SIFMA

Securities Industry and Financial Markets Association

February 18, 2010

Via Electronic Delivery

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: FDIC Advanced Notice of Proposed Rulemaking Regarding Incorporating Employee Compensation Criteria Into The Risk Assessment System (RIN #3064-AD56)

Dear Mr. Feldman:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is submitting this letter in response to the request by the Federal Deposit Insurance Corporation (the "FDIC") for comments on the Advanced Notice of Proposed Rulemaking Regarding Incorporating Employee Compensation Criteria Into The Risk Assessment System (the "ANPR"). The ANPR was published in the Federal Register on January 19, 2010 and requested comment "on ways that the FDIC's risk-based deposit insurance assessment system (risk-based assessment system) could be changed to account for the risks posed by certain employee compensation programs." SIFMA appreciates the opportunity to comment on certain of the matters discussed in the ANPR.

SIFMA has a number of concerns with the ANPR and the changes contemplated by the FDIC. First, the ANPR does not adequately consider the efforts made by other regulatory supervisors. The ANPR also proposes a "model" form of compensation that takes the type of "all or nothing" approach discouraged by other regulators and does not appear to address the concerns raised elsewhere in the ANPR. Furthermore, the ANPR provides little analysis as to why its overall proposed approach would fulfill the ANPR's stated purpose of reducing risk to the banking system. In this regard, the ANPR relies on academic research that does not establish that compensation may have played a role in triggering the financial crisis, as well as Material Loss Reviews ("MLRs") primarily relating to the compensation of loan officers to support broader-based executive compensation regulation.

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

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Finally, SIFMA questions whether the proposals contained in the ANPR are within the FDIC's risk-based assessment authority, as well as the factual basis for exercising such authority, here. SIFMA will address these authority issues if the FDIC ultimately moves forward with its proposal. However, SIFMA urges the FDIC to abandon the ANPR's proposals and use its existing authority to oversee compensation practices in a way that encourages pay for performance and mitigates risk.

Coordination with Other Regulatory Supervisors

While the ANPR is "intended to be a complementary effort to the supervisory standards being developed both domestically and internationally to address the risks posed by poorly designed compensation programs," SIFMA is concerned that it does not appropriately consider the significant work already done by the Financial Stability Board (the "FSB") and the Federal Reserve Board (the "Fed"). The Fed currently is in the process of finalizing guidance for banks and their holding companies that has significant overlap with the ANPR's purposes and coverage. SIFMA is concerned that the FDIC will adopt an approach that is inconsistent with the Fed's approach to assuring that firms' compensation practices do not adversely impact the safety and soundness of the firm. Such inconsistencies could undercut the efforts of both regulators.

SIFMA is particularly concerned about the ANPR's assertion that it seeks "to use the deposit insurance assessment system to provide incentives for institutions to meet higher standards [than the minimum regulatory standards], should they choose to do so." SIFMA believes that the regulatory initiatives already underway by the Fed and other banking regulators world-wide do not intend merely to provide some bare minimum of conduct, but instead are intended to provide comprehensive standards designed to assure that a bank's compensation program does not adversely affect safety and soundness.

Proposing a "Model" Form of Compensation

The ANPR proposes promulgating a "model" form of compensation that, if adopted, would allow financial institutions to avoid being charged increased risk premiums. However, the ANPR contains no analysis of (i) whether the model form of compensation (or the scope of employees subject to such model) would be consistent with that of other regulators; (ii) to what extent a compensation system substantially in compliance with the model was already in place at the institutions examined in the MLRs or at other financial institutions that failed or were "bailed out"; or (iii) whether the model would meaningfully reduce risk to the FDIC. Nor does the ANPR address at all the question of how to calibrate compensation structures to a specific risk premium – even though this concept is at the heart of the ANPR's stated purpose. Finally, the ANPR does not explain or address why its model form of compensation would solve the problems that the ANPR claims to have identified. The FDIC should consider whether mandating specific forms and features of compensation at financial institutions creates more risk than it mitigates. For example, as discussed below, the model form would not permit tying the compensation of a loan officer to the performance of the loans that he or she originates, nor would it be flexible enough to incorporate innovations that could favorably impact safety and soundness.

Additionally, the ANPR suggests covering employees who receive a portion of their compensation according to a "formula"; SIFMA expects that defining what constitutes a "formula" will be impossible as a practical matter given the fact that discretion plays a role in practically all compensation decisions. Similarly, attempting to define what constitutes a "significant" portion of compensation will ultimately lead to considerable confusion, particularly if what the FDIC considers "significant" does not align with what any other regulator considers "significant."

