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May 31, 2011 **VIA EMAIL ONLY AT: regcomments@ncua.gov**

Mary Rupp, Secretary of the Board
NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Styskal, Wiese & Melchione, LLP Comments on "Notice of Proposed Rulemaking for Incentive-Based Compensation Arrangements"

Dear Ms. Rupp:

This letter is written on behalf of Styskal, Wiese & Melchione, L.L.P., a law firm located in Southern California which represents hundreds of credit unions, both state and federal. The firm began representing credit unions in all aspects of their operations on an almost exclusive basis in 1987. We offer the following discussion as a comment on the Notice of Proposed Rulemaking regarding incentive-based compensation ("Proposed Rule").

In general, we understand Congress's intent in requiring the promulgation of incentive-based compensation regulations, and that the NCUA is bound to issue such rules. We also agree that incentive compensation has contributed to safety and soundness problems for many financial institutions in the United States, although our observation is that this has not been a typical problem for credit unions. We are concerned with the ever growing and more intensive reporting requirements placed on credit unions, and the growing body of regulations requiring ever-increasing time from volunteer Boards of Directors.

With respect to the Proposed Rule, we believe that certain changes or clarifications could be made to assist credit unions in complying with its provisions and to allow credit unions to compete effectively with other types of financial institutions. Our comments fall into four general categories: (1) clarification of definitions; (2) clarification on deferral of compensation and interaction with tax law; (3) changes to other NCUA Regulations regarding incentive compensation to account for the Proposed Rule; and (4) consideration of additional information when examining excessive compensation.

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1. <u>Clarification of Definitions</u>

In proposed § 751.3(g), "Incentive-based compensation" is defined as "any variable compensation that serves as an incentive for performance." While the Proposed Rule suggests that compensation that does not vary based on risk-taking activities, or compensation like 401(k) matching, would not be included in this definition, we believe that the actual language may be interpreted in two different ways, and could therefore be vague in its application. First, the definition could be read that incentive-based compensation means any variable compensation where the variable nature of the compensation serves as an incentive for performance. Second, the definition could be read that incentive-based compensation is any compensation that serves as an incentive for performance[1] where that compensation is also variable. If the second reading is applied, we believe the Proposed Rule may have significant unintended consequences.

For example, some executive compensation packages are not specifically "incentive" compensation, but are nonetheless variable, and may incidentally fall into the Proposed Rule under the second potential meaning above. Deferred compensation arrangements that are common among credit union executive payment packages involve payment based on formulas. These formulas may be calculated in such a way as to directly account for performance, and thus the variable nature of the compensation is itself an incentive. However, other deferred compensation arrangements where the levels are not directly based on performance may nonetheless be variable in order to account for external economic factors (e.g., interest rates, inflation, etc.).

Yet other deferred compensation formulas may <u>indirectly</u> be related to incentive payments. Indeed, many deferred compensation formulas are based on "total compensation" over a period of time. "Total compensation" generally includes base salary, as well as bonuses and similar incentive payments. We do not believe such formulas should be included in the definition of "incentive compensation."

We do not believe these types of variable compensation arrangements were meant to be covered by the Proposed Rule. Thus, we suggest that the NCUA clarify that the definition of "incentive-based compensation" is "any variable compensation where the variable nature of the compensation directly serves as an incentive for performance." We believe that deferred compensation formulas that are based on "total compensation" and thus only indirectly related to incentive payments should not be included in the definition.
Additionally, as noted by other commenters, the Proposed Rule currently appears to include incentives based on both individual performance and the overall financial performance of the institution. We do not believe that compensation arrangements or incentive payments based

[1] We note that all compensation in the employment context is, essentially, an incentive for performance.

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on the overall financial performance of an institution pose safety and soundness concerns of the same type as compensation arrangements based on individual performance. The NCUA has long recognized that distinction in 12 C.F.R. § 701.21(c)(8)(iii)(B). Thus, we believe that the NCUA should examine and consider an exception to § 751.3(g) for compensation based solely on the overall financial performance of the credit union.

2. Tax Implications for Deferral of Payments

While few credit unions will be required to defer payment under the Proposed Rule, there is a clear indication that deferral of payments is appropriate as one method of controlling risk and providing incentives for long term performance, not merely short term gains. We agree that deferral of payments can be a very effective tool. However, we are concerned that without more explicit discussion of the possible tax implications of such deferrals, many credit unions and their employees may run afoul of IRS rules in this area. Specifically, a taxable event occurs whenever an employee's interest in compensation vests, or when there is no substantial risk of forfeiture. A very significant portion of executive compensation legal work is determining when compensation will vest under 12 U.S.C. § 457(f) and corresponding regulations, and further controlling when payments are made based on that vesting date. Thus, NCUA and credit unions will need to take care in this area, so as to not create programs where employees have unconditional rights to benefits, but on a delayed basis. Any such programs could cause significant tax liability for employees before they are actually paid.

