

Center On Executive Compensation – Section 956 Comment Summary

- **Overall Theme** – The proposed rule fails to focus on risk and instead focuses on the form of pay as well as pay magnitude. The result is an excessively over-inclusive regulation which covers employees and incentive plans that have no potential of creating material risk. For a final rule, the regulators should return to the principles-based approach used in the 2010 Incentive Compensation Standards which allows companies to determine which incentive plans and participants have actual potential for inappropriate risk-taking.
- **Overall Structure** – The Center’s comments begin with an executive summary, summarizing the comment letter’s theme and our key points. The comments then have a discussion of the universal requirements which apply to all institutions followed by a discussion of the requirements applying to only L1 and L2 institutions.
- **Argument Summary:** The following is a brief summary of the Center’s key arguments.
 - **Universal Requirements:** Our key concern with the universal requirement is focused on the ramifications of the proposed rule’s definitions of incentive compensation and covered person. The definitions, which do not focus at all on the risk-potential of a plan or participant, result in an overly broad number of plans and participants being covered under 956’s universal requirements. We suggest that a final rule adopt a “Risk Litmus Test” which is a principles-based extension of the 2010 Incentive Compensation Standards that allows companies to evaluate their own plans and participant pools to identify those with actual risk potential. The 956 universal requirements would only apply to these plans.
 - **“Excessive” & “Material Risk-Taking” Prohibitions:** The Center voices support for the concepts endorsed by the proposed rule, but discusses our concerns that the only way compliance can be evaluated is by using hindsight judgment which upends good faith board decision-making.
 - **Recordkeeping Requirement:** Using the Risk-Litmus Test dramatically cuts down on the number of plans which would be required to be recorded and documented under 956.
 - **Exclusion of Broad-Based or Profit Sharing Plans:** If the regulators choose not to adopt the Risk-Litmus Test approach, we ask for the exclusion of broad-based and profit sharing plans from the scope of Section 956.
 - **L1 & L2 Requirements:** Our primary concern here, as with the universal requirement, is the tremendous over-inclusion of individuals resulting from the definition of Significant Risk-Taker. We detail how the proposed rule’s definition of Significant Risk-Taker will result in the coverage of individuals under the definition with no risk-potential. These individuals will often fill roles with cross-industry skill sets, making retention and recruitment more difficult and costly. We suggest that a final rule replace the definition of Significant Risk-Taker with one which follows a blueprint detailed in the 2010 FDIC Guidance, whereby Significant Risk-Takers would be individuals identified by an institution who individually or in the aggregate can expose the firm to material financial harm. We explain how this would limit the definition of SRT to largely traditional roles for financial institutions and thus remove the concerns with retaining and recruiting talent for cross-industry roles.

- **Dollar Threshold Test & Rebuttable Presumption:** As an alternative approach to the FDIC approach detailed above, we suggest the Relative Compensation Test (2%/5% Test) be replaced by a \$1,000,000 threshold whereby anyone making over this amount would be considered a Significant Risk-Taker. We recommend that, in addition to the test, that companies would have the ability to still remove the designation from an employee upon a demonstration that the individual does not have the potential to engage in risk-taking behavior.
- **Mandatory Deferrals:** Our recommendation is that the Regulators only require a three-year mandatory deferral requirement for qualifying incentive compensation (short-term plans). We argue effectively that long-term incentive compensation is already inherently deferred and able to reflect realized risk.
- **Scaled Deferral:** As an alternative to our primary mandatory deferral recommendation, we recommend the Regulators provide for a scaled deferral for individuals who are new to the requirement. The scaled deferral is aimed at addressing the cash short-fall which would otherwise be imposed on newly designated SRTs/SEOs and thus work to prevent companies from having to increase compensation to address the gap. The chart with the projected scale is below.

		<u>Year One</u>	<u>Year Two</u>	<u>Year Three</u>	<u>Year Four</u>
<u>Executive Officers</u>	L1	10%	25%	50%	60%
	L2	10%	25%	50%	
<u>SRTs</u>	L1	10%	25%	40%	50%
	L2	10%	25%	40%	

- **Deferral Mechanics – “Substantial Equity & Cash”:** We request that the Regulators clarify the requirement that deferrals be made in “substantially” both equity and cash. Pursuant to the rule, an individual’s deferral amount will consist of a deferral from both short-term and long-term incentive plans. We’d like to make sure the “substantial” standard applies to the total deferral amount and not to each deferral made on a plan-by-plan basis. This would cause companies to have to make significant changes to incentive plans, such as altering annual cash bonus plans to also include equity, simply to satisfy the deferral requirements.
- **Deferral Mechanics – 15% Value Limitation on Options:** The Center rebuts the proposed rule’s presumption that options inherently lead to inappropriate risk-taking and ask for the limitation to be either removed or increased.
- **Deferral Mechanics – Bonus Caps:** We argue for a complete removal of the arbitrary and mandated caps on incentive plan bonuses of 125% for executive officers and 150% for significant risk-takers. In the alternative, we argue for a 200% cap for both SRTs and executive officers.
- **Accounting Difficulties:** The substantial uncertainty resulting from an open-ended potential for forfeiture, adjustments, and clawbacks has the potential to force companies from fixed to variable stock accounting.