A number of the specific proposals related to the ANPR's model form of compensation also raise serious concerns. For example, the ANPR prescribes that restricted stock not be granted at a discount. This concept is puzzling in that most stock awards are granted without the payment of any consideration. Even if the award is based on a formula that produces a dollar number to be converted to restricted stock, it is the formula that gives rise to the relevant number, rather than the conversion of that number into an amount of restricted stock. The ANPR model also would mandate that significant awards of company stock become vested over a multi-year period and be subject to clawback, or else banks would be subject to increased risk premium rates. SIFMA notes that the ANPR also does not seem to take into account routine vesting events, such as retirement, or those vesting events countenanced by existing FDIC regulations, such as death or disability.

The ANPR goes on to propose that a significant portion of compensation should be in the form of restricted stock *and* subject to a look-back mechanism. There appears to be no consideration given to the fact that the stock itself may be a sufficient adjustment to reflect the risks involved, nor any acknowledgement that the size of the award may already have been reduced at grant to take into account the same risks that the ANPR seeks to address through its look-back mechanism. The one-size-fits all approach suggested by the ANPR does not take into account that other notional measures to adjust deferred compensation may be more effective at protecting the safety and soundness of the institution (*e.g.*, a notional measure based on the performance of the institution's loan portfolio). This is particularly puzzling given the fact that the MLRs addressing compensation issues were so singularly focused on the compensation of loan officers.

The Fed's October 2009 Proposed Guidance on Sound Incentive Compensation Policies (the "Proposed Fed Guidance") rejected a one-size fits all approach, indicating that "methods for achieving balance [between compensation and incentivizing inappropriate levels of risk-taking] are not exclusive, and additional methods or variations may exist or be developed. Moreover, *each method has its own advantages and disadvantages*." (Emphasis added). The FDIC should consider whether mandating a single, fixed compensation structure, approach or a series of required metrics may actually increase, rather than decrease, systemic risk. The Proposed Fed Guidance specifically cautions against this approach when it says:

> "[t]he use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to provide at least some employees with incentives to take excessive risks."

Similarly, the FSB Principles (adopted by all G-20 members) clearly stated that "one size does not fit all" when it comes to compensation practices at financial institutions. SIFMA is extremely concerned that the ANPR would adopt the same one-size-fits-all approach against which other regulators have cautioned.

A particularly troubling aspect of the ANPR's "all or nothing" approach is that it does not take into account the possibility that certain minor variations from the mandated form of compensation would not adversely impact safety and soundness and therefore should not result in the imposition of any additional risk premium. Nor does it consider that completely different compensation systems with other risk mitigation mechanisms might be even more effective at protecting safety and soundness. The approach suggested by the ANPR could lock covered institutions into a single compensation system that might not address safety and soundness (and the institution's business interests) as effectively as other systems currently available or that might become available through innovation.

Finally, SIFMA notes that the ANPR would add additional requirements for an independent compensation committee and independent compensation professionals. While SIFMA does not believe that it is inappropriate for an independent compensation committee to be responsible for compensation decisions that impact an institution's senior executives, SIFMA would suggest that instead of mandating a new requirement, that the FDIC first consider existing requirements and other reform efforts which are already in place or are underway. Public companies are already subject to four different requirements that compensation for executives be set by an independent compensation committee: NYSE/NASDAQ listing standards, Section 162(m) of the Internal Revenue Code, state corporate law, and Rule 16b-3 of the Securities Exchange Act of 1934. Pending legislation in the Senate (already passed by the House) would also address both of these issues. The risk of overlapping, duplicative and inconsistent regulation in this area suggests that the FDIC should refrain from addressing this issue at this time.

Academic Basis for Proposed Changes

In addition to SIFMA's substantive concerns regarding the ANPR, SIFMA has certain concerns regarding the academic basis on which it is being proposed that SIFMA feels compelled to address. The articles cited by the ANPR do not establish the role that compensation practices may have played in the financial crisis. For example, the Bebchuk, Cohen and Spamann article reaches the conclusion that:

> "it is not possible to rule out…that [bank] executives' pay arrangements provided them with excessive risk-taking incentives."

Concluding that "it is not possible to rule out" a particular theory does not in fact support that the theory is correct, and should not be a basis for adding a vast new regulatory scheme.

Similarly, the Chen, Steiner and White article cited in the ANPR for the proposition that "some compensation structures misalign incentives and induce imprudent risk taking within financial organizations," found "evidence that option-based wealth enhances shareholder wealth" by promoting "good" risk-taking among executives. However, the ANPR would preclude the use of options as a form of compensation available without penalty for covered employees.

Finally, the Macey and O'Hara paper cited by the ANPR to support the purported "broad consensus" on the link between compensation practices and the financial crisis contains only one extremely limited reference to the topic of executive compensation – a general statement that "agency problems occur when the principal (shareholders) lacks the necessary power or information to monitor and control the agent (managers) and when the compensation of the principal and the agent is not aligned." The article goes on to cite golden parachutes – a form of compensation that certainly does not appear to be within the ANPR's range of "acceptable" remuneration practices – as an effective means of aligning shareholders' interests with those of executives.

SIFMA also is concerned that the ANPR did not consider studies that have reached a contrary conclusion regarding the effect, if any, of executive compensation practices on the stability of financial institutions. Professors John E. Core and Wayne R. Guay, from the Wharton School at the University of Pennsylvania stated in a recent academic paper[2] that "most rhetoric favoring additional executive compensation regulation does not rely on evidence or careful analysis as to why existing compensation practices are flawed (since there is little clear evidence that arrangements are systematically flawed)." Similar conclusions have been reached by other academics and consulting groups. For example, a 2009 study[3] by the consulting firm Watson Wyatt (now Towers Watson) analyzed executive compensation at S&P 1,500 firms from 2005 to 2007 to determine the impact of elements of executive compensation architecture on corporate risk and performance. The study concluded that factors such as a higher proportion of fixed to variable pay, fewer overall equity incentives and the use of restricted stock instead of options (*i.e.*, elements conventionally seen as "good" at mitigating risk) actually lead to *poorer* risk management. Similarly, a working paper[4] by Rüdiger Fahlenbrach and René Stulz from December 2009 states:

> There is no evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis and evidence that these banks actually performed worse both in terms of stock returns and in terms of

[2] "Is there a case for regulating executive pay in the financial services industry?" available at http://knowledge.wharton.upenn.edu/papers/download/Brookings_Core_Guay_1_25_10_SSRN.pdf.

[3] "Designing Executive Compensation to Manage Risks and Maximize Returns," available at http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=21310.

[4] "Bank CEO Incentives and the Credit Crisis," available at http://ssrn.com/abstract=1439859.

accounting return on equity (ROE). Further, banks with higher option compensation and with a larger fraction of compensation given in the form of cash bonuses did not have worse performance during the crisis.

SIFMA is not suggesting that it has a definitive answer as to whether compensation systems at financial institutions may or may not impact the institutions' safety and soundness. However, SIFMA is extremely concerned about the potential impact of a substantive regulation such as the one proposed by the ANPR that is based on what is at best inconsistent and inconclusive academic research.

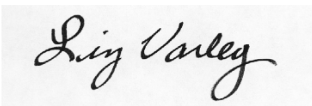
Material Loss Reviews Do Not Establish Grounds to Modify Premiums

Similar to its concern about the academic research cited in the ANPR, SIFMA is concerned about the ANPR's references to a number of MLRs from 2009 that reviewed the circumstances surrounding certain financial institution failures in support of the proposition that that certain compensation programs can "ultimately increase the institution's risk of failure." In particular, the ANPR cites, without any detailed analysis, the fact that 35% of the MLRs listed employee compensation practices as *a* factor contributing to the losses resulting from financial institution failures. The ANPR does not indicate whether or the extent to which the size of the institution being reviewed was considered. While smaller banks may not have been subject to special scrutiny with respect to their risk management practices in the past, banks that are part of larger or global institutions are not only already subject to regulation from numerous national and multinational supervisors, but also have been focused on risk management issues due to their size and available resources. The ANPR also does not seem to acknowledge that 65% of the MLRs (in other words, nearly twice as many) did not list compensation as even one of the factors contributing to failure. Moreover, where compensation was cited as a factor, the situation appears to have been limited to the methods for awarding compensation to loan officers for generating loans. Again, as noted above, the ANPR's model form of compensation would prohibit linking the compensation of a loan officer to the ultimate performance of the loans – an arrangement that would more directly tie the loan officer's compensation to relevant performance than the use of company stock.

As with the academic research cited by the ANPR, SIFMA believes that the FDIC's experience with MLRs in 2009 is at best inconclusive with respect to the need for the type of broad regulation that the ANPR proposes. Furthermore, the FDIC should consider whether situations involving the compensation of loan officers are an adequate basis for regulating the compensation of all "employees whose business activities can present significant risk to the institution and who also receive a portion of their compensation according to formulas based on meeting performance goals…includ[ing] the institution's senior management, among others."

SIFMA appreciates the opportunity to submit this comment letter. SIFMA would be happy to discuss with you any of the comments described above or any other matters you feel would be helpful in evaluating the ANPR. Please do not hesitate to contact the undersigned at 202-962-7329 or via email at evarley@sifma.org if you would like to discuss these matters further.

Sincerely,



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