May 31, 2011

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

Re: Incentive-based Compensation Arrangements
SEC File Number S7-12-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") issued jointly by the Securities and Exchange Commission ("Commission"), the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, and the Federal Housing Finance Agency (collectively, "Agencies").

The Proposed Rules would implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which requires the Agencies to issue regulations limiting incentive-based compensation arrangements offered by depository institutions, broker-dealers, and other types of financial institutions.

INTRODUCTION

Executive compensation policies that encouraged short-sighted and high-risk corporate behavior were undoubtedly major contributors to the financial crisis. The report of the House Financial Services Committee 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 financial crisis has 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."[2]

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 H.R. Rep. No. 111-236, 111th Cong., 1st Sess. 6 (2009), incorporated herein as if fully set forth here ("House Report").

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Another recent reflection on the financial crisis described the harmful impact of poorly designed compensation systems in these terms:

> 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.[3]

Even before the crisis, the Commission had begun to promulgate rules substantially improving the disclosure regime for executive compensation.[4] After the crisis, 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. [5]

In addition, Section 956 of the Dodd-Frank Act imposes new 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

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3 *The Financial Crisis Inquiry Report*, Financial Crisis Inquiry Commission, at xix (Jan. 2011), incorporated herein as if fully set forth here.

4 Executive Compensation and Related Person Disclosure, SEC Release No. 33-8732A (Aug. 29, 2006) (Final Rule), 71 Fed. Reg. 53158 (Sept. 8, 2006).

5 Dodd-Frank Act §§ 951-957.

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- 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.

SUMMARY OF COMMENTS

To achieve the statutory purposes underlying the Dodd Frank Act, the Proposed Rules must be strengthened in the following ways:

- The definition of "incentive-based compensation" should be expanded to include additional forms of compensation that can serve as incentives to high risk behavior.
- Annual reports regarding incentive-based compensation should contain additional detail regarding incentive-based compensation arrangements; they should be submitted to the respective Agencies in a single electronic, searchable format; and they should be updated promptly in the event that compensation arrangements undergo material changes.
- The factors used to determine whether compensation is excessive should include the degree to which the officer's services contributed to the long-term health and stability of the specific financial institution.
- Reliance upon compensation practices at comparable institutions as a measure of excessive compensation should be severely limited.
- Only independent board members should be responsible for overseeing the establishment and oversight of incentive-based compensation arrangements.
- Mandatory deferral of incentive-based executive compensation should apply at all covered financial institutions, not only those with over $50 billion in assets.
- The Agencies should prohibit the directors and employees covered by the Proposed Rules from using hedging or other strategies to insulate themselves from potential losses in the value of equity they receive as incentive-based compensation.

COMMENTS

The Proposed Rules Should Include a Broader Definition of "Incentive-Based Compensation."

The reporting obligations and prohibitions in the Proposed Rules apply only to "incentive-based compensation" arrangements. The term "incentive-based compensation" is currently defined to mean "any **variable** compensation that serves as an incentive for performance."[6] This definition is critically important since it will determine the scope of the Proposed Rules.

The definition of "incentive-based compensation" is broadly framed, but it may nevertheless exclude some forms of compensation that the Dodd-Frank Act intended to cover. Statements in the Release support this concern. For example, the Release explains that "salary" would not be considered incentive-based compensation.[7] However, although salary is generally a fixed stream of money, it obviously can be structured in ways that would make it an extremely powerful incentive. Large salary increases linked to near-term performance metrics could certainly induce the type of high-risk behavior that the Dodd-Frank Act sought to eliminate.

While traditional salary, even at high levels, was not the target of Section 956 of the Dodd-Frank Act, salary and other benefits should be subject to those new requirements if such forms of compensation are used to circumvent the law on incentive-based compensation.

The definition should therefore be broadened to include "**any** compensation," regardless of label, structure, design, or intent, whether fixed or variable, that serves as incentive-based compensation. This expansion of the definition is especially important since novel salary arrangements, including dramatic performance-based escalation clauses, can be expected to appear once the Proposed Rules are in effect.

When the curbs on traditional incentive-based compensation are in place, covered institutions will undoubtedly attempt to devise means for circumventing the new restrictions. If the Proposed Rules are written or interpreted to categorically exclude salary, regardless of how it is structured or adjusted over time, then they will create a significant loophole and the purposes of the Dodd-Frank Act will be undermined.

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[6] Proposed Rules § 248.203(g). Unless otherwise indicated, citations to specific sections of the Proposed Rules are to the Commission's version of the Proposed Rules.

[7] Incentive-Based Compensation Arrangements, SEC Release No. 64140, 76 Fed. Reg. 21170, 21175 (Apr. 14, 2011) ("Release").

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The Proposed Rules Should Strengthen the Reporting Obligations in Terms of Content, Format, and Frequency.

The Proposed Rules would require covered financial institutions to file annual reports disclosing the structure of their incentive-based compensation arrangements. These reporting obligations are an important component of the Proposed Rules, as they will enable the Commission and other Agencies to ensure compliance with the new compensation standards, to identify potentially high risk compensation structures, and to take remedial action when necessary. To help fulfill these purposes, the Proposed Rules should be strengthened in three important respects.

First, the Proposed Rules should specify the required information in greater detail. The general formulation of the reporting requirement is appropriate but not sufficient. It establishes an important "principles"-based standard by requiring each report to describe the structure of the institution's incentive-based compensation arrangements in a way 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 benefits . . . or could lead to material financial loss to the covered financial institution."[8] Although the Proposed Rules also specify some minimum information that must be included in the reports, such as the "components" of the incentive-based compensation arrangements, they do not require sufficient detail.[9]

The Proposed Rules should require reports to include more information about the "components" of incentive-based compensation arrangements. For example, among the information that would be necessary to adequately describe an incentive-based compensation arrangement would be the types of compensation offered, such as stock, options, or other forms of remuneration, the applicable vesting schedules, and the contingencies or goals that entitle covered persons to the compensation. This level of specificity is necessary to ensure that reporting institutions supply enough information to enable the Agencies to identify compensation structures that are excessive, as required under Section 956 of the Dodd-Frank Act.

Second, the Proposed Rules should also require covered institutions to file their annual reports in a single, searchable, electronic format, with standard fields. As suggested in the Release, this modification will provide a more efficient and less burdensome way for institutions to comply with their reporting obligations.[10] It will also promote fast and efficient analysis of the reports by the Commission and each of the other Agencies. In addition, mandatory use of a single electronic format will prove valuable to the Financial Stability Oversight Council ("Council"). Incentive-based compensation arrangements that are in place across a wide variety of financial institutions will undoubtedly be an important focus of the Council as it seeks to identify potential systemic risks. Uniform electronic formatting of reports and other market data to the maximum extent possible will assist the Council in it surveillance activities.

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[8] Proposed Rules § 248.204(a).

[9] Proposed Rules § 248.204(c)(1).

[10] Release at 21177.

As a general proposition, enhanced regulation of the financial services industry will increasingly depend upon the ability of regulators to quickly organize and search large volumes of both narrative information and numerical data. To enable regulators to accomplish these tasks, reports and other data flows from market participants must be packaged in a uniform electronic format that permits meaningful analysis. In their rulemakings under the Dodd-Frank Act, all regulators should strive to achieve this goal of establishing uniform electronic reporting standards.

Finally, the Proposed Rules should also require covered institutions to file prompt updates between annual reporting cycles, once any material changes to their incentive-based compensation arrangements are adopted. Requiring such amendments would not place an undue burden on reporting institutions but would confer significant benefits. The time periods over which compensation arrangements can influence executive behavior and increase institutional risk are potentially quite short, and can certainly be less than a year. Requiring prompt reporting of updates will enable the Commission and the Agencies to identify and address early on any changes in compensation arrangements that may encourage inappropriate risks.

The Proposed Rules Should Expand the List of Factors Used to Determine When Compensation Is Excessive, and They Should Limit the Role of Compensation Practices at Comparable Institutions as a Measure of Excessive Compensation.

The Proposed Rules would prohibit covered financial institutions from establishing any type of incentive-based compensation that encourages inappropriate risks by providing a covered person with excessive compensation.[11] The Proposed Rules include a list of factors that the Agencies must consider when determining whether incentive-based compensation is "excessive," including items such as the value of all benefits provided to the covered person and the financial condition of the financial institution.[12]

Those factors are appropriate, but they omit one of the most important determinants of excessive incentive-based compensation: the extent to which the covered person's services actually contributed to the long-term well-being of the specific financial institution.

The Proposed Rules touch on this factor but only in negative terms. One of the seven listed considerations is "any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution."[13] The Proposed Rules should also require an assessment of the **value added**, not just the **abuses committed**, by the covered person receiving compensation. Where the value added has been non-existent, minimal, or even negative, this should have a direct bearing on judgments about whether compensation is excessive.

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[11] Proposed Rules § 248.205.
[12] Proposed Rules § 248.205(a)(2).
[13] Proposed Rules § 248.205(a)(2)(vi).

To implement this additional consideration, the Proposed Rules should include two important limitations. First, the contribution by the covered person should be measured in terms of the financial institution as a whole, not a business unit within the institution. The improved performance of a business unit may not correspond with the performance of the institution overall, and it may actually come at the expense of the institution. To ensure that the covered person's contribution is properly evaluated when identifying excessive compensation, only that person's impact on the entire institution should be considered.

Second, the Proposed Rules should specify that there must be a causal connection between the covered person's service and long-term institutional success. This entails factoring out influences such as industry or stock market trends that cause traditional measures of corporate prosperity to rise without regard to an employee's business judgment, acumen, or leadership.

The factors identified in the Proposed Rules for identifying excessive incentive-based compensation raise another serious concern. When determining whether compensation is excessive in a given case, the Agencies are to consider "comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets."[14]

This test creates the obvious danger that the acceptable norm or benchmark for compensation will be much too high, since "comparable" financial institutions are likely to be steeped in a tradition of excessive compensation. There is no question that the financial services industry has long been characterized by huge and, in many cases, unjustifiable compensation packages for its senior executives.[15] Reliance on these inflated compensation practices as a standard for implementing Section 956 of the Dodd-Frank Act will only entrench the excessive and risk-inducing compensation formulas that the law was intended to eradicate.

The remedy for this problem is to ensure that compensation practices at other institutions may only serve as a yardstick if, and to the extent that, those compensation practices themselves are demonstrably reasonable and not "excessive." In addition, to ensure that any such comparisons are fair, the universe of "comparable" institutions should be more narrowly defined. It should be limited to institutions with comparable business operations, not just institutions that are similar in size, geographic location, or complexity.

The Proposed Rules Should Require Independent Board Members to Oversee Incentive-Based Compensation Arrangements.

The Proposed Rules would prohibit a covered financial institution from establishing any type of incentive-based compensation arrangement that could lead to a "material

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14 Proposed Rules § 248.205(a)(2)(iv).

15 *See* House Report, *supra* n. 2, at 7-8.

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financial loss" to the covered institution.[16] Under the Proposed Rules, the only acceptable incentive-based compensation arrangements would be those that—

- Balance risk and financial reward, applying a variety of factors;
- Are subject to risk management controls; and
- Are actively overseen by the board of directors or one of its committees.[17]

The third element regarding board oversight must be strengthened. The Proposed Rules should require all compensation practices at covered financial institutions to be established, implemented, monitored, and revised solely by independent board members. Those independent board members should comprise the financial institution's compensation committee, but regardless of form, the key requirement is that only independent board members oversee compensation matters.

Only this approach will increase the likelihood that covered financial institutions will adhere faithfully to the requirements set forth in Section 956 of the Dodd-Frank Act and in the Proposed Rules.

Moreover, this approach will promote consistency with the other provisions in the Dodd-Frank Act aimed at improving executive compensation practices. For example, Section 952 of the Dodd-Frank Act requires the compensation committees of public companies to be comprised solely of independent board members, and it also promotes greater independence among the consultants that a compensation committee may hire. These important enhancements in the corporate governance structures that oversee executive compensation should also apply to the oversight of incentive-based compensation arrangements under Section 956 of the Dodd-Frank Act.

The Proposed Rules Should Require Deferral of Incentive-Based Executive Compensation at All Covered Financial Institutions, Not Only Those with $50 Billion or More in Assets.

The Proposed Rules would require only the largest covered financial institutions, defined as those with over $50 billion in assets, to defer at least 50 percent of an executive officer's annual incentive-based compensation over a period of at least three years.[18] The Proposed Rules would also require that such deferred amounts of incentive-based compensation be adjusted for actual losses of the covered financial institution or other measures of performance that are realized during the deferral period.[19]

These are valuable provisions that will help foster more appropriate risk-taking by the executives at large covered financial institutions. Two changes are necessary, however.

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16 Proposed Rules § 248.205(b)(1).
17 Proposed Rules § 248.205(b)(2).
18 Proposed Rules § 248.205(b)(3)(i)(A).
19 Proposed Rules § 248.205(b)(3)(i)(B).

First, the Proposed Rules should include a safeguard against attempts by covered persons to delay loss recognition beyond the three-year period to avoid downward adjustments in compensation. The safeguard should provide that, in the event of such deliberate evasion, the three-year deferral period shall be extended until the time that losses are realized, and adjustments to compensation shall be instituted retroactively.

The Proposed Rules should also expand the scope of the deferral requirements. They should apply to all covered institutions, not only the largest entities. **Nothing in the text of Section 956 of the Dodd-Frank Act suggests that more robust compensation controls such as mandatory deferral should apply only to very large financial institutions.**

Moreover, the rationale for limiting the deferral requirement to just the largest financial institutions as explained in the Release is not persuasive. The Release indicates that "larger covered financial institutions tend to have more diverse business operations, which can make it more difficult to immediately recognize and assess risks for the organization as a whole."[20] To the extent this is true, it is a matter of degree and does not warrant a bright line threshold set at the high level of $50 billion. Smaller financial institutions also engage in complex transactions and multiple lines of business, presenting risks that are difficult to quantify in advance. Thus, under the rationale in the Release, these institutions should also be subject to the deferral requirement.

Other considerations support broader application of the deferral requirement. Applying the deferral requirement to a larger class of financial institutions would not burden the vast majority of financial institutions. Most financial institutions have less than $1 billion in assets,[21] and all of those institutions would remain exempt from Section 956 of the Dodd-Frank Act and the Proposed Rules, including the deferral requirement. Yet applying the deferral requirement to the institutions with assets between $1 billion and $50 billion is nevertheless important, since those institutions are certainly large enough to have systemic impact.

Eliminating the arbitrary $50 billion threshold will also eliminate opportunities to evade the new requirements. With the asset threshold in place, financial institutions may be tempted to reorganize their corporate structures or to adopt certain accounting methodologies so that they fall below the $50 billion asset test and thereby avoid the deferral requirement for incentive-based compensation. Removing the threshold ensures that no financial entity will be able to game the system in this fashion.

Finally, applying the deferral requirement equally to the mid- and larger-sized financial institutions would eliminate the type of regulatory disparity that opponents of

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[20] Release at 21180.

[21] For example, the Release indicates that among institutions regulated by the FDIC, 4,466 have less than $1 billion in assets, 289 have assets between $1 and $50 billion, and 301 have assets over $50 billion. Release at 21187. Thus, expanding the scope of the deferral requirement would have a small impact with respect to the total universe of FDIC-regulated entities, reaching an additional 289 firms but leaving 4,466 institutions unaffected. A similar conclusion follows from data regarding OCC-regulated entities (1,215 with assets under $1 billion, 140 between $1 and $50 billion, and 18 with assets over $50 billion). Release at 21187.

reform often decry. In response to the Proposed Rules, the larger institutions will presumably argue that they will lose top quality management personnel to the banks and other institutions that are not subject to the deferral requirement. Setting aside the merits of this dubious claim, if the deferral requirement is applied across the board (with the exception of the smallest firms), then the largest institutions will be unable to claim any disadvantage in their efforts to attract and retain top executives.[22]

The Proposed Rules Should Prohibit Covered Persons From Using Hedging Strategies to Mitigate Fluctuations in the Value of Equity Awarded as Incentive-Based Compensation.

In the Release, the Agencies invite comment on whether those who receive equity as part of an incentive-based compensation arrangement should be prohibited from hedging against market fluctuations in the value of that equity, using financial derivatives, insurance contracts, or other devices however labeled or structured.[23] We urge the Agencies to prohibit such conduct.

Allowing directors and employees who are subject to the new limitations on incentive-based compensation to deploy these hedging strategies, however labeled or structured, would sever or at least weaken the link between risk and reward that the Dodd-Frank Act seeks to establish in the realm of executive compensation. The comment letter submitted on the Proposed Rules by Senators Menendez, Lautenberg, and Merkley provides useful context on this issue, by confirming that the practice of hedging equity compensation is not insignificant and that it has been used by executives who presided over some of the most notorious corporate meltdowns in recent memory, including MCI and Enron.[24]

The Dodd-Frank Act reflects a serious concern with the practice of hedging against the decrease in market value of equity securities that are awarded as part of executive compensation. In Section 955, the Act requires public companies to disclose in proxy statements whether any director or employee is permitted to engage in such activity. Although Congress stopped short of outlawing the practice, the Agencies can and should do so in their regulations.

To do otherwise would undoubtedly weaken the remedial measures in Section 956, which are critical to reducing excessive risk-taking by our financial institutions.

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22 As noted in the Release, the Federal Housing Finance Agency is proposing to adopt a version of the Proposed Rules that applies the deferral requirement to all of the institutions it regulates, regardless of size, including all of the Federal Home Loan Banks. Release at 21180 n. 29.

23 Release at 21183.

24 Letter from Senators Robert Menendez, Frank Lautenberg, and Jeff Merkley to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, on Proposed Rules (Mar. 31, 2011), at 1-2, incorporated herein as if fully set forth here.

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CONCLUSION

Section 956 of the Dodd-Frank Act is an important component of the effort to reform executive compensation practices. With the changes described above, the Proposed Rules will effectively implement the reporting obligations and prohibitions relating to incentive-based compensation that Congress intended. We hope our comments are helpful.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Securities Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
shall@bettermarkets.com

www.bettermarkets.com