July 22, 2016

Board of Governors of the Federal Reserve System

Subject: Comments regarding "Incentive-based Compensation Arrangements"
Section 956(e) of the Dodd-Frank Act
12 CFR Part 236

Compensation Advisory Partners LLC ("CAP") appreciates the opportunity to comment on Section 956(e) of the Dodd-Frank Act. CAP is a leading independent consulting firm specializing in executive and director compensation program design and related corporate governance matters. Our consultants serve as advisors to Boards and/or senior management at many leading companies, and have an interest in advancing sound corporate governance. A significant portion of our clients are financial institutions, including covered institutions.

Background

The Joint Agencies proposed rules issued in April 2016 ("proposed rules") that cover a broad array of topics from how to determine the asset size of an institution to the appropriate time period for document maintenance. As advisors to the board of directors of financial institutions and as practitioners in executive compensation for over 20 years, we feel it would be most helpful to the Agencies for us to comment on: (1) the areas where we have hands-on experience with our clients in implementing sound incentive guidance over the last five years, and (2) questions you have raised regarding the proposed rules that we feel may detrimentally impact the balance between mitigating risk and providing competitive and well thought out compensation programs that drive business performance.

The proposed rules are a significant departure from the principles-based guidance issued to covered institutions in 2011. The proposed rules are more prescriptive and focus on requiring larger and longer deferrals, downward adjustments to compensation outcomes, forfeitures, and clawbacks, as well as explicitly prohibiting certain pay practices. For institutions which have spent considerable time and expense over the last five years working to align their incentive compensation programs with the 2011 guidance, aspects of the proposed rules will be met with some consternation.

We think that the Agencies missed a critical step in the process by not providing a new comprehensive horizontal review of the progress that has been made by financial institutions in reaction to the principles-based guidance provided in 2011. In our role as advisors, we have seen tremendous changes in risk controls and incentive processes at our clients that are covered institutions. We have also seen that they have been working closely with their regulators over the last five years to address concerns about incentive compensation. Our view is that the original principles-based guidance included aspects that were necessary to "fix" incentive compensation in financial institutions and that the introduction of risk reviews for senior executives and the potential for forfeiture of deferred awards provides an effective risk mitigation tool.

However, in the absence of a comprehensive horizontal review, it is unclear to us what is to be gained by further modifications to incentive compensation. There is a principle that if something is not broken, there is not a need to fix it. If the Agencies could effectively demonstrate that the incentive compensation at covered financial institutions is still "broken", there may be more of an appetite for additional change.

Of particular concern are instances where the new prescriptions are not based on empirical evidence that demonstrates the new requirements will mitigate risk to any greater degree than current guidance. We believe, and will describe in more detail below, that there are significant areas (e.g., covered employees, size and form of deferrals, vesting, etc.) where the current principles-based guidelines should be retained, monitored and only changed if an evidence-based argument can be made that they are ineffective, or not sufficiently effective.

Our comments are detailed below, and are organized by topic citing, where applicable, specific questions posed within the proposed rules.

Compliance Date (1.1, 1.2, 3.1)

In determining the appropriate compliance date, there are two issues to be considered. First, the vast majority of covered institutions' incentive compensation programs follow a calendar year. Goals are communicated at the beginning of the year and results are determined following year-end. Plan changes are thoroughly vetted and shared with participants before the beginning of the year, which can support and drive desired behaviors. We would suggest that any compliance date be set consistent with the start of a calendar year (or the company's fiscal year). Second, as currently proposed, companies will need a significant amount of time to bring their incentive plans into compliance and communicate with covered staff once the rules are approved. Aside from what may be required for documentation, governance, etc. We therefore suggest that the rules go into effect in the first fiscal year following the 540 days.

Covered Employees and Criteria Used (2.19-2.22)

For the past four years covered institutions have worked diligently with their regulators to identify Category 1 and Category 2 employees – senior executives and 'material risk takers'. Companies have developed rigorous criteria and processes, including internal committees who review and evaluate the groups and individuals within their organizations who are likely to expose the institution to material losses.

The proposed rules introduce an entirely new approach that will require all institutions to revamp their current efforts without a clear rationale for why it would improve the outcomes. Below is a discussion of our concerns with the proposed approach:

- 1/3 of Total Compensation Delivered as Incentive Compensation Threshold
  - Incentive compensation of 1/3 of total compensation may be viewed as a "meaningful" incentive; however, our view is that the type of employee receiving the award is a much more important consideration
  - The assumption that 1/3 of total compensation can be used as a cutoff for considering any individual to be a potential risk-taker is flawed
- Use of 5% or 2% of Highest Compensated Individuals
  - Formulas are equally likely to gather too many or too few of the appropriate positions with no identified means to adjust the outcome as no two institutions are the same
  - There are many positions that are considered staff/functional (control groups). They may be well paid positions and receive incentives that amount to 1/3 of total compensation but they would not be considered significant risk takers if a qualitative assessment were completed
  - Positions including technology, human resources, legal, finance/accounting and operations would be swept into the covered category with no rationale other than their inclusion by formula
  - Including large numbers of people because they receive a certain level of incentive could have the effect of forcing companies to reduce incentive compensation and increase fixed compensation only to avoid including people they feel should not be subject to the rules
- Exposure Test (i.e., 0.5% of assets)
  - While the exposure test attempts to identify individuals who have the ability/authority to commit or expose the institution's capital, it is not a measure generally associated with an individual (outside of lending, specialized areas or executive management)
  - Many organizations make these decisions by Committee and the exposure test may end up pulling relatively junior employees into the covered employee group
  - Applying this criterion will take institutions considerable time and cost to develop without any other apparent benefit

We suggest that the Agencies reconsider whether the significant investment by the banks and regulators that has been achieved to date is sufficient to identify the appropriate population without subjecting companies to additional time and cost for a modest/immaterial improvement in outcome.

Deferrals and Vesting Periods (2.38, 7.7)

In response to 2011 proposed rules, institutions with over $50B in assets have introduced the deferral of 50% of incentive compensation for senior executives over a minimum of 3 years. This practice has also been extended to other 'material risk takers' or category 2 employees, in some cases at more or less than the 50% depending on their position and level of compensation. For executive/senior management, long-term incentives including performance plans and restricted stock have been the primary vehicles used for deferrals. For other employees, deferrals have taken the form of restricted stock. Three years represents the most common deferral period.

In response to the proposed rules in their treatment of short term and long-term deferrals and to the minimum amounts and timing, we have the following observations:

- **Qualifying Incentive Compensation vs. Long-term Compensation:** Making a distinction between annual (short-term) and long-term compensation is not reflective of how most institutions make their compensation decisions
  - Many companies make a total compensation decision and then allocate the incentive pay among vehicