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SW&M

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July 21, 2016 **VIA EMAIL ONLY: regcomments@ncua.gov**

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

Re: SW&M Comments on Notice of Proposed Rulemaking Regarding the Incentive-Based Compensation Arrangements

Dear Mr. Poliquin:

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, nationwide. 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 in conjunction with the other federal financial regulators. 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 ensure that the Proposed Rule fairly effectuates Congress's intent.

1. <u>Definition of Incentive Compensation</u>

In proposed § 751.2(r), "Incentive-based compensation" is defined as "any variable compensation, fees, or benefits that serve as an incentive or reward 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 indirectly 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, the Proposed Rule 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 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 § 751.2(r) for compensation based solely on the overall financial performance of the credit union.

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

Re: SW&M Comments on Notice of Proposed Rulemaking Regarding the Incentive-Based Compensation Arrangements

2. Definition of Senior Executive

We strongly believe that the Proposed Rule should be tailored to minimize confusion and contradictory or misaligned standards at financial institutions. One area in which the definitions in the Proposed Rule and other NCUA regulations do not align is in the definition of "senior executive officers."

Elsewhere in the NCUA's rules and regulations, this term refers to the CEO, CFO, and "assistant CEOs" (a facts and circumstances based term which is often interpreted to mean direct reports to the CEO, or persons fulfilling job functions like an "assistant CEO"). This longstanding standard in the NCUA's rules has created confusion over the years, but has also served to ensure that people with true control over operations are not able to use that authority to the institution's detriment. It is an organizational chart based test, rather than a title based test.

For the purposes of the Proposed Rule, the agencies have included a list of "chief" positions, and noted that any individual performing the functions of such a title is a "senior executive." So, regardless of title, the person in charge of a covered institution's lending programs or investment programs will likely be considered a "senior executive officer." Many of the positions in the list are assigned farther down in organizational charts than "assistant CEOs" for many of our clients, particularly when including the "catch all" of "head of a business line."

The lack of alignment between these two sets of definitions will prove particularly problematic when credit unions attempt to draft clear compensation policies that take into account both the Proposed Rule and regulations such as § 701.21(c)(8). Having two identical terms that mean slightly different things and that would be required to be included in the same policies and procedures does not assist credit unions with compliance. We strongly believe that these definitions should be aligned in all areas of the NCUA's rules related to compensation.

In doing so, however, the NCUA should also be aware of the collateral impact of further extensions of the definitions in NCUA's existing regulations. For example, if the Proposed Rule's definition of "senior executive officer" were extended to § 721.7, then common compensation arrangements for the heads of business lines could be prohibited, whereas currently they need only be under a Board policy and subject to annual review of internal controls. Ultimately, we believe this merits repeal of or exceptions to other NCUA regulations (as discussed in additional detail below); however, at a minimum, the NCUA's examiners should be instructed in the Supplementary Information to any Final Rule as to the differences between these various definitions should they not be revised to align.

Re: SW&M Comments on Notice of Proposed Rulemaking Regarding the Incentive-Based Compensation Arrangements

3. Governance Considerations

   Throughout the Proposed Rule, the general tenor is that Boards of Directors should be more involved in the design and oversight of compensation plans for all levels of employees. This seems to be a part of a growing trend in financial institution regulation to involve Boards of Directors in ever-increasing operational details. We believe this trend is ultimately detrimental to the volunteer culture of credit unions. While the universal nature of the Proposed Rule may assist in diminishing differences between charters for the purposes of risk management, it also diminishes differences between charters in terms of culture and operations.

   We believe the solution for this issue would be to review the obligations for credit union Boards of Directors to ensure that each is emphasized in the regulation and accompanying Supplementary Information as requiring only high level design of potential internal control systems and outside limitations for incentive programs for non-senior management of Level 3 credit unions to be established in Board Policy and reporting.

4. Section 751.6

   This Section of the Proposed Rule provides for the possibility of imposition of increased requirements for Level 3 credit unions over $10 billion in assets. While we agree that there may be scenarios where institutions with higher asset levels could be complex or systemically important enough to merit additional safety and soundness review, we disagree that § 751.6 is an appropriate method of accomplishing this goal. This is for several reasons, including:

   A. Section 751.6 does not clearly provide how re-designation or application of increased standards will be imposed initially. Are these powers to be exercised by Regional Directors? Will individual examiners in the course of an examination be permitted to wield this authority? The NCUA and the other financial regulators should provide clarity as to these initial procedures and what rights to hearings or other procedural protections are available for regulated institutions.

   B. Section 751.6 does not provide any due process rights for credit unions (or other financial institutions designated under the corollaries to 751.6) to review or appeal determinations by their regulators that they should be subject to increased Level 2 or Level 1 requirements. As elevation to a Level 2 designation (or imposition of any Level 2 or Level 1 requirements) would involve significant regulatory burden, it should not be imposed without some regulatory appeal mechanism. Indeed, without such a system established in the regulation, designation as a Level 2 institution would not even carry normal Supervisory Review Board appeal rights.

Re: SW&M Comments on Notice of Proposed Rulemaking Regarding the Incentive-Based Compensation Arrangements

C. Section 751.6 does not contain the standards by which regulators will determine that a financial institution will be subject to increased standards. While the Proposed Rule notes that the regulators will create those standards, it is not clear that such standards cannot be enforced prior to publication. We have concerns that this will result in development of regulations outside of the requirements of the Administrative Procedures Act, or at a minimum standards that are not subject to review and comment by the industry, concerned members, and other financial institution professionals. As the regulators have seen from the thousands of comments to the 2011 proposal, this is an area which should be subject to public review, as it has significant implications for the operations of affected institutions.

5. Additional Portions of the NCUA's Rules and 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 are already limited by 12 C.F.R. § 701.21(c)(8), § 721.7, and § 701.23(g). 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. Section 721.7 contains similar prohibitions for compensation based on incidental powers. Section 701.23(g) contains these prohibitions regarding the purchase and sale of eligible obligations. We are concerned that the broad prohibitions in the existing regulations and the intensive requirements under the Proposed Rule do not mesh cohesively, and believe that changes should be made to each of them to reflect the statutorily mandated scheme under the Proposed Rule.

While there are exceptions to § 701.21(c)(8), § 721.7, and § 701.23(g), the exceptions 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, the existing prohibitions on incentive compensation has prevented credit unions from attracting talent. While there is an apparent attempt through the Proposed Rule to create consistent rules for financial institutions in the requirements around incentive-based compensation, credit unions will be at a significant disadvantage for attracting talent after the implementation of the Proposed Rule—credit unions will not only have the burden of significant governance requirements of the Proposed Rule, but will have them without actually being able to provide the compensation the rule was intended to guard against.

Re: SW&M Comments on Notice of Proposed Rulemaking Regarding the Incentive-Based Compensation Arrangements

However, we do not believe that the incentive compensation rule can (or should) completely supplant § 701.21(c)(8), § 721.7, or § 701.23(g). 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 the application of the restrictions of these subsections. In our comments to the 2011 Proposal, we suggested proposed language which would effectuate such an exception.[2]

We believe that the application of the Proposed Rule to senior management and other employees of Level 3 credit unions in place of the existing patch-work of regulations 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 these subsections would also provide significant benefits to the competitiveness of credit unions in attracting personnel. Without such a change to these subsections, we believe that the Proposed 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 who are able to expose their institutions to risk).

We thank you for the opportunity to comment on this important topic. If the NCUA has questions about our comments, we would be pleased to discuss them.

Sincerely,

STYSKAL, WIESE & MELCHIONE, LLP

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[2] Please also see our letter of August 3, 2015 to the Office of General Counsel in response to the NCUA's annual regulatory review, which suggested further revisions to § 701.21(c)(8).

[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.