Statement of the U.S. Chamber of Commerce

ON: "Holding Executives Accountable After Recent Bank Failures"

TO: U.S. Senate Committee on Banking, Housing, and Urban Affairs

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Chairman Brown, Ranking Member Scott: my name is Tom Quaadman, Executive Vice President of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness. Thank you for the opportunity to testify today regarding recent bank failures, executive compensation, and the importance of a well-functioning system of corporate governance.

The failure of Silicon Valley Bank has prompted many legitimate questions about the nature of bank management, regulation, supervision, and the compensation incentives of bank executives. The work of policymakers and the regulatory system to investigate the causes of SVB's failure and subsequent entities is crucial, and the business community is one of the beneficiaries of these investigations. To create well-functioning and attractive capital markets in the United States, the entire economic ecosystem needs to have well-defined and clear regulation that can be well-understood, implemented, and adhered to. While the circumstance of bank failure is a difficult way to learn lessons about what regulations are working and which are not, the work of this Committee, the House Financial Services Committee, and the prudential regulators to identify how such failures happen helps to improve the marketplace for all participants.

There are, however, important aspects of the SVB failure that must not be overlooked and cannot be understated; Chief among these is the blatant mismanagement of the bank and an unexplained disregard for clear regulation. For instance, despite a clear requirement that financial institutions maintain a Chief Risk Officer (CRO), SVB was effectively without one for 8 months.[1] According to SVB's risk committee charter, the CRO is responsible for reporting "regularly" on the company's "top risks, significant risk issues and overall management."[2] Moreover, according to the company's 2022 proxy statement, the Chief Risk Officer "reviews and shares her input on [compensation] risk assessments, and reports and discusses with the committee her risk assessment of our compensation programs (including plan design and execution), and any recommendations."[3] In 2022, the company concluded that "Based on these assessments and discussions, we do not believe that our

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[1] "Silicon Valley Bank had no chief risk officer for 8 months while the VC market was spiraling." *Fortune*. March 10, 2023. Available at: https://fortune.com/2023/03/10/silicon-valley-bank-chief-risk-officer/

[2] Silicon Valley Bank Risk Committee Charter. Available at: https://www.svb.com/globalassets/library/uploadedfiles/content/corporate-governance/board-risk-committee-charter_april-2022-final.pdf

[3] Silicon Valley Bank 2022 Proxy Statement, pg. 29. Available at: https://www.svb.com/globalassets/library/uploadedfiles/content/corporate/2022-proxy-statement.pdf

compensation program promotes excessive risk taking or creates risks that are reasonably likely to have a material adverse effect on the company."[4] As the Congressional Research Service identifies, SVB had, over the last year and a half leading up to the failure, received six supervisory warnings from the Federal Reserve System (Fed) and offered some of the most generous compensation packages among publicly traded banks.[5] It is clear that the absence of a CRO – and management's failure to appoint a new one – had an impact both on the company's overall risk assessment and the compensation plans deployed at the company.

As Members of Congress and other stakeholders have rightly pointed out, mismanagement at the bank and delinquencies related to supervisory action are not necessarily due to a lack of regulation. Human error is elemental to SVB's failure. Consequently, one of the questions left outstanding relates to appropriate management safeguards, repercussions, and examining compensation incentives to be sure they sufficiently align the interests of the entity as a whole and broader market with individual interest.

In response to this question, some Members of Congress and regulators have called for rulemaking under section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), despite guidance issued in 2011. Section 956 seeks to limit compensation packages that encourage excessive risk-taking. Incentive-based compensation arrangements are critical tools in the management of financial institutions. Compensation plans are uniquely designed by boards of directors and management and are tailored for the employees of a particular institution. While financial institutions should avoid excessive risk that damages the long-term viability of the firm and potentially the financial system as a whole, it is essential that any regulator charged with writing compensation rules comprehensively study all the relevant issues and data and analyze the likely effects of its regulations on the highly competitive market for talent. To date, the agencies responsible for section 956 have taken a much too prescriptive approach that deviates from congressional intent when they have proposed rules in 2011 and 2016.[6]

To be clear, compensation should not create perverse incentives, including awarding bonuses to executives when internal company crisis is imminent, and clawbacks can be a tool to help disincentivize unsavory corporate behavior. However, if the costs of a section 956 rule outweigh its benefits, professionals may flee covered businesses in favor of other

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[4] *Id*.

[5] Congressional Research Service. "Silicon Valley Bank's Failure and Potential Director/Officer Liability." April 7, 2023. Available at: https://crsreports.congress.gov/product/pdf/LSB/LSB10946

[6] Comments from Tom Quaadman responding to the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, National Credit Union Administration, and Securities and Exchange Commission's "Reproposed Rule on Incentive-Based Compensation Arrangements." July 21, 2016. Pg. 5. Available at: https://www.sec.gov/comments/s7-07-16/s70716-25.pdf. *See also*: Comments from Tom Quaadman responding to SEC "Proposed Rules on Incentive-Based Compensation Arrangements Release No. 34-64140. July 13, 2011. Available at: https://www.sec.gov/comments/s7-12-11/s71211-742.pdf. *See also*: Comments from Tom Quaadman responding to Fed, FDIC, OCC, and SEC "Incentive Based Compensation Arrangements." February 25, 2014. Available at: https://www.sec.gov/comments/s7-12-11/s71211-752.pdf.

financial firms, other industries, or seek opportunities in jurisdictions whose regulators more appropriately balance the putative governmental interest in regulating compensation plans with management's ability – and, under prevailing corporation law, its statutory duty – to make business judgments for the benefit of the firm's owners.

This result could actually have the effect of undermining regulators' goals in promulgating these rules by discouraging the most talented individuals – those most capable of preventing or managing the types of losses the regulator is trying to proscribe – from working in the financial services sector. It might also chill the kind of healthy risk-taking – lending, financing, and investing – that spurs economic growth and job creation in our capitalist system, resulting in corporate stagnation. If section 956 implementation becomes the clarion call from SVB's failure, then the regulators required to promulgate those rules need to start on those rules afresh and not reprise the proposal from 2011 or reproposal from 2016. Too much has changed, both from a government policy perspective and an internal corporate hygienics perspective, for regulators to simply pick up where the rulemaking was last left off seven years ago. At the very minimum, regulators must perform a rigorous cost benefit analysis, allow the stakeholder community ample time to comment, and evaluate whether the prescriptive approach previously proposed is in harmony with congressional intent in the original statute.

There is a global competition for talent on the chief executive and senior executive level. This competition for talent should also be viewed through the lens of the context of a business. For instance, a business that needs to execute a turn-around may have to pay a premium for the talent. Such a premium may not fit nicely within the box of a pay versus performance disclosure; however, it is within the interest of a corporation and necessary to fulfilling the fiduciary duty of the board. Increased government intervention in compensation issues, such as the raise in the IRS deduction for compensation in the early 1990's, set the stage for income enhancements outside of salary and increased compensation packages, skewing that market.

In a related vein, recent legislative proposals to claw back executive compensation from executives at failed banks[7] should adequately weigh the costs and benefits of such policies, particularly from the perspective of attracting and retaining human capital in covered industries. While aspects of these policies may be appropriate and well-intentioned, they should not unduly punish executives, directors, and other employees who may not have had influence over recent crises or mismanagement. Unnecessarily disincentivizing top talent from participating in the financial sector may well result in additional mismanagement or, worse, additional failures.[8]

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[7] *See*: S. 1045, Failed Bank Executives Clawback Act; S. 1181, Bank Management Accountability Act.

[8] Wayne Guay, Wharton School of the University of Pennsylvania. "Can Bonus Clawback Rules Fix Finance Industry Incentives?" May 4, 2016. "… the new plan targets not only senior executives at financial institutions, but also lower-level employees who handle large sums of money, a provision that could potentially include tens of thousands of industry professionals … This is sparking concerns that financial workers could abandon banks and take their talents to less-regulated institutions." Available at: https://knowledge.wharton.upenn.edu/article/can-bonus-clawback-rules-fix-finance-industry-incentives/

Beyond a parochial focus on financial institutions, the corporate governance landscape in the U.S. has changed rapidly and dramatically in the last decade, including topics like director elections and executive compensation. Setting aside the Dodd-Frank Act, the SEC has been pushing rulemaking and other initiatives in the corporate governance space that do not have a direct congressional mandate, adding compliance burdens without analyzing the aggregate impact of those changes. It is not an overstatement to say that corporate governance, and by extension the executive compensation space, has gotten significantly more complex in the last two years alone. Companies must be able to understand their responsibilities and how to execute them, and compounding changes to corporate governance policies create a challenge for companies to observe sound corporate governance practices.

Companies need to be able to focus on financial factors in their corporate governance and compensation decisions. When company management is made to focus on mandated factors other than performance, it can serve as a distraction. Of concern, the SEC's recent pay vs. performance rule sought to incorporate factors beyond company financial performance into compensation considerations.[9] That mandate exceeded congressional intent of the Dodd-Frank Act and may have an impact on companies' ability to focus on long-term performance and growth.

Corporate governance – and, by extension, executive compensation – does not exist in isolation; it is directly tied to American competitiveness and the attractiveness of the American capital markets. Overburdening companies with compliance mandates diminishes the public company model and thereby reduces the incentives for U.S. companies to go, and stay, public. There is need for regulation in the marketplace, but regulations must appropriately balance the costs and benefits, be well-considered, and must be practical.

Accordingly, it should be recognized that with the recent banking issues the relevant agencies and the Department of Justice have many tools at their disposal to punish wrongdoing. A rush to judgment and implementing new policies around compensation will have ramifications well beyond the banking sector and may ultimately impact all public companies. It is important for Congress, the Administration, and the relevant agencies to consider the evidence at hand and not to swing wildly in such a manner as to create an atmosphere that will prevent businesses from going and staying public. Such an outcome will harm American competitiveness and main street investors.

Thank you for the opportunity to participate in this conversation and I look forward to your questions.

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[9] Comments of Tom Quaadman to the SEC, "Reopening of Comment Period on Pay Versus Performance; Proposed Rule, Securities and Exchange Commission." March 4, 2022. Pg. 4. Available at: http://www.centerforcapitalmarkets.com/wp-content/uploads/2022/03/220304_Comments_PayvPerformanceReopening_SEC.pdf?#