3. Interaction with Other NCUA Regulations

The institution of an incentive compensation rule for credit unions implies strongly that there would be individuals for whom the incentive compensation rule would apply. Looking at credit union variable compensation, however, many programs that would pose a strong safety and soundness concern is already limited by 12 C.F.R. § 701.21(c)(8). Section 701.21(c)(8) prohibits credit unions from compensating employees or volunteers "in connection with any loan made by the credit union." Indeed, a recent NCUA Office of General Counsel Legal Opinion Letter extended this rule to additionally cover compensation in connection with loans not made by the credit union.[2] We are concerned that the broad prohibition in § 701.21(c)(8) and the intensive reporting requirements under the Proposed Rule do not mesh cohesively, and believe that changes should be made to § 701.21(c)(8) to reflect the statutorily mandated scheme under the Proposed Rule.

[2] If the scope of § 701.21(c)(8)'s prohibition is to remain as it has been interpreted in Legal Opinion Letters and in the preambles to the NCUA's regulations, we believe its wording should be changed to reflect that the regulation actually prohibits compensation in connection with the credit union's lending function.

While there are exceptions to § 701.21(c)(8), the exception which currently allows or credit unions to implement incentive-based compensation for lower level employees in lending departments does not apply to the primary individuals covered by the Proposed Rule, namely executive officers.

Unfortunately, § 701.21(c)(8)'s prohibitions on lending-related incentive compensation has prevented credit unions from attracting talent that might be used to otherwise participate in the lending marketplace with banks and other financial institutions. Indeed, many vice presidents of lending, senior VPs, and other similar positions in lending and secondary marketing roles in major financial institutions are provided with loan-related incentive compensation. Particularly in the area of secondary marketing, the talent is rarified, and will often gravitate towards the companies and industries that are able to compensate them as banks do—based on their performance. Section 701.21(c)(8) has, by prohibiting pay based on performance for a large segment of the employees who would have the know-how to produce income for credit unions, prevented credit unions from effectively competing in the marketplace.

Today, even with the tax advantages that credit unions have, many consumers go to banks or brokers for their mortgage loans, because companies with channels to mortgage bankers (persons who sell large volumes of mortgage loans on the secondary market, especially Fannie Mae and Freddie Mac). Mortgage bankers and the brokers who sell to them are able to offer better rates or better terms than portfolio lenders, or lenders with only infrequent connections to the purchasers of loans. We do not believe that § 701.21(c)(8)'s increasingly broad application is warranted.

However, we do not believe that the incentive compensation rule can (or should) completely supplant § 701.21(c)(8). We agree that credit union volunteers should not be permitted to benefit from loans made by their credit union. However, we believe that employees, including senior management employees, if the incentive compensation rule applies or if a credit union agrees to be governed by the reporting requirements of the rule, should be excluded from 701.21(c)(8), likely through the addition of a "701.21(c)(8)(iii)(E)" reading as follows:

> "(E) Payment, by a Federal credit union to which Part 751 of this chapter applies, of any compensation to a "covered person" as defined in § 751.3(d) of this chapter, which payment is not prohibited under § 751.5 of this chapter."

We believe that the application of the Proposed Rule to senior management and other employees would impose sufficient requirements for internal controls, board review, and

NCUA oversight to pose no greater risk to credit unions or the NCUSIF.[3] Application of the Proposed Rule rather than § 701.21(c)(8) would also provide significant benefits to the competitiveness of credit unions in attracting personnel. Without such a change to § 701.21(c)(8), we believe that the new incentive compensation rule will prove to be duplicative at best, and at worst an intensive reporting and policy requirement which will not have any interaction with the employees for whom it was designed (i.e., executive officers in the area of lending).

4. Consideration of Additional Information when Examining Excessive Compensation

Section 751.5(a)(2) provides a list of factors the NCUA will take into account in determining whether any incentive-based compensation arrangement is excessive. We believe the NCUA may wish to clarify in § 751.5(a)(2)(iv) that "comparable institutions" may include institutions other than credit unions. Many credit unions over $1 billion in assets compete closely with community banks, savings associations, and other financial institutions, both for customers and for employee talent. If consideration of compensation is limited to consideration in the arena of one charter type, then the rule may not be applied evenly.

Additionally, the operations of financial institutions of comparable size can vary widely. The NCUA and the other Agencies requested comment whether the nature of operations at comparable institutions should be considered in determining whether compensation is excessive. We believe that the Agencies should consider the operations involved at the covered financial institution and the compensation of employees involved in similar operations at other financial institutions. Such consideration would help ensure that no one type of financial institution, or size of financial institution, obtains a competitive advantage when attracting employee talent.

5. Conclusion

In sum, we believe that Congress's public policy direction has been made clear, and that in light of those decisions, the Proposed Rule is necessary. However, in the context of the NCUA's current Rules and Regulations and the competitive position held by credit unions among the various types of financial institutions in the United States, changes should be made to the Proposed Rule and § 701.21(c)(8) to allow credit unions to grow and thrive.

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[3] We would also suggest that the NCUA consider allowing credit unions under $1 billion in assets to "opt in" to compliance with Part 751 in order to gain an exemption from § 701.21(c)(8). This would permit credit unions to attract talent for lending departments and vice president roles without regard to the somewhat arbitrary $1 billion asset level. We assume that the NCUA would wish to have some written assurances from credit unions, or a formal waiver process, to obtain such an allowance.

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We hope that these comments are helpful as the NCUA and the other Agencies consider the Proposed Rule. If you have any questions, please do not hesitate to call.

Sincerely,

STYSKAL, WIESE & MELCHIONE, LLP

Timothy I. Oppelt

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