IBC
International Bancshares Corporation

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VIA [DELIVERY METHOD]

Chief Counsel's Office, Comment Processing
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, D.C. 20219
Attn: Docket ID OCC-2011-001; RIN 1557-AD39

James P. Sheesley, Assistant Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429
Attn: Comments RIN 3064-AD86

Clinton Jones, General Counsel
Federal Housing Finance Agency
400 7th Street SW
Washington, D.C. 20219
Attn: Comments/RIN 2590-AB30

Melane Conyers-Ausbrooks, Secretary
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428
Attn: RIN 3133-AE48

Re: IBC Comment Letter on the Interagency Notice of Proposed Rulemaking for Incentive-Based Compensation Arrangements

Ladies and Gentlemen:

The following comments are submitted by International Bancshares Corporation ("IBC"), a publicly traded, multi-bank financial holding company headquartered in Laredo, Texas. The first IBC Bank was founded in 1966 to meet the needs of small businesses in Laredo. Today IBC maintains 166 facilities and 256 ATMs, serving 75 communities in Texas and Oklahoma through five separately state-chartered banks ranging in size from approximately $470 million to $8.9 billion, with consolidated assets totaling over $15 billion. IBC is one of the largest independent commercial bank holding companies headquartered in Texas.

IBC appreciates the opportunity to comment on that certain interagency notice of proposed rulemaking regarding incentive-based compensation arrangements, dated May 6, 2024 (the "NPR"),[1] issued by the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Housing Finance Agency ("FHFA") and the National Credit Union Association ("NCUA"; together with the OCC, FDIC and FHFA, the "Agencies").[2] The NPR would implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"),[3] which tasks the appropriate federal regulators—including the Agencies, along with the Board of Governors of the Federal Reserve System ("FRB") and the U.S. Securities and Exchange Commission ("SEC")—to jointly prescribe regulations or guidelines (i) prohibiting incentive-based compensation arrangements that encourage inappropriate risk-taking by a covered financial institution by providing compensation, fees or benefits that is excessive or could result in material financial loss; and (ii) obligating the covered financial institutions to disclose, to the appropriate federal regulator, information concerning such compensation arrangements. If approved, the NPR would complete one of the final remaining pieces of the Act. Practitioners anticipate

[1] *See generally* Notice of Proposed Rulemaking and Request for Public Comment: Incentive-based Compensation Arrangements (May 6, 2024) [hereinafter, NPR 2024].

[2] Noticeably absent from the group of Agencies proposing the NPR, is the Federal Reserve Board and the Securities Exchange Commission. *See infra* notes 4–5 and accompanying text.

[3] Pub. L. 111–203, 124 Stat. 1376 (2010).

P.O. DRAWER 1359, LAREDO, TEXAS 78042-1359 (956) 722-7611

that the SEC will take action in the near future, as its recent rulemaking agenda reflects an intention to implement a rulemaking on incentive-based compensation.[4] However, the likelihood of the NPR's adoption remains uncertain as it will not advance in the rulemaking process unless and until all six regulators join in proposing it and there has been significant doubt as to whether the FRB will participate.[5]

The NPR represents the third proposed rulemaking aiming to regulate incentive-based compensation arrangements by certain covered financial institutions, initially proposed in 2011 and subsequently modified and reproposed in 2016 ("2016 Proposal").[6] Specifically, the NPR restates the regulatory text from the 2016 Proposal in its entirety, while incorporating a new Preamble requesting feedback to certain questions and certain proposed alternatives that will be considered for the final rule.[7] The new questions and alternative provisions pose certain risks that the final rule will be even more prescriptive and onerous than previously proposed. Additionally, the Agencies specifically request comment from those who previously submitted comment to the 2016 Proposal, requesting clarification on whether the respective organization's current commentary supersedes its previously submitted comments, in part or in whole. Accordingly, IBC submits these comments to echo its concerns previously submitted in response to the 2016 Proposal, as well as to provide additional feedback pertaining to certain material changes stemming from the modified proposed alternatives and questions posed in the NPR.[8]

IBC takes a particular interest in the NPR because of the wide-ranging impact it will likely have on IBC operations, including in ways that are superfluous to the underlying purpose of the NPR. Overall, IBC understands that the intent behind Section 956 of the Act was Congress' desire to curtail excessive risk-taking of the type that contributed to the 2008 financial crisis. In particular, one of the primary objectives of Section 956 was to address the perception that flawed compensation plan designs contributed to financial institutions taking such inappropriate risks that in turn contributed to the financial crisis and ultimately led to the failure of individual banks during the time of the crisis. In addition to the financial crisis, the modified Preamble cites flawed incentive-based compensation practices as a contributing factor to the 2016 Wells Fargo cross-selling scandal. It also mentions the more recent collapse of Silicon Valley Bank ("SVB") in 2023, marking the second-largest failure of a financial institution in U.S. history. Following the failure of SVB, regulators largely attributed the failure to poorly structured incentive-based compensation arrangements, citing such practices as an area of supervisory concern.[9] While IBC agrees a well-structured incentive-based compensation arrangement can promote the health of a financial institution by aligning the interests of the executives and employees with those of the institution's shareholders, the NPR is overly broad and imprudently imposes burdens on entities and persons that were not contributing actors to the financial crisis and do not raise the types of risks the regulation was designed to address. Such additional

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[4] SEC, Rulemaking Agenda: Incentive-Based Compensation Arrangements, RIN 3235-AL06 (Fall 2023), available at: https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202310&RIN=3235-AL06.

[5] *See* HOUSE FINANCIAL SERVICES COMMITTEE, Hearing on the Federal Reserve's Semi-Annual Monetary Policy Report (Mar. 6, 2023) (responding to a question as to whether the FRB would "commit to helping finalize the Dodd-Frank section of 956 this year", FRB Chair Jerome Powell stated, "I would like to understand the problem we're solving, and then I would like to see a proposal that addresses that problem").

[6] 81 FR 37673 (June 10, 2016) [hereinafter, 2016 Proposal].

[7] *See* NPR 2024, *supra* note 1, at 47–73.

[8] SEC, Comments on Proposed Rule: Incentive-based Compensation Arrangements (Release No. 34-77776; File No. S7-07-16), International Bancshares Corporation Comment Letter (July 21, 2016), available at: https://www.sec.gov/comments/s7-07-16/s70716-22.pdf.

[9] *See, e.g.*, Board of Governors, Federal Reserve System, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*, at 75 (April 28, 2023), available at: https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf ("Stronger or more specific supervisory guidance or rules on incentive compensation for firms of SVBFG's size, complexity, and risk profile — or more rigorous enforcement of existing guidance and rules — may have mitigated these risks.").

burdens create uncertainty and cause additional expense for financial institutions with minimal or no benefit to shareholders or the health of the financial industry, generally. Moreover, the NPR includes numerous terms that are overly broad and ambiguous, as drafted, increasing the already inordinate burden financial institutions carry as they seek to implement policies and procedures to comply with the NPR.

Accordingly, IBC is submitting this letter to comment on the following aspects of the NPR:

- **Overview of New Considerations and Alternatives;**
- **Definitions, Scope, and Applicability;**
- **Tiered Application Based on Asset Levels;**
- **Definition of Incentive-Based Compensation;**
- **"Excessive" Compensation and the Performance Measure Requirement;**
- **Deferral, Forfeiture and Downward Adjustment, Clawback;**
- **Compensation Opportunity Caps;**
- **Risk Management, Governance and Recordkeeping; and**
- **Impact on Community Banks.**

In particular, the Agencies can and should address these issues in a manner that contributes to the achievement of the important policy objectives of Section 956 of the Act by incorporating necessary changes, as set forth herein. Accordingly, IBC appreciates the Agencies' consideration of the foregoing comments to the NPR regarding Incentive-Based Compensation Arrangements.

I. OVERVIEW OF NEW CONSIDERATIONS AND ALTERNATIVES

As aforementioned, the current iteration of the NPR consists of the same regulatory text from the 2016 Proposal, while incorporating a modified Preamble that explores potential alternatives to certain provisions and poses additional questions with request to comment. As discussed in the Preamble, the Agencies justify such modifications, as constituting a reflection of the "various developments in incentive-based compensation, risk management, and governance practices" since the issuance of the 2016 Proposal.[10] However, for reasons outlined herein, the implementation of such modifications and proposed alternatives would likely result in a final rule with progressively more rigorous requirements than those set forth under the 2016 Proposal and IBC strongly urges the Agencies to take these negative effects into consideration.

Despite the Agencies efforts to provide such proposed alternative provisions in the modified Preamble to the NPR, the outcomes resulting from the implementation of such alternatives would impose even more rigid restrictions on financial institutions, such as: (i) shortening the time period for compliance; (ii) establishing additional requirements for smaller covered institutions, such as IBC's banks; (iii) providing less discretion for certain covered institutions, by requiring such institutions to recover incentive-based compensation by forfeiture, mandating downward adjustments for certain adverse outcomes, and imposing a clawback obligation; (iv) prohibiting incentive-based compensation determined by transaction revenue or volume; (v) mandating banks to establish performance measures and targets before the respective performance period begins; (vi) adding a requirement for covered institutions' to include, as part of their risk management framework, a requirement that a risk management and controls assessment from the independent risk and control functions be considered when setting incentive-based compensation for their senior executive officers and significant risk-takers; and (vii) modifying the "significant risk-taker" test to take a more "flexible risk-based approach."[11] In addition to IBC's

[10] NPR 2024, *supra* note 1, at 47.

[11] *See* NPR 2024, *supra* note 1, at 47–73.

commentary on the regulatory text of the NPR, this letter will address such proposed alternatives and their excessive reach resulting in myriad consequences to financial institutions.

II. DEFINITIONS, SCOPE, AND APPLICABILITY

In general, the purpose of the NPR is to prohibit those certain incentive-based compensation arrangements, for "covered persons" at "covered institutions" that encourage inappropriate risks by providing excessive compensation, fees, or benefits, or by encouraging inappropriate risks that could lead to material financial losses.[12] However, for reasons further discussed below, IBC cautions that the scope of certain definitions included in the NPR, as drafted, will likely result in a net cast too broad for proper applicability. Accordingly, as this Part II describes in detail, such definitions should be refined prior to implementation of a final rule. At a minimum, incorporating additional exemptions and exclusions to both definitions is necessary to ensure application does not exceed what the Act prescribes.

1) *Covered Financial Institutions*

If adopted, the NPR would broadly apply to all "covered institutions," which would include those financial institutions that have at least $1 billion in total consolidated assets and that fall within one of the following categories of covered financial institutions, as identified in Section 956: (i) depository institutions; (ii) subsidiaries of depository institutions; (iii) depository institution holding companies; (iv) nonbank subsidiaries of depository institution holding companies; (v) U.S. branches of foreign banks; (vi) non-depository trust companies; (vii) broker-dealers; (viii) investment advisers; and (ix) certain other types of financial institutions such as credit unions, Fannie Mae, and Freddie Mac.[13] The NPR would also expand the scope of covered financial institutions under the Act to include Federal Home Loan Banks.[14]

Importantly, as further discussed in Part III below, IBC would be considered a Level 3 institution, which would provide the applicable federal regulators with unfettered discretion to treat it as a Level 1 or Level 2 institution through the NPR's reservation of authority for Level 3 covered institutions. Thus, under the NPR, the definition of "covered institutions" is significantly broader in scope than Section 956 specifically identifies, and should be modified accordingly to ensure application is limited to the appropriate entities authorized under the Act.

2) *Covered Persons*

The NPR would apply to incentive-based compensation paid to "covered persons", which includes "any executive officer, employee, director, or principal shareholder who receives incentive-based compensation at a covered institution."[15] In contrast to the NPR's definition, the Act defines a "covered person" as "any person that offers or provides a consumer financial product or service [and] any affiliate of such a person if the affiliate acts as a service provider to such person."[16] Thus, the scope of employees embraced by the NPR's definition of "covered persons" is overly broad, far exceeding what is required under the Act. The breadth of coverage under this definition, as drafted, far surpasses the requirements set forth by Congress in its statutory charge to the regulators under Section 956 of the Act, in addition to going beyond the

[12] *Id.* at 44.

[13] *Id.* at 8–9, and 15.

[14] *Id.* at 8.

[15] *See* NPR 2024, *supra* note 1, at 92.

[16] Under the Act, the term "covered person" is defined as "any person that offers or provides a consumer financial product or service and "any affiliate of such a person if the affiliate acts as a service provider to such person." *See* 12 U.S.C. § 5481(6).

underlying purpose of such statutory provision, which prohibits only what the regulators determine to be "excessive compensation" that "could lead to a material financial loss to the covered institution."[17] Indeed, as mentioned above, Section 956 was motivated by a desire to curtail the type of excessive risk-taking that contributed to the financial crisis and the failure of individual banks during the time of the crisis. By contrast, the NPR covers *any* "employee," including those that are unlikely to be incentivized to take risks that threaten the bank's stability, such as bank tellers. In so doing, it negatively impacts a bank's ability to reward such employees with performance-based compensation.

IBC has long sought to show its appreciation to IBC employees by providing reward for outstanding performance, and imposing such a restriction may deter strong performance and potentially disincentivize employee recruitment and retention. Moreover, if the NPR is adopted as drafted, IBC will be obliged to justify and exhaustively document its decisions related to awarding such compensation, even for employees that have no ability to put the stability or financial performance of IBC at risk—which, even then, will remain subject to a regulator's discretion to analyze whether it constitutes a form of prohibited compensation. Therefore, revision to limit the term "covered person" is crucial in order to more closely hew to the statutory charge and limit application to those holding an employment role within the organization that actually allows them to exercise control over and responsibility for decisions that could result in a material financial loss. Perhaps this limitation could be structured to incorporate a required compensation level and/or a threshold limitation similar to that applicable to determining "senior executive officers" or "significant risk-takers." For example, the compensation threshold could be limited in application to the top ten senior executive officers or the top ten highest paid executives in an organization. Certainly, the legislative intent was not to subject lower-level officers and employees to a micro-managed process by the regulators. Thus, limiting the definition of "covered persons" to those actually capable of causing "material financial loss" is critical.

a. Exclusions to Limit SEO Applicability to the Most Senior Executives in an Organization

Notably, the most rigorous requirements are imposed on a subset of covered persons at Level 1 and Level 2 institutions referred to as "senior executive officers" and "significant risk-takers" ("SEOs" and "SRTs", respectively) that receive incentive-based compensation.[18] Moreover, as discussed in detail in Part III below, the NPR grants a reservation of authority to treat a Level 3 institution as a Level 1 or Level 2 institution, by allowing the applicable regulator to use its discretion if they deem it appropriate to subject a Level 3 institution to the strictures applied to Level 1 or Level 2 institutions. Ultimately, this confers an unlimited amount of discretion to the applicable regulator. Thus, although IBC is considered a Level 3 institution under the NPR's tiered-system of applicability, we take a strong interest in and to those specific provisions which set forth such additional requirements for Level 1 and 2 institutions, as such requirements may implicate IBC as well. Therefore, for reasons explained in this Part II, IBC urges the Agencies to further limit the scope of SEOs and SRTs, and provide further exclusion to the definition of SEO to limit applicability to the most senior executives in an organization and provide guidance for identifying certain risk-taking activities for determining if one falls within the SRT scope.

As outlined in the NPR, a "senior executive officer" is generally defined to include covered persons who hold the title of, or function as, "president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head

[17] *See* NPR 2024, *supra* note 1, at 83; *see also infra* Part V.

[18] In short, SEOs are identified by title and function, while SRTs are based on their relative level of incentive compensation or ability to expose financial assets to risk. *See generally* NPR 2024, *supra* note 1, at 97.

of a major business line or control function."[19] The definition of SEO is vague and ambiguous. In effect, the scope of applicability would erroneously capture employment positions that should not be included. In Question 2.6, the Agencies invite comment on whether the types of positions identified in the proposed definition are appropriate and whether the scope of positions listed should be expanded or narrowed.[20] IBC seeks further clarification from the Agencies as it pertains to the scope of the SEO definition, and suggests that certain exclusions be incorporated into the definition in order to ensure that such stringent requirements are not inappropriately applied to an employee who does not occupy a senior executive role within an organization, such as those who serve in the capacity of support personnel—e.g., human resources (HR), information technology (IT) or marketing employees. It seems logical, in the context of this part of the NPR, to conclude that the positions meant to be covered by the SEO definition are "C-suite" type executives and those with financial, audit and control related responsibilities. But as drafted, the expansive list and broad "business line" and "control function" references could result in the inclusion of persons heading functions seemingly unrelated to the NPR's substance. This would expand the group of executives far beyond those traditionally thought of as SEOs and covers personnel not intended to be covered by the statute.

In addition to those persons who hold a title in one of the enumerated positions listed, the definition also includes catch-all language, to cover those persons who serve as the "head of a major business line or control function."[21] This language is not only exceedingly broad, but ambiguous, which is particularly concerning since those swept into this aspect of the provision are implicated in other provisions of the NPR, such as the mandatory deferrals and clawbacks.[22] Indeed, in Question 2.7, the Agencies inquire as to whether the term "major business line," as proposed, provides sufficient information to allow a covered institution to adequately identify those individuals who are the head of a major business line.[23] The Agencies ask whether the NPR should instead refer (i) to a "core business line," as defined in FDIC and FRB rules relating to resolution planning;[24] (ii) to a "principal business unit, division or function," as described in SEC definitions of the term "executive officer";[25] or (iii) to business lines that contribute greater than a specified amount to the covered institution's total annual revenues or profit. Of the three choices provided, IBC believes that the definition of "core business line" appears to be the most suitable, as it focuses on business lines potentially posing material risks to the financial institution, while allowing such institution the discretion to determine which business lines meet that standard. However, the definition of "core business line" also includes "associated operations, services, functions and support,"[26] which could encompass functions such as support personnel that should not be swept into the definition—such as those working in departments like HR, marketing, and IT. IBC suggests the definition of SEO be revised to provide specific exclusions of persons who serve an organization in support function roles, even where such persons hold managerial titles or responsibilities, and even where they—or the larger department they serve—directly

[19] *Id.* at 97, 127, 155 and 180.

[20] *Id.* at 48–49.

[21] *Id.* at 97.

[22] *See infra* Part VI.

[23] *See* NPR 2024, *supra* note 1, at 49.

[24] 12 CFR § 381.2(d) (defining "core business line" as "those business lines of the covered company, including *associated operations, services, functions and support*, that, in the view of the covered company, upon failure would result in a material loss of revenue, profit, or franchise value") (emphasis added).

[25] 17 CFR § 240.3b–7 (defining "executive officer" as a business's "president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant").

[26] *See supra* note 24.

report to functions that would qualify as "major business lines or control function[s]."[27] Accordingly, IBC proposes the following additional language to be incorporated into Section ___.2(gg)[28] for clarification purposes:

(1) For purposes of this part, "major business line or control function" means any business line or control function that, in the view of the covered institution, upon failure would result in a material loss of revenue, profit, or franchise value.

(2) For purposes of this part, "major business line or control function" shall not include any business line or function that is: (A) limited to performing personnel, human resources, information technology or marketing functions; or (B) limited to performing any other function that does not involve: (i) providing financial services on behalf of the institution; or (ii) performing financial transactions, such as investments, on behalf of the institution.

IBC does not suggest that "major business line" be defined in terms of "business lines that contribute greater than a specified amount to the covered institution's total annual revenues or profit."[29] This would create both uncertainty and unwieldy burden for an institute attempting to understand who is covered by this rule, and would require reevaluation on an annual or more frequent basis. All these uncertainties will contribute to the existing challenges of hiring and retaining qualified officers and employees, and will certainly drive up levels of basic compensation to remove the uncertainty posed by incentive compensation; thus, impeding the success of countless financial institutions and businesses.

b. Significant Risk-Taker Test

In the NPR, a "significant risk-taker" is generally defined as a non-senior executive who receives an amount that is at least one-third of their total compensation in incentive-based compensation and fall under one of two tests. The first test—the "relative compensation" test—requires the non-senior executive be among the top 2%–5% (depending on whether the entity is a Level 1 or Level 2 institution) of the highest compensated non-senior executive covered persons at the relevant institution.[30] The second test—the "exposure" test—requires the non-senior executive to have the authority and ability to "commit or expose" at least 0.5% of the capital of the covered institution or Section 956 affiliate, regardless of whether the individual is a covered person of the applicable legal entity.[31] Alternatively, in its modified Preamble to the NPR, the Agencies posit consideration as to a streamlined definition of SRT. The alternative "flexible risk-based" approach, would effectively replace the original two-test methodology described above, by requiring covered institutions to identify their SRTs and submit notice of such identification method to its primary federal regulator.[32] A variation of this alternative would be for an institution to identify SRTs based on their own methodology but maintain the relative compensation test as a component of such methodology.

IBC supports the alternative approach, as the flexibility allowed would be consistent with IBC's preferred approach to incentive-based compensation—the principles-based approach, as further described in Part III below—ultimately resulting in the advancement of a more effective and tailored regulatory framework. In

[27] *See* NPR 2024, *supra* note 1, at 97.

[28] *Id.*

[29] *Id.* at 48.

[30] *See id.* at 98 (defining the "relative compensation test" as being "based on the amounts of annual base salary and incentive-based compensation of a covered person relative to other covered persons working for the covered institution and its affiliate covered institutions").

[31] *See id.* (defining the "exposure test" as "based on whether the covered person has authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution").

[32] *Id.* at 67.

contrast, the other approaches presented in the NPR reject the principles-based approach for a "one-size-fits-all" methodology that is inconsistent with the flexibility required of, and the diversity inherent in, the financial services sector.

III. TIERED APPLICATION BASED ON ASSET LEVELS

Under its current iteration, the NPR distinguishes covered institutions by their average total consolidated asset size,[33] with "less prescriptive incentive-based compensation program requirements" for the smallest covered institutions within the statutory scope and "progressively more rigorous requirements" for the larger covered institutions.[34] However, the modified Preamble considers whether it would be appropriate to revise the scope of covered institution, by collapsing Level 1 and Level 2 institutions into a single category.[35] By utilizing a two-tier regulatory structure (replacing the previously proposed three-tiered regime), the general prohibitions and requirements of the NPR would continue to apply to all covered institutions, but the additional more stringent prohibitions and enhanced requirements would apply only to those covered institutions with average consolidated assets of more than $50 billion. Notably, as discussed below, the NPR contains a reservation of authority, which gives the relevant regulatory body the ability to impose the more rigorous provisions applicable to Level 1 or Level 2 institutions to smaller covered institutions, based on such institution's complexity of operations or compensation practices. Moreover, subsidiaries of other covered institutions would be subject to the same requirements at the same level as the parent institution.

1) *Reservation of Authority for Level 3 Covered Institutions*

Perhaps the most significant issue under the NPR as it pertains to IBC, is the reservation of authority, which allows the regulators far too much discretionary authority to treat a smaller enterprise, such as IBC, as a much larger institution. Indeed, the NPR imposes more stringent requirements on larger institutions—i.e., Level 1 and Level 2 entities—that fall within the scope of the "covered institution" categorization. While IBC would be considered a "Level 3" institution under the definition, the NPR also allows potentially unfettered leeway to the applicable federal regulator to treat a Level 3 institution as a Level 1 or Level 2 institution.[36] Such reservation of authority results in an egregious overreach, which is an unfortunate occurrence we see all too often in current regulatory regimes. Consequently, incentive-based compensation arrangements provided to SEOs and SRTs at Level 1 and Level 2 covered institutions are subject to the additional requirements under the NPR. The trickle-down effect of such extensive regulatory oversight can be extremely destructive.

Importantly, the exercise of such authority by the applicable regulator is warranted if such regulator determines that the Level 3 covered institution's "complexity of operations or compensation practices are

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[33] Under the NPR, covered institutions are broken down into the following three tiers based on the value of the entity's assets:

- Level 1 (Greater than or equal to $250 billion);
- Level 2 (Greater than or equal to $50 billion and less than $250 billion);
- Level 3 (Greater than or equal to $1 billion and less than $50 billion).

[34] *Id.* at 15.

[35] *See* NPR 2024, *supra* note 1, at 66–67 (explaining that one level would include covered institutions with average total consolidated assets amounting in more than $1 billion but less than $50 billion, and a second level that would include covered institutions with more than $50 billion in average total consolidated assets).

[36] In particular, the NPR's reservation of authority would allow the appropriate federal regulator of a Level 3 covered institution with average total consolidated assets greater than or equal to $10 billion and less than $50 billion to require the institution to comply with some or all of the provisions applicable to Level 1 and 2 institutions.

consistent with those of a Level 1 or Level 2 covered institution."[37] In particular, the Agencies will consider "the activities, complexity of operations, risk profile, and compensation practices of the Level 3 covered institution, in addition to any other relevant factors" to make such a determination.[38] This authority provides practically an unrestricted amount of discretion. The NPR does not appear to restrict the Agencies' ability to decide whether the complexity of a Level 3 institution's operations or compensation practices are congruous with the operations or compensation practices of a Level 1 or 2 institution.[39] Rather, if the applicable agency makes that determination to its own satisfaction, it may treat the Level 3 institution as a Level 1 or 2, thus imposing a multitude of additional stringent requirements, that would not otherwise be imposed on such institution. The provisions applicable to Level 1 and Level 2 institutions under the NPR go far beyond those applicable to Level 3, and in most cases would be grossly inappropriate to apply to a community bank or other entity falling within the Level 3 asset size parameters. Such discretionary authority could too easily lead to an abuse of power and place potentially dramatically disparate regulatory burdens on competing financial institutions, both within the same "Level," but more specifically, where smaller community banks are being subjected to the much more prescriptive requirements otherwise placed on much larger institutions that have more resources to bear such burdens.

In the 2016 Proposal, the following explanation was provided: "[a] Level 3 covered institution could have significant levels of off-balance sheet activities, such as derivatives that may entail complexities of operations and greater risk than balance sheet measures would indicate, making the institution's risk profile more akin to that of a Level 1 or Level 2 covered institution. Additionally, a Level 3 covered institution might be involved in particular high-risk business lines, such as lending to distressed borrowers or investing or trading in illiquid assets, and make significant use of incentive-based compensation to reward risk-takers. Still other Level 3 covered institutions might have or be part of a complex organizational structure, such as operating with multiple legal entities in multiple foreign jurisdictions."[40] While this language provides some examples of situations that may (or may not) trigger a regulator's exercise of this authority, it remains unclear just what limits there are on such exercise. Considering this explanation by the Agencies in the 2016 Proposal, while "[t]he Agencies expect they only would use this authority on an infrequent basis" and that "[t]his approach has been used in other rules for purposes of tailoring the application of requirements and providing flexibility to accommodate the variations in size, complexity, and overall risk profile of financial institutions," this does not provide sufficient comfort or clarity to Level 3 institutions.[41]

It is particularly important to understand when and how the heightened treatment could apply, since so much is at stake. Unlike other rules that involve "tailoring" and "flexibility" in less dramatic ways such as requiring a greater level of detail in policies and procedures that are already required, this rule imposes very substantive and prescriptive requirements on Level 1 and Level 2 institutions that are not imposed at all on Level 3 institutions. Thus, going from Level 3 to Level 1 or Level 2 is not merely a matter of being expected to increase reporting or to augment activities that the institution is already doing. Rather, it would be a matter of making profound, substantive changes in a disruptive manner, including providing for clawback of compensation and deferring compensation for numerous persons. Such a dramatic change warrants clearer and more predictable standards for when this could occur, with less or no discretion on behalf of

[37] NPR 2024, *supra* note 1, at 99.

[38] *Id.*

[39] *See* NPR 2024, *supra* note 1, at 137.

[40] *See* 2016 Proposal, *supra* note 6 at 46.

[41] *Id.*

regulators—or, alternatively, and more appropriately, an abandonment of such prescriptive measures and an adoption of a principles-based approach for all institutions regardless of asset size.[42]

Accordingly, IBC suggests the Agencies adopt a principles-based approach for *all covered institutions* rather than an arbitrary application based upon asset size, or the removal of any discretion on the part of regulators to treat a smaller enterprise, such as IBC, as a much larger institution. Alternatively, at an absolute minimum, IBC urges the Agencies to revise this provision to include specific notice and response mechanisms. To illustrate, IBC requests that such revision provide a requirement of the respective agency proposing to treat a Level 3 institution as a Level 1 or Level 2 institution to give the covered institution written notice of its proposed determination, including a clearly articulated list of the reasons underlying such action, and provide the institution with no less than 90 days to respond to the notice. After such agency reviews and responds to the institution's response, the institution should have at least one additional opportunity to formally respond to the regulator, with no fewer than 60 days to provide the second response. Any final determination the agency makes after receiving the institution's responses should be considered a material supervisory determination that could be appealed through the Ombudsman of the respective agency under the normal procedures applicable to such an appeal. Additionally, IBC suggests that such treatment could not take effect, and could not apply to any aspect of the covered institution's activities, until the compensation year following the year in which the final determination is made after all appeals are exhausted.

2) *Treatment of Affiliates or Subsidiaries*

As briefly mentioned above, under the NPR, institutions that are subsidiaries of other covered institutions would be subject to the same requirements as the parent covered institution. Thus, the subsidiary would be assigned to a level based on the parent's consolidated assets, rather than its own. Indeed, this is true "even if the subsidiary covered institution is smaller than the parent covered institution."[43] Such feature of the NPR is referred to as "consolidation" and is designed to "reinforce the ability of institutions to establish and maintain effective risk management and controls for the entire consolidated organization with respect to the organization's incentive-based compensation program."[44]

The NPR's definition of "affiliate" and "subsidiary" sets too low a threshold to trigger affiliate or subsidiary status. As drafted in the Proposal, "affiliate" status is triggered once there is "control," and "subsidiary" status is triggered once there is "control" *or* "any ownership interest"—with "control" defined for both purposes to mean the power to vote 25% or more of any class of voting securities, the ability to control the election of a majority of the directors, or where a regulator determines the company directly or indirectly exercises a controlling influence over the management or policies of the company.[45] Such terms are inconsistent with respect to the ownership threshold that would apply. In any event, while a 25% threshold for ownership or control may make sense for Bank Holding Company Act purposes, it is unclear that, absent the exercise of management control, ownership below a majority, or 51%, is a reasonable threshold for purposes of this NPR.

While IBC agrees with the decision to exclude from the definition of "subsidiary", merchant banking investments that are owned or controlled by a holding company pursuant to Regulation Y or that were

[42] The principles-based approach to incentive-based compensation is reflected in the "Guidance on Sound Incentive Compensation Polices," adopted in 2010 by the Federal Reserve, the OCC, the Office of Thrift Supervision, and FDIC. *See* 75 Fed. Reg. 36395 (2010).

[43] *Id.* at 21.

[44] *Id.*

[45] *See id.* at 90 (defining affiliate); *id.* at 91 (defining control); *id.* at 99 (defining subsidiary).

acquired in the ordinary course of collecting debt, a request for clarification is warranted so as to confirm that neither term is intended to include application to passive investments made directly at a bank level, such as a limited partnership or a corporation in which it does not have or perform a management function. Furthermore, it is inapt to focus on stock ownership to the exclusion of other relevant factors. For instance, in the case of entities such as limited partnerships, where the covered institution does not actively participate in the day-to-day operations, particularly including the compensation-setting practices of the entity, it seems unhelpful to focus on the percentage of voting securities held (or the fact in itself that voting securities are held) without also considering the extent to which the covered institution is involved in the specific practices covered by this rule. Therefore, IBC suggests that the definitions of "affiliate" and "subsidiary" be revised to exclude any entity whose compensation practices the covered institution does not control or influence.

IV. DEFINITION OF INCENTIVE-BASED COMPENSATION

The NPR regulates "incentive-based compensation," which is sweepingly defined to include any "variable compensation, fees, or benefits that incentivize or reward performance."[46] In the Preamble, the Agencies seek feedback on the proposed definition of incentive-based compensation. In particular, they inquire as to whether modifications should be made to include additional and/or fewer forms of compensation, as well as whether certain forms of incentive-based compensation should be excluded from the definition.[47] Additionally, in Question 2.15, reasoning that while they do not expect most pensions to meet the NPR's definition of "incentive-based compensation" since pensions generally are not conditioned on performance achievement, the Agencies nonetheless acknowledge that designing a pension to meet the definition may be possible.[48] Accordingly, the Agencies invite comment on whether the NPR should contain express provisions addressing the status of pensions in relation to the definition of incentive-based compensation.

As discussed in further detail below, IBC believes the definition of incentive-based compensation is overly broad such that it captures more forms of compensation than the authorizing provision under the Act intended to restrict. The definition of incentive-based compensation, as drafted, would include certain referral fees, annual and multi-year bonuses, equity-based awards, profit-sharing plans, and similar arrangements. Thus, at a minimum, additional exclusions are necessary. For example, IBC believes the definition should be revised to clarify that fixed contributions to 401(k) plans are excluded under the definition. Moreover, other performance-based pay that does not threaten bank stability should also be excluded. IBC believes certain limitations should be incorporated into the NPR to exclude performance-based compensation, such as certain performance-based commissions that do not threaten the stability or financial performance of the financial institution or otherwise incent the employee to take undue risks to the institution. To illustrate, assume a financial institution's employee acts as a middleman between the financial institution's customer and an insurance broker. The institution does not insure the underlying product and thus it is not reflected on its balance sheet. The employee earns a permissible referral fee on the referral. In this case, the employee's actions do not—and in fact *cannot*—put the stability or financial performance of the institution at risk, and therefore this type of compensation should not be covered by the NPR. The same can be said for an employee of an investment bank who merely connects parties to a transaction, such as a merger, acquisition, or private placement, provides certain services in connection with the transaction, and only earns a fee for its services. Lastly, in addition to the above, IBC urges the Agencies to consider including an additional exemption from the definition to account for a specific de minimis amount of incentive-based pay, such as $25,000.

V. "EXCESSIVE" COMPENSATION AND PERFORMANCE MEASURES

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[46] *See* NPR 2024, *supra* note 1, at 93.

[47] *Id.* at 50.

[48] *Id.* at 50–51.

The NPR emphasizes that all covered institutions must prohibit incentive-based compensation arrangements that encourage inappropriate risks (i) by providing covered persons with "excessive compensation" or (ii) that could lead to a "material financial loss."[49] The NPR provides for specific performance measures and other guidelines to measure whether a compensation practice would contravene this provision. Incentive-based compensation is considered "excessive" when amounts paid are "unreasonable or disproportionate to the value of the services performed" by the covered person, based on a list of non-exhaustive factors enumerated in the NPR.[50] Additionally, an incentive-based compensation arrangement encourages inappropriate risks that could lead to "material financial loss" to the covered institution, unless the arrangement: (i) appropriately balances risk and reward; (ii) is compatible with effective risk management and controls; and (iii) is supported by effective governance.[51] Thus, in order to appropriately balance risk and reward, the incentive-based arrangement must include the following: (i) both financial and non-financial performance criteria, allowing the non-financial criteria to override the financial criteria when appropriate; (ii) an appropriately weighted consideration of risk-taking applicable to the individual's role and type of business at the covered institution; and (iii) amounts are subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures of financial and non-financial performance.[52]

In the modified Preamble, the Agencies invite comment on the requirements for performance measures contained in Section ___.4(d) of the NPR, inquiring as to whether such measures are sufficiently tailored to allow for incentive-based compensation arrangements that appropriately balance risk and reward.[53] IBC urges the Agencies to consider that such performance measures are not necessary for certain types of incentive compensation. As of now, in certain contexts, there are already specific regulatory limitations on the ways that certain bank personnel may be compensated. For instance, under the Loan Originator Compensation Rule (the "LOCR") of Regulation Z issued by the Consumer Financial Protection Bureau under the Act, "loan originators" may not be compensated based on any term of a consumer mortgage loan transaction, or any proxy for such a term.[54] The restrictions under that rule also extend to the amount of profits-based compensation that loan originators may receive, with a general hard limit of 10% of total compensation. Under the NPR, as drafted, it is unclear whether such parameters provide a safe harbor for the compensation of loan originators. Rather, it appears that such compensation to loan originators could still be potentially subject to criticism under the NPR even if their compensation complies in all regards with the LOCR. Intuitively, it seems that compliance with the LOCR, or any other specific law or regulation limiting compensation practices for a specific type of person, should govern the issue.

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[49] *Id.* at 103; *see also infra* notes 78–79 and accompanying text (noting the definition under the NPR differs from that defined in the SEC's recently enacted rule implementing clawback provisions, which defines incentive-based compensation as "any compensation that is granted, earned or vested based on the attainment of a financial reporting measure").

[50] The NPR provides for specific performance measures and other guidelines to measure whether a compensation practice would contravene this provision, such as (i) the total value of all compensation, fees, or benefits provided to the covered person; (ii) the compensation history of the covered person and other individuals at the institution with comparable expertise; (iii) the institution's financial condition; (iv) compensation practices at comparable institutions (based upon asset size, location, and complexity of operations and assets, among other factors); (v) the projected total costs and benefits for post-employment benefits; and (vi) the covered person's connection with "any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered institution." *See* NPR 2024, *supra* note 1, at 103–04.

[51] *See* NPR 2024, *supra* note 1, at 104.

[52] *Id.* at 105.

[53] *Id.* at 52.

[54] 12 CFR § 1026.36(d) (prohibiting compensation payments, directly or indirectly, to a mortgage broker or any other "loan originator" that is based on a mortgage transaction's terms or conditions, except the amount of credit extended).

Accordingly, IBC suggests the inclusion of language in Section ___.4(d) to create a safe harbor for incentive-based compensation practices that satisfy requirements under other federal laws or regulations to be deemed to satisfy the requirements of such section. Foremost, IBC agrees with the proposed exclusion for fixed compensation that does not vary based on a performance measure, such as a 401(k) contribution based on a fixed percentage of an employee's salary. Thus, the final rule should clarify that this exclusion is also intended to cover a profit-sharing plan governed by the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act (ERISA), specifically including employer contributions to a profit sharing plan qualified under 401(a) that are based on salary, years of service, or a combination of both.[55]

VI. DEFERRAL, FORFEITURE AND DOWNWARD ADJUSTMENT, CLAWBACK

If finalized as drafted, the NPR would impose certain enhanced requirements on Level 1 and Level 2 covered institutions as it pertains to the structure of such institutions' incentive compensation awarded to its SEOs and SRTs, including: (i) downward adjustment and forfeiture of unvested incentive compensation based on poor performance; (ii) mandatory deferral of 40–60% of incentive compensation for 3–4 years; (iii) minimum seven-year clawback provisions for misconduct or fraud; (iv) limits on leverage factors for incentive compensation above target levels; (iv) prohibitions on certain performance metrics; (v) required mix of deferred cash and equity; and (vi) enhanced risk management frameworks and governance.

Importantly, the modified Preamble poses additional questions on all aspects of the deferral, forfeiture, downward adjustment and clawback requirements. For example, the Agencies invite feedback on things such as minimum periods/percentages, level playing fields, tax/accounting, use of debt-like instruments and triggering events.[56] Moreover, the Preamble includes an alternative provision which would limit the discretion of a Level 1 or Level 2 covered institution to seek recovery for incentive-based compensation by *requiring*—as opposed to *requiring consideration of*—forfeiture and downward adjustment of incentive-based compensation for those certain adverse outcomes as listed in Section ___.7(b)(2) of the NPR.[57] Under such alternative, covered institutions would also be required to formalize the governance and review processes surrounding such decision-making, and to document the decisions made.[58] Similarly, as it relates to the clawback requirement, an alternative provision would *require* a Level 1 or Level 2 institution to clawback—as opposed to *consider* clawing back—any vested incentive-based compensation from a current or former SEO or SRT under the same circumstances as identified in the NPR.[59]

1) *Mandatory Deferrals*

The NPR requires covered institutions subject to incentive-based compensation to continued risk of forfeiture through certain mandatory deferral periods—i.e., minimum vesting periods. These mandatory deferrals set forth certain specific deferral periods and percentages applicable to the incentive-based compensation of SEOs and SRTs at Level 1 and Level 2 institutions, including a four year deferral of 60% of a Level 1 SEO's "Other Incentive-Based Compensation" and 50% of a Level 1 SRT's "Other Incentive-Based Compensation."[60] Additionally, in Question A.5 to the modified Preamble, the Agencies contemplate

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[55] *See* NPR 2024, *supra* note 1, at 39.

[56] *See generally id.* at 54–61 (outlining questions and alternatives for consideration as it relates to the NPR's provisions on deferral, forfeiture and downward adjustment, and clawback requirements for level 1 and level 2 institutions).

[57] *Id.* at 71.

[58] *Id.*

[59] *Id.*

[60] *See* NPR 2024, *supra* note 1, at 107.

whether the proposed minimum required deferral amounts and minimum required deferral periods in Sections ___.7(a)(1) and (a)(2) should be simplified by using a single deferral percentage of 60% and deferral period of four years for both SEOs and SRTs at covered institutions with average total consolidated assets of more than 50 billion, if the two-level alternative described in Part III above is adopted as final.[61]

IBC does not believe the Agencies have convincingly explained the underlying rationale for the deferral time periods and percentages, except that they are apparently consistent with some existing industry practices and with "international standards on compensation."[62] It is also not clear why these numbers should differ between Level 1 and Level 2 institutions. At any rate, such mandatory deferrals should not apply at all to Level 3 institutions. Requiring such deferrals would place smaller institutions at an even greater disadvantage relative to larger entities, which ultimately have the ability and resources to provide more significant amounts of compensation, generally. Having to defer significant amounts of what is already a smaller amount of compensation from the outset—and being required to defer such significant sums over a significant amount of time—will further make the prospect of working for a smaller financial institution less appealing to talented candidates who are in high demand.

2) *Forfeiture and Downward Adjustment*

Under the NPR, a covered institution must *consider* whether forfeiture or downward adjustment is appropriate with respect to incentive-based compensation of an SEO or SRT who is responsible for the occurrence of any of the following events: (i) poor financial performance at the covered institution attributable to a significant deviation from such institution's risk policies parameters; (ii) inappropriate risk-taking; (iii) material risk management or control failures; (iv) non-compliance with laws, resulting in an enforcement action or a requirement to restate financials to correct a material error; or (v) any other type of misconduct or unacceptable performance.[63] Moreover, the Agencies posit an alternative consideration in Section ___.7(b), wherein they contemplate *requiring* forfeiture and downward adjustment on the occurrence of the same events in addition to the several enhanced requirements—in whatever form adopted as final—to Level 3 institutions.[64] Thus, consideration of the NPR's alternative, hinges on the issue of whether forfeiture and downward adjustments should be mandated, rather than discretionary.

If adopted as final, the NPR will expect significant changes from covered institutions. Of particular concern to IBC is that most of the alternatives posed by the Agencies will certainly result in less flexibility and discretion for covered institutions seeking to recover incentive-based compensation. The alternative provision related to forfeiture and downward adjustment, mentioned above, is a primary example evidencing the unduly restrictive nature of these alternatives. Imposing a *mandatory* recovery of incentive-based compensation upon certain adverse outcomes, rather than allowing covered institutions to merely *consider* such recovery, unreasonably limits the rights and freedoms of covered institutions to make decisions based on its own financial condition, industry expertise and supervisory assessments, among other things. Moreover, changing the provision to mandate forfeiture or downward adjustment would be a significant deviation from current industry practice and raises several key questions, such as what type of scenarios will require a forfeiture or downward adjustment, and how the appropriate size of the forfeiture or downward adjustment will be assessed and determined. As such, IBC urges the Agencies to consider the cumulative impact these alternatives will have on covered institutions, such as the negative repercussions

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[61] *Id.* at 67.

[62] *See* 2016 Proposal, *supra* note 6, at 53.

[63] *See* NPR 2024, *supra* note 1, at 107.

[64] Such enhanced requirements include: (i) limits on leverage; (ii) prohibition on use of relative performance measures; (iii) prohibition on volume-driven incentive compensation; and (iv) prohibitions on hedging. *Id.* at 70–71.

which will certainly result from implementing such excessive limitations to the flexibility and discretion of U.S. financial institutions.

3) *Clawback Provisions*

While the core content of the NPR largely resembles the 2016 Proposal, the Preamble contains several new questions that could lead to significantly different outcomes than was formerly envisioned just merely eight years ago. Principal among such issues is establishing the appropriate party to decide when incentive-based compensation should be clawed back. Under the previous iteration, this determination would fall to the respective covered institution. However, the modified Preamble explains the Agencies are considering giving the applicable regulatory agency the discretion to decide whether clawbacks are warranted.[65]

As defined in the NPR, the term "clawback" establishes a mechanism by which a covered institution has the ability to recover vested incentive-based compensation from a covered person for a period of seven years following the applicable vesting date for the underlying compensation.[66] When combined with the NPR's mandatory deferral provisions, a significant portion of a covered person's compensation could be "at risk" and uncertain for a period of ten or more years. In the NPR, Level 1 and Level 2 institutions would be required to include clawback provisions in incentive-based compensation arrangements for SEOs and SRTs which, at a minimum, would allow for recovery of up to 100% of vested incentive-based compensation from a current or former SEO or SRT for seven years following the date on which such compensation vests upon the occurrence of certain fault based risk events.[67] Thus, under an identified set of circumstances, all vested incentive-based compensation for SEOs and SRTs—whether deferred before vesting or paid out immediately upon award—would be required to be subject to clawback for a period no less than seven years following the date on which such incentive-based compensation vests.

The result of the long-term nature of the proposed clawback is that a covered person would not have certainty with respect to earned compensation for *over a decade*. Who would want to work under such extreme conditions? Notably, these clawback periods are considerably longer than those adopted under the Act for other public companies and are based on employee misconduct rather than financial restatements. This presents unique issues to the financial institutions industry that would likely lead to myriad issues and unintended negative consequences, such as qualified employees seeking employment outside the financial industry, or at smaller banks that are not subject to such onerous restrictions. Moreover, it would likely lead to financial institutions moving what would be incentive compensation into other forms of compensation, such as base salary, in order to attract and retain top performers who might otherwise seek employment in industries not subject to these restrictions. Such a result in particular would undermine the purpose of incentive-based compensation and take compensation decisions out of the hands of shareholders and remove incentives for good performance. Amid the negative discussions around incentive-based compensation related to the financial crisis, it is important to remember that incentive compensation incentivizes actions that *benefit* the financial institution. It allows a financial institution to motivate employees toward outstanding performance, and ensures that employees have "skin in the game" as to how their actions affect the bank. Incentive compensation also functions as a retention tool, providing for future benefits if the employee commits to the institution. While IBC agrees with the fault-based approach to the proposed clawback provision, IBC emphasizes that this provision should be carefully crafted such that it is

[65] *Id.* at 71.

[66] Under the Proposal, Level 1 or Level 2 institutions must incorporate clawback provisions that permit the institution to recover incentive-based compensation paid to SEOs and SRTs for seven years after vesting if the covered institution determines that the individual engaged in (i) misconduct resulting in significant financial or reputational harm to the institution; (ii) fraud; or (iii) intentional misrepresentation of information used to determine the applicable incentive-based compensation.

[67] *Id.* at 105.

not ripe for abuse. For example, it should be drafted such that a different board or set of executives could not arbitrarily decide that an executive "intentionally misrepresented information" used to determine the compensation seven years after the fact.

Moreover, it is unclear how a clawback of any duration, particularly seven years, would work in practice. There are inherent administrative, accounting, and tax issues that must be addressed in connection with any clawback provision (as well as with other aspects of the NPR, such as risk adjustments and deferral payments of incentive plans). For instance, under Internal Revenue Service (IRS) rules, income must be reported and tax must be paid in the year it is received, even if it is subject to potential recovery, with the employer taking a corresponding tax deduction at that time. Indeed, under IRS rules, it is *not administratively possible* to file an amended tax return after a period of six years, and repayment on an after-tax basis mathematically gives the employee a slight windfall. Alternatively, the employee could repay the full amount and claim a deduction in the year the compensation is repaid, but absent application of a special remedial provision like Section 1341 under the IRC, the employee is left without a full recovery for the tax that was already paid due to phaseouts, tax rate differentials, deduction limitations, and the alternative minimum tax. These potential problems could take many employees "out of the game," so to speak. Thus, as proposed, the potential risks associated with incentive-based compensation would be far too great for any employee to accept, especially for those living paycheck to paycheck. There are similar technical issues related to recovery of any employment taxes and the tax effect to the employer who has already treated the payment as compensation and taken a deduction or the initial payment. Accordingly, IBC urges the Agencies to consult and coordinate with the IRS regarding any form of clawback provision to ensure fair treatment of income taxes, deductions, and employment taxes related to the previously reported compensation payment.

Notably, the clawback under the NPR would be in addition to the clawback rules under Section 954 of the Act, adopted by the SEC in 2022, implementing Section 10D of the Securities Exchange Act of 1934.[68] IBC noted in its 2016 comment letter, and echoes here, that the clawback provisions in the NPR differ from those presented in the listing standard proposed by the SEC in 2015, regarding recovery of erroneously awarded compensation. Indeed, the NPR's clawback requirement focuses on the covered persons misconduct, whereas the separate clawback requirement applies to public companies under the recently implemented SEC rules pursuant to Section 954 is triggered by a restatement of financial statements, whether or not the executive engaged in misconduct. That distinction certainly leads to confusion and apparently duplicative administrative obligations. In particular, IBC strongly agrees with the structure of the clawback in the NPR to the extent it does not include a no-fault, strict-liability causation element like that in the SEC's final rule. However, the seven-year clawback period provided for in the NPR not only is inconsistent with that in the SEC's final rule, but it establishes an impediment for the financial institutions industry that could cause it to lose talented employees to other industries that are not subject to the onerous restrictions in the NPR. The NPR and the SEC clawback rule aim to reach a different set on employees—with the NPR subjecting SRTs and SEOs to the clawback (including "heads of major business lines"),[69] while the SEC final rule applies to "the president [and] any vice-president of the issuer in charge of a principal business unit."[70]

[68] SEC, Final Rule: Listing Standards for Recovery of Erroneously Awarded Compensation (2022), available at: https://www.sec.gov/files/rules/final/2022/33-11126.pdf [hereinafter, SEC Final Rule]; *see also* SEC, Comm'r Jaime Lizárraga: Statement on Listing Standards for Recovery of Erroneously Awarded Compensation (Oct. 26, 2022), available at: https://www.sec.gov/news/statement/lizarraga-statement-clawbacks-102622#.ZnBbYUaqExE.

[69] NPR 2024, *supra* note 1, at 49.

[70] *See* SEC Final Rule, *supra* note 75, at 216.

While IBC believes the definition in the SEC clawback rule is vague and broad, it still appears to regulate a more select group than as defined in the NPR. Having two separate sets of clawback provisions apply to a publicly traded entity is unnecessarily burdensome. Any two clawback provisions required of a publicly traded financial institution should not conflict with one another. Therefore, at a minimum, IBC recommends the Agencies revise the clawback provisions so that they are carefully tailored to meet the goal of Section 956 of the Act without stifling a financial institution's ability to negotiate competitively for employees within the global marketplace or subject it to inconsistent rules. Lastly, IBC recommends limiting the clawback provisions to a reasonable period of time, such as two years.

VII. COMPENSATION OPPORTUNITY CAPS

In addition to the clawbacks mentioned above, the NPR would set specific upward limits on the amount of incentive-based compensation that may be paid to SEOs and SRTs—125% and 150%, respectively—of target amounts for performance measure goals established at the beginning of the relevant performance period.[71] However, it is unclear why both specific caps *and* clawback provisions are necessary. Moreover, the NPR does not explain how or why the percentages amounts of 125% and 150% were determined. Notably, it does not prescribe any limits on setting the target amount. Instead, it merely states that performance measures for Level 1 and Level 2 institutions may not be based solely on (i) relative industry peer performance comparisons, or (ii) transaction revenue or volume without regard to "transaction quality" (undefined) or compliance with sound risk management.[72] This further chips away at any flexibility the institution and its shareholders have to properly encourage and reward excellent performance. Some institutions operate with lower base pay and have to compensate employees with bonuses or other incentive compensation. As proposed, institutions may have to abandon incentive compensation due to the combined effect of the associated risks imposed on the employee coupled with the excessive compliance burden imposed on the institution. Therefore, if the clawback provisions are to be retained for the final rule, IBC suggests the deletion of such compensation opportunity caps altogether.

In Question 8.5, the Agencies specifically ask whether this limitation on maximum incentive-based compensation opportunity should apply to Level 3 institutions.[73] IBC strongly urges that it should not. Smaller institutions already face challenges in attracting and retaining high performers, and in compensating them appropriately and competitively vis-à-vis other employers. It is of vital importance to permit employees of smaller institutions to be rewarded for outstanding performance, including extraordinary performance that ends up vastly outpacing the original performance measures and targets. Setting such limits would create disincentives to outperform expectations. This would be true at financial institutions of all sizes, of course, but would be felt particularly acutely at a small financial institution.

VIII. RISK MANAGEMENT, GOVERNANCE AND RECORDKEEPING

The NPR mandates Level 1 and Level 2 covered institutions to adopt a risk management framework for its incentive-based compensation programs. Moreover, the NPR adds a new requirement for Level 1 and Level 2 institutions to implement, as part of their risk management frameworks, that "a risk management and controls assessment from the independent risk and control functions" be a guiding consideration when making an incentive-based compensation determination for SEOs and SRTs.[74] Indeed, in the NPR, the Agencies provide an overview of such an assessment from independent risk and control functions required

[71] NPR 2024, *supra* note 1, at 114.

[72] *Id.* at 145.

[73] *Id.* at 61–62.

[74] *Id.* at 73.

when setting such compensation awards. A covered institution will be considered in compliance with this requirement, only if its respective risk management framework: (i) is independent of any lines of business; (ii) includes an independent compliance program providing for internal controls, testing, monitoring and training with written policies and procedures; and (iii) is commensurate with the size and complexity of the financial institution's operations.[75] Additionally, the NPR imposes certain disclosure and recordkeeping requirements on covered institutions, such as requiring each institution create and maintain—annually and for minimum of seven years—comprehensive records of such institution's incentive-based compensation arrangements for certain covered persons, and requiring disclosure of such records to the appropriate federal regulator.[76]

While IBC understands that vital aspects of prudent risk management are through the promotion of proper corporate governance and sound incentive-based compensation practices, the seven-year record retention period imposed by the NPR is excessive and unnecessary. It exceeds the record retention period under most other banking regulations, many of which provide for a two year retention period in order to ensure that records confirming compliance will be available for examiners to review through one or two examination cycles. If, as IBC suggests herein, the clawback period is shortened, the record retention period should also be shortened accordingly. Thus, IBC suggests a two year record retention period to correspond with the aforementioned suggestion of a two year clawback period. As to the substance of the records required to be maintained, the Agencies inquire in Question 5.1 whether a template would be helpful.[77] IBC suggests, at a minimum, a template should be provided, the use of which would not be mandatory but would instead provide a safe harbor for compliance for those certain covered institutions that decide to use it at their discretion. Such a template would serve the dual purpose of alleviating regulatory burden particularly for small institutions without substantial administrative resources to create and compile records from scratch, giving guidance as to the preferred format and content of such records, while allowing institutions flexibility to use their own forms if they so choose.

IX. IMPACT ON COMMUNITY BANKS

Importantly, because the NPR would only apply to covered institutions of at least $1 billion in consolidated assets, in the Preamble to the NPR, the Agencies state that the NPR is not expected to apply to any "small banking organization[s]" for purposes of the Regulatory Flexibility Act.[78] The Preamble goes on to state "the FDIC certifies that the [NPR] would not have a significant economic impact on a substantial number of small FDIC-supervised institutions."[79] The NPR also repeatedly states that, if promulgated, it would not would have a significant economic impact on a substantial number of "small entities" supervised by each agency.[80]

While $1 billion in assets, on its face, may not seem to be an amount of money applicable to "small entities," the fact that the NPR measures asset size on a consolidated basis makes a large difference in this regard. Section 956 of the Act only specifies that the NPR may not apply to entities with assets less than $1 billion;

[75] *Id.* at 115.

[76] *Id.* at 106.

[77] *Id.* at 53 ("[W]ould it be helpful to use a template with a standardized information list?").

[78] *See* NPR 2024, *supra* note 1, at 75 ("Given that the SBA defines a small banking organization as having $850 million or less in assets, the FDIC estimates that no small, FDIC-supervised IDI would be subject to the [P]roposed [R]ule.")

[79] *Id.* at 75.

[80] *Id.* at 74–76.

it does not dictate that such an asset level must be measured on a consolidated basis.[81] Consequently, because the Agencies have categorized institutions based on consolidated assets, the NPR inappropriately captures small community banks and other small entities that, on their own, would never be covered by the NPR. For reasons described herein, among the NPR's myriad issues, as a result of such categorization, the NPR unfairly impacts smaller community banks, which were not responsible for causing the 2008 financial crisis—or the more recent bank failures in 2023—yet such banks are now being swept into regulations meant to address the problematic actions and financial institutions that did.[82]

At IBC, our operations will be affected in numerous ways by the implementation of the NPR as drafted. Even as a Level 3 institution, IBC will face lengthy recordkeeping requirements, as well as, more broadly, second-guessing by regulators of the compensation programs that have worked very well throughout IBC's almost 60 year history. IBC operates in a highly competitive market for talent and this will further hinder our ability to attract the most outstanding candidates for employment. Moreover, the administrative and cost burden imposed by the NPR will be significant, and possibly cause elimination of most if not all incentive compensation. Compliance with the NPR will require involvement of personnel throughout our enterprise. IBC urgently requests the Agencies consider the recommendations IBC makes in this letter to mitigate the unfair impacts that will result from the NPR. IBC does not believe the compensation payments of institutions under $20 billion are abusive, unreasonable, or excessive; thus, such institutions should not be subject to these excessive regulations.

For the past 58 years, IBC has played an important role in the communities it serves. Indeed, the slogan of IBC Bank—"*We Do More*"—reflects IBC's dedication to the growth and success of the customers and communities it serves. Such dedication to growth can be reflected in the composition of IBC's workforce, which is comprised of more than 2,200 diverse employees, including employees at the senior executive officer level. While IBC agrees with the important policy objective of ensuring that incentive-based compensation practices do not undercut the safety and soundness of U.S. financial institutions by encouraging inappropriate risk-taking, we believe that the NPR appears to grossly exceed its statutory mandate and will likely have wide-reaching consequences. Indeed, if the NPR is adopted as drafted, it will likely erode the financial service industry's ability to recruit and retain high-quality talent in a competitive and rapidly evolving market, and will undermine efforts to responsibly manage risk and successfully operate businesses within the industry.

[81] 12 U.S.C. § 5641(f) ("The requirements of this section shall not apply to covered financial institutions with assets of less than $1,000,000,000.").

[82] *See, e.g.*, Board of Governors, Federal Reserve System, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank", at 75 (April 28, 2023), available at: https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf ("Stronger or more specific supervisory guidance or rules on incentive compensation for firms of SVBFG's size, complexity, and risk profile — or more rigorous enforcement of existing guidance and rules — may have mitigated these risks."). Moreover, FRB Vice Chair for Supervision, Michael Barr, found fault in SVB's board compensation committee, noting the holding company SVB Financial Group's "senior management responded to the incentives approved by the board of directors; they were not compensated to manage the bank's risk, and they did not do so effectively." *Id.*

Thank you for your consideration of this critical request and for your continued efforts to protect the American peoples' financial well-being, and our Nation's economy. If you have any questions, please contact the undersigned.

Respectfully submitted,

INTERNATIONAL BANCSHARES CORPORATION

Dennis Nixon
President & CEO
International Bancshares Corporation