

August 30, 2017

*Via Electronic Mail*

Secretariat to the Financial Stability Board  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

Re: Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices

Ladies and Gentlemen:

The Clearing House Association L.L.C.<sup>1</sup> appreciates the opportunity to respond to the Financial Stability Board’s publication of its “Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices Consultative Document” released on June 20, 2017.<sup>2</sup> Certainly, reducing the incidence of misconduct at financial institutions is a laudable goal, but we do not believe that the current proposal would meaningfully advance this aim. In particular, we believe that the Proposed Supplementary Guidance’s approach to addressing misconduct is unduly and unnecessarily specific and prescriptive and fails to provide appropriate latitude for significant differences in labor, compensation, and governance practices and norms across different jurisdictions. It also does not appear to be based on robust analysis or data, or any evidence that the types of compensation practices favored by the proposal have proven more effective in addressing misconduct than those disfavored – let alone, that disfavored practices have had a material effect on financial stability.<sup>3</sup> Presumably, the global financial crisis has presented a wealth of data that could be analyzed in this regard. We note, for example, that the 2008 compensation plan for Lehman Brothers – whose failure was arguably the largest contributor to financial instability – is public. As we read that plan, it included deferred compensation of at least 50% for senior executives, and a 100% clawback of such deferred

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<sup>1</sup> The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly \$2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

<sup>2</sup> Financial Stability Board, “Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices, Consultative Document,” June 20, 2017, available at: <http://www.fsb.org/wp-content/uploads/R200617.pdf>.

<sup>3</sup> In this regard, we note the contrast between the proposal and FSB work in other areas such as total loss absorbing capacity, which was quite rigorous.

compensation for involuntary termination.<sup>4</sup> One might thus conclude that catastrophic errors of the type committed by Lehman Brothers management were not materially the result of their compensation structure. Of course, Lehman is one case, and perhaps a rigorous analysis of performance during the global financial crisis would identify trends whereby one compensation regime produced materially different outcomes than others. But no such analysis underlies this proposal

Rather, the Proposed Supplementary Guidance notes, “Recent events have raised broad prudential concerns about effective governance, risk management and controls and their application to incentive-based compensation practices, particularly in the area of misconduct.” The proposal, however, does not identify the events, the concerns, how they are linked, or how the proposed restrictions would have prevented those events or reduced those concerns.

The proposal does not even define “misconduct.” If that definition is limited to knowing malfeasance – fraud, for example – then the need for the proposal seems quite limited. Misconduct in the financial services industry, like misconduct in other industries, is subject to a wide variety of penalties, both civil and criminal, all intended to disincentivize misconduct. We think it is fair to say that if the prospect of imprisonment, fines, debarment and public humiliation is insufficient to discourage an employee from committing misconduct, then a year or two of additional deferral in compensation (which likely would be forfeited in its totality) is unlikely to make a material difference. If the term “misconduct” is meant to comprise poor judgment or poor analysis of risk, the proposal fails to link any of its proposed restrictions to any analysis or data suggesting that they would improve judgment or analysis.

Of course, none of this is to say that deferrals or clawbacks are not good practices. We expect that firms would continue many of the practices prescribed in the guidance because they protect *shareholders*. Clawbacks may be a useful tool for firms to seek reimbursement for employee conduct that causes a financial loss. However, we believe it is quite a stretch to say that clawbacks have any effect on *financial stability*.<sup>5</sup>

Finally, the Proposed Supplementary Guidance does not account for the existing public sector compensation frameworks that have been successfully implemented in various jurisdictions.

As discussed further herein, we have concerns that the overly prescriptive nature of the proposal would hinder institutions’ ability to effectively address misconduct. However, should the FSB seek to provide internationally endorsed guidance in this area, we suggest that the FSB

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<sup>4</sup> See Lehman Brothers Holdings Inc., “Compensation and Benefits Committee of the Board of Directors,” (January 28, 2008) at LB 010215 and LB 010225 available at: [https://web.stanford.edu/~jbulow/Lehmandocs/docs/DEBTORS/LBHI\\_SEC07940\\_027123-027211.pdf](https://web.stanford.edu/~jbulow/Lehmandocs/docs/DEBTORS/LBHI_SEC07940_027123-027211.pdf).

<sup>5</sup> We note that U.S. regulators proposed overly prescriptive incentive-based compensation restrictions in 2016. They received criticism for that proposal, including from The Clearing House, and thus far have chosen not to finalize those restrictions. See Notice of Proposed Rulemaking and Request for Comment on Incentive-Based Compensation Arrangements, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Credit Union Administration and the U.S. Securities and Exchange Commission, 81 Fed. Reg. 37,670 (June 10, 2016).

issue a revised consultation that recognizes the successful implementation of various public sector compensation frameworks, avoids the introduction of any new, specific standards, and provides bank boards and management with appropriate flexibility to maintain dynamic compensation practices that evolve over time to keep pace with legal, market, and risk-management developments. Further, any guidance should be appropriately tailored to address misconduct risk, rather than addressing risk in general. The FSB makes clear that the Proposed Supplementary Guidance is intended to address misconduct risk. For example, the background section to the proposal states that its purpose “is the effective use of compensation tools based on strong governance and management of misconduct risk through compensation practices, including robust performance management practices.” However, the proposal in other sections appears to refer to both misconduct risk *and* risk generally.<sup>6</sup> To avoid confusion, the FSB should ensure that the scope of the Proposed Supplementary Guidance remains focused solely on misconduct risk.

### **I. The Proposed Supplementary Guidance is unduly prescriptive and unnecessary given the evolution of local regulatory frameworks for bank compensation.**

The proposal includes several prescriptive elements that could make it more difficult for institutions to employ flexible and effective risk management practices that can evolve over time. For example, the Proposed Supplementary Guidance specifies numerous elements that must be used to address misconduct risk, including “appropriately weighted” non-financial measures, scenarios that should lead to adjustments, and procedures to be followed in making performance adjustments. Prescriptive international standards of such specificity are inappropriate, and examiner enforcement of those standards would be subjective and varying.

Misconduct risk, and the use of compensation tools to address such risk, is best managed by an institution’s management, working with home country authorities where appropriate. As stated in TCH’s 2016 *“The Role of the Board of Directors in Promoting Effective Governance and Safety and Soundness for Large U.S. Banking Organizations,”* a core board function includes oversight of the enterprise-wide compensation philosophy that appropriately balances risk and reward and takes into account compliance performance and ethical and responsible behavior.<sup>7</sup> Requirements that are too prescriptive in this regard could inappropriately usurp the role of the board and management. There are substantial complexities involved in the design of compensation arrangements and their use as a tool to address risk, including misconduct risk, at financial institutions. Indeed, firms must balance a number of factors and dynamics in determining whether and to what extent compensation should be used to address misconduct. Senior management, operating under the board of director’s ultimate oversight, has the requisite understanding of an institution’s businesses, employees, geographic footprint, competitors, and risk tolerances to effectively deploy one or more tools to deter and remediate misconduct. An

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<sup>6</sup> For example, Item #5 under the Proposed Supplementary Guidance states, in part, that “Compensation should be adjusted for all types of risk, both financial and non-financial, including misconduct or behavior that can result in harm to both firms and their customers.” A better formulation to preserve the intended scope of the Proposed Supplementary Guidance would be to state that “Compensation may be adjusted for all types of misconduct or behavior that results in harm to firms or their customers.”

<sup>7</sup> See The Clearing House “The Role of the Board of Directors in Promoting Effective Governance and Safety and Soundness for Large U.S. Banking Organizations,” (May 2016), available at: [https://www.theclearinghouse.org/~media/action%20line/documents/volume%20vii/tch\\_report\\_the-role-of-the-board-of-directors-in-promoting-governance.ashx](https://www.theclearinghouse.org/~media/action%20line/documents/volume%20vii/tch_report_the-role-of-the-board-of-directors-in-promoting-governance.ashx)

institution's incentives to address misconduct are substantial, as instances of misconduct can harm a firm's performance and its shareholders, and result in criminal and civil penalties. Institutions' shareholders, boards of directors, and senior management also generally have a strong interest in the design of rational compensation schemes.

Continued developments in the regulation of bank compensation by FSB member jurisdictions further render the prescriptive standards included in the Proposed Supplementary Guidance unnecessary. Since the financial crisis, various countries have developed frameworks for appropriately managing compensation practices, consistent with the FSB's 2009 Principles for Sound Compensation Practices and their Implementation Standards.<sup>8</sup> For example, in the United States, in 2010, the OCC, the Federal Reserve and the FDIC (the "Banking Agencies") adopted formal, principles-based guidance in this regard.<sup>9</sup> Since that time, financial firms in the United States have continually adapted their compensation arrangements to (i) be more sensitive to numerous risks, including misconduct risk, (ii) provide balanced incentives, (iii) reflect the diversity of financial organizations and (iv) maintain competitive balance with a growing number of unregulated competitors. These changes would have been impossible to predict seven years ago when the Guidance was developed, and the industry continues to refine and innovate with respect to its incentive compensation practices. The significant progress and redesign that compensation practices have undergone in the United States since the financial crisis, even in the absence of mandatory requirements to do so, demonstrates (i) the commitment that the industry has to ensuring that compensation programs are risk-balanced, and (ii) the effectiveness of a principles-based framework in deterring inappropriate behavior.

## **II. The Proposed Supplementary Guidance would prescribe compensation practices at a level of specificity that is inconsistent with important differences across FSB jurisdictions and bears little relationship to the FSB's financial stability objectives.**

International standards are particularly inappropriate in the compensation realm because of substantial divergences in labor markets and compensation markets and relevant legal frameworks across jurisdictions. First, the behavior that constitutes "misconduct" differs substantially across jurisdictions. Criminal and civil laws, cultural norms, business practices and expectations, and professional and ethical duties and obligations vary considerably from one nation to another, necessarily resulting in different concepts of misconduct. Second, compensation systems on their own may not be the most effective tools to address misconduct in all circumstances across jurisdictions. Different countries and cultures may respond differently to compensation-related incentives (and different compensation-related mechanisms) versus other incentives in certain instances. For example, in certain cases, termination of employment may be a more appropriate and effective tool to punish and deter misconduct. In addition, certain of the FSB's proposals could increase litigation and other risks for financial institutions. In certain jurisdictions, for example, the use of compensation adjustments, such as clawbacks, may carry employment litigation risk. A uniform international approach – particularly one that includes

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<sup>8</sup> See Financial Stability Forum, Principles for Sound Compensation Practices (April 2, 2009), available at: [http://www.fsb.org/wp-content/uploads/r\\_0904b.pdf](http://www.fsb.org/wp-content/uploads/r_0904b.pdf); FSB Principles for Sound Compensation Practices Implementation Standards (September 25, 2009), available at: [http://www.fsb.org/wp-content/uploads/r\\_090925c.pdf](http://www.fsb.org/wp-content/uploads/r_090925c.pdf)

<sup>9</sup> See Guidance on Sound Incentive Compensation Policies, Office of the Comptroller of the Currency, Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of Thrift Supervision, Treasury, 75 Fed. Reg. 36,396 (June 25, 2010).

specific punitive actions with respect to employee compensation – is likely to be in tension, if not outright conflict, with local labor practices that afford employees legal or bargained-for procedural and other protections. Further, there may be legal implications under national privacy laws in connection with the proposed standards regarding increased communication to all employees about compensation implications for misconduct.

Finally, a uniform international approach may not allow institutions to adequately consider competitive concerns in determining appropriate tools to address misconduct. For example, banks are increasingly competing against technology firms in multiple jurisdictions. The FSB is not proposing to apply standards to the compensation practices of those firms, and thus, there is a risk that an international compensation system that allows banks to compete in one country could render it non-competitive in others.

### III. Guiding Principles for Improvement

For the foregoing reasons, should the FSB seek to provide internationally endorsed guidance in this area, we suggest that the FSB issue a revised consultation that recognizes existing public sector compensation frameworks that have been successfully implemented in various jurisdictions and avoids any use of specific, prescriptive standards. In addition, and consistent with the themes enumerated above, we highlight the following principles that should guide any such work:

- **Compensation systems may encourage prudent behavior but are not designed to “identify, monitor, prevent and remediate misconduct”.**
  - Banks have entire risk management frameworks designed to identify, monitor and remediate misconduct, which may include, among other things, surveillance systems, training requirements, human resources policies, culture and conduct programs, and risk self-evaluations. Reliance on compensation systems to play this identification, monitoring, and remediation role is inappropriate. Rather, compensation programs may be one part of this larger whole. Indeed, a compensation system may be most appropriately used to reflect the determination that misconduct has occurred by negatively adjusting compensation results, which may serve as a deterrent for individuals to engage in misconduct.
  
- **Management, subject to the ultimate oversight of the board of directors, is best able to effectively address misconduct.**
  - It is the responsibility of management to identify, prevent and remediate misconduct (including in decision-making with respect to adjustments of individual employee incentive compensation), subject to the board’s ultimate oversight. Firms should have the flexibility to determine, at their discretion, whether to involve other functions, including, but not limited to, control functions.
  - The board of directors should oversee the development and implementation of the organization’s conduct standards, and the enterprise-wide compensation philosophy that appropriately balances risk and reward and takes into account compliance performance and ethical and responsible behavior.

- Under principles of corporate governance, the board has the ability to delegate functions to board committees. In addition, board functions at the various levels of the organization may be coordinated at the top-tier parent holding company. They do not need to be performed by the board or board committee of each legal entity within the organization.
  - It is unreasonable and impractical to suggest that an organization's board of directors be on the frontlines in, for example, defining "misconduct risk", or normally being involved in individual compensation assessments and recommendations, as subjecting boards to granular requirements would detract from the board's other important responsibilities, such as guiding corporate strategy, monitoring economic risks, and overseeing programs to attract, retain, and develop talent.
- **Prescriptive standards to manage misconduct through compensation systems are inappropriate, as they are inflexible and can thus be counterproductive in addressing misconduct risk.**
- Compensation adjustments are just one means, among other non-financial actions, that an organization may utilize to encourage good behavior and to create disincentives for misconduct. Compensation adjustments alone are not always the most effective or appropriate actions to address misconduct. For example, non-compensatory disciplinary actions (e.g., termination of employment) may be appropriate in certain circumstances.
  - Further, requiring the adoption of compensation elements could lead to challenges and incentives that could be difficult to reverse or adjust in a timely manner. For example, in Europe, restrictions on compensation structure have resulted in significant increases in fixed pay, which may in fact limit the ability of a banking organization to incentivize appropriate risk-taking and banks' flexibility to reduce costs during economic downturns.<sup>10</sup> In fact, in connection with the interagency proposal regarding incentive-based compensation restrictions, the SEC recognized that prescriptive deferral requirements may increase risk taking.<sup>11</sup>
  - This shift in compensation practices, driven by prescriptive incentive compensation regulations, may result in limiting the ability of compensation systems to deter misconduct because fixed pay makes up an increasingly large percentage of total compensation. It is more difficult to adjust future fixed pay or recoup fixed pay that has already been paid because of misconduct compared to

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<sup>10</sup> See Jenny Anderson, "European Banking Authority Clarifies Rules on Pay," *The New York Times* (Mar. 4, 2015) ("[t]hat [bonus] cap, which limits bankers to bonuses equal to one or two times their salaries, inspired banks to invent new pay categories that they designated as fixed pay in an attempt to bolster overall pay").

<sup>11</sup> See 81 Fed. Reg. 37,670 at 37,785 (June 10, 2016) ("There could be situations . . . where bonus deferral could actually lead to an increase in risk-taking incentives. For example, if firm performance during the deferral period significantly declines and causes a significant loss in the value of deferred compensation, senior executive officers and significant risktakers could potentially have an incentive to engage in high-risk actions in an effort to recoup at least some of the value of their deferred compensation." *Internal citation omitted*).

variable incentive pay, which can be adjusted or forfeited prior to vesting and payment--or even clawed back after payment--more easily.

- The costs of implementing a standardized approach to managing misconduct risk through compensation systems are substantial. Not only could the costs manifest themselves in requirements to unnecessarily restructure an institution's established compensation program, but they could also result in increases to fixed compensation and the loss of employees due to a competitive disadvantage relative to unregulated competitors. Covered persons will likely either demand increased fixed compensation to offset losses imposed on them by prescriptive compensation requirements or pursue opportunities at competitors that are not subject to such requirements.
- Banks' ability to provide credit, liquidity and risk management services depends in large part on their ability to employ talented individuals. For this reason, it is vitally important that banks are able to attract and retain talented individuals in a labor marketplace where regulated institutions must compete for talent with a wide variety of businesses – including financial, technology and other industries that are less regulated or unregulated. It is of particular importance that financial institutions maintain their ability to compete for employees in key control and other functions, like risk and IT, which are fundamental to the operation of a safe and sound banking organization.
- An overly broad set of compensation restrictions that are globally applicable to a wide universe of bank employees would be particularly harmful to banks' ability to attract and retain talent and, in turn, to their safety and soundness. Other industries with which financial institutions compete for talented employees, particularly those employees whose skill sets are in demand in a variety of industries and not limited to the banking industry, such as individuals with expertise in cybersecurity, are not obligated to implement compensation restrictions to address risk. In order to compete with other industries and firms, banks require flexibility in their compensation programs to be able to tailor those programs based on several factors, including their geographic location, their business lines, the companies with whom they compete for talent, and the responsibilities of specific employees or groups of employees.

➤ **Principles-based guidelines would allow institutions to incentivize good behavior and address instances of misconduct.**

- As demonstrated by the implementation in various jurisdictions of principles-based guidelines regarding the use of compensation to address risk, including the implementation in the United States of the 2010 *Guidance on Sound Incentive Compensation Policies*, a principles-based approach would permit diversity of incentive compensation practices among financial institutions and allow institutions to respond nimbly to changes in the institution's businesses and activities, laws and other obligations, incentives, and employee behavior to successfully identify, punish, and deter misconduct on a real-time basis.
  - The 2010 Guidance explained that the agencies' believed that "a principles-based framework . . . is the most effective way to address

incentive compensation practices, given the differences in the size and complexity of banking organizations covered by the guidance and the complexity, diversity, and range of use of incentive compensation arrangements by those organizations. For example, activities and risks may vary significantly across banking organizations and across employees within a particular banking organization. For this reason, the methods used to achieve appropriately risk-sensitive compensation arrangements likely will differ across and within organizations, and use of a single, formulaic approach likely will provide at least some employees with incentives to take imprudent risks.”<sup>12</sup>

- The 2010 Guidance also states that the Agencies considered whether to require certain forms of compensation or whether to ban other forms. Ultimately, the agencies concluded not to adopt such rigid requirements and that “incentive compensation arrangements of various forms and levels may be properly structured so as not to encourage imprudent risk-taking.”<sup>13</sup>
- A principles-based approach would allow banks to have the flexibility to design compensation systems and arrangements that have features that are appropriately risk-balanced in light of the conduct such compensation systems and arrangements are designed to induce and the level of risk such conduct poses to the firm, customers, and other stakeholders, if not properly managed.
- In particular, organizations should have flexibility to:
  - Design, communicate, and administer a compensation system for addressing misconduct that best reflects the organization’s businesses and employees. Overly-prescriptive standards could be counterproductive to the firm’s ability to address misconduct risk.
    - For example, a standard that specific misconduct triggers be delineated ex ante could negatively affect an organization’s ability to address instances of misconduct that may not have been initially contemplated at the outset of a compensation system, and providing an ex ante explanation may result in increased levels of misconduct (e.g., employees may engage in misconduct after performing a cost-benefit analysis relative to the impact on compensation).
  - Make fact-specific determinations regarding which individuals within an organization should be subject to compensation adjustments as a result of misconduct;
  - Design their compensation systems to make individualized determinations as to the appropriate weighting of non-financial measures and the specific non-financial measures to be included in a compensation system design;

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<sup>12</sup> See 75 Fed. Reg. at 36,399.

<sup>13</sup> *Id.*



- Determine the appropriate amount of compensation that should be placed at risk of reduction, including the ability to determine that *no compensation* should be placed at risk, in order to develop appropriately-tailored compensation systems for its employee population;
- Make compensation adjustment determinations based on the specific facts and circumstances surrounding misconduct; and
- Determine the appropriate mechanisms to adjust variable compensation according to the particular facts surrounding an instance of misconduct. Prescriptive requirements, such as requiring in-year adjustments, could be inappropriate and require premature actions before a holistic review and assessment has occurred.

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We appreciate the opportunity to provide input on the Proposed Supplementary Guidance. Should you have any questions or require additional information, please do not hesitate to contact me at (202) 649-4619 or by email at [Paige.Pidano@theclearinghouse.org](mailto:Paige.Pidano@theclearinghouse.org).

Respectfully submitted,



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