness of incentive-based compensation arrangements because employees more heavily discount the potential impact of such arrangements."[53]

In fact, based on all the considerations set forth above, establishing a deferral period of at least as long as a full business cycle would be more appropriate and effective.

B. The vesting formula should be limited to cliff, not pro rata, vesting.

The Proposal provides that deferred compensation may vest in annual increments, but no faster than on a pro-rata basis. The Proposal portrays this arrangement as one that would help prevent covered institutions from "defeating the purpose of the deferral requirement by allowing vesting of most of the required deferral amounts immediately after the award date."[54] But this approach fails to meet its stated goal, and it actually defeats the very purpose of deferring compensation.

Under the pro-rata scenario, a quarter of the deferred incentive-based compensation promised to a senior executive officer at the largest institutions would vest with each passing year, adding to the already vested, non-deferred compensation. This renders the overall length of the vesting period largely a fiction since what matters most is the annually vested increment, not the full vesting period.

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50 *Id*. n.154.

51 The Prudential Regulation Authority in the United Kingdom has stipulated that the minimum deferral period shall be seven years for senior managers and five years for risk managers. *Id*. at 37722.

52 *Id*. at 37721 (emphasis added).

53 *Id*.

54 *Id*. at 37718.

In addition, the result conflicts with the underlying purpose of a significant deferral period. The longer the deferral period, the more accurate the assessment of the risks actually facing an institution. In other words, the most precise understanding of the amount of incentive-based compensation that an executive or significant risk taker should actually receive comes at or near the end of the vesting period. But at that point, under the pro rata approach, all or nearly all of the incentive-based compensation will have vested. In short, when the institution is best equipped to assess the executive's contribution to excessive or inappropriate risks, the compensation is already vested.

The solution is clear and simple. The Proposal must be amended to require cliff vesting, whereby the entire amount of the deferred compensation vests only at the conclusion of the deferral period. This approach is especially important if the vesting period is not extended to cover at least a full business cycle, as argued in Section III.A., above.

IV. STOCK OPTIONS: STOCK OPTIONS SHOULD BE BANNED AS A FORM OF INCENTIVE-BASED COMPENSATION, INCLUDING AS A FORM OF DEFERRED INCENTIVE-BASED COMPENSATION.

The Proposal would allow incentive-based compensation to include an unlimited number of stock options. The only restriction it would impose is a cap of 15% on the amount of ***deferred*** incentive-based compensation that could take the form of options. However, this approach conflicts with the language and purposes of Section 956, academic studies, and prevailing trends. Accordingly, the Proposal should be revised to eliminate options altogether as a permitted form of incentive-based compensation, deferred or otherwise.

Options by their nature are asymmetrical, as they offer large payoffs when the price of the underlying asset rises, and little or no downside if the asset price falls. As a result, they can actually create incentives for covered persons "to take inappropriate risks in order to increase the covered institution's short-term share price, possibly without giving appropriate weight to long-term risks."[55] Academic literature supports the point. It shows a positive correlation between executive holdings of stock options and securities fraud and manipulation of earnings.[56] Notwithstanding these characteristics of options, the Proposal would allow incentive-based compensation to include an unlimited number of stock options. Thus, it would allow a form of compensation that ***incentivizes*** risk to be embedded in compensation arrangements that, under Section 956, must be structured to ***discourage*** inappropriate risks.

That plainly conflicts with the intent of Section 956, and it arguably violates the plain language of the statute. As noted in the Proposal, "A covered institution must not establish or maintain any type of incentive-based compensation arrangement, or any ***feature*** of any such arrangement, that encourages inappropriate risks by the covered institution"[57]

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[55] *Id*. at 37727.

[56] *Id*. n.184.

[57] Incentive-Based Compensation Arrangements, *supra* note 2 at 103 (emphasis added).

While options do not appear by name in this language, the reference to "features" that encourage inappropriate risks would certainly seem to encompass options, in light of their asymmetric nature and the empirical evidence clearly correlating them with not only risky but fraudulent behavior.

It follows that the Proposal must be revised to eliminate stock options as eligible deferred compensation. The 2016 proposal acknowledges the need to limit the role of options as part of deferred compensation but still allows options to comprise a significant portion—15%. It provides little justification for this approach, citing only the financial regulators' general desire to "[allow] for some flexibility in the design and operation of incentive-based compensation arrangements."[58] And it fails to explain why that flexibility, for the benefit of the covered institutions, deserves priority over the risk-mitigation goals underlying Section 956. In fact, it does not deserve priority. The approach is especially weak given the larger context; under the Proposal, covered persons would still be able to receive unlimited options as part of their incentive-based compensation package, so abolishing options solely as part of deferred compensation would do little to restrict the "flexibility" that the financial regulators seek to preserve.

As with the other issues discussed above, the regulators' approach is actually inconsistent with the prevailing trend, which "is moving away from its historical reliance on options as part of incentive-based compensation." According to the 2016 proposal, a sample of disclosures from large covered institutions "shows minimal usage of stock options among CEOs and other named executive officers."[59] As a general matter, there is no justification for establishing regulatory standards that lag behind industry trends from the very day they are proposed, and that axiom certainly applies here.

V. <u>HEDGING: THE PROHIBITION ON HEDGING SHOULD COVER INDIVIDUALS, NOT ONLY THE INSTITUTIONS ACTING ON THEIR BEHALF.</u>

The Proposal would prevent covered institutions from purchasing hedging and similar instruments on behalf of covered persons to hedge or offset any decrease in the value of the covered person's incentive-based compensation.

This is certainly appropriate, but it does not go far enough. In addition, covered institutions must be required under the final rule to prohibit their senior executive officers and significant risk-takers from themselves hedging against the potential decrease in the value of their incentive-based compensation.

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58 Incentive-Based Compensation Arrangements, *supra* note 27 at 37728.

59 *Id*.

The need for a prohibition against hedging is clear. As explained in the 2016 proposal, "Personal hedging strategies may undermine the effect of risk-balancing mechanisms such as deferral, downward adjustment, and forfeiture, or may otherwise negatively affect the goals of these risk-balancing mechanisms and their overall efficacy in inhibiting inappropriate risk-taking."[60] What is not clear is why the financial regulators were satisfied with a limited provision that only prohibits the institutions from hedging on behalf of the covered person. The 2011 proposal actually acknowledges the possibility that covered persons who received incentive-based compensation in the form of equity "might wish to use personal hedging strategies as a way to assure the value of deferred equity compensation."[61] But there is no explanation as to why this concern was addressed through the half-measure set forth, which would allow covered persons the freedom to engage in hedging.

This gap must be closed, or the risk-mitigating goals of Section 956 will be substantially undermined. The effectiveness of measures such as deferral periods, downward adjustments, and forfeitures will be largely blunted if senior executive officers and significant risk-takers can essentially guarantee themselves the rewards of incentive-based compensation regardless of the impact that their conduct may have on the value of that compensation.

VI. COMPLIANCE PERIOD: THE PERIOD FOR COMPLIANCE WITH A FINAL RULE SHOULD BE SHORTENED.

The Proposal provides for a compliance period of at least 540 days (18 months) after a financial institution becomes subject to the rule. Better Markets recommends a compliance period of no more than 365 days (1 year) after a financial institution becomes subject to the rule.

As noted earlier in this letter, a final rule to protect the American people and financial stability from unsafe and flawed incentive-compensation arrangements is now more than 13 years overdue. The financial institutions that would be subject to a rule have had plenty of time to prepare and providing a full year after a rule is finalized is more than enough time for complete compliance.

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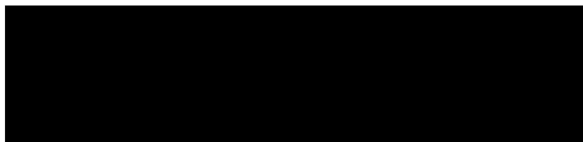
[60] *Id.*at 37733.

[61] *Id*. at 37734.

CONCLUSION

We hope these comments are helpful as you develop a coordinated rulemaking for incentive-based compensation arrangements.

Sincerely,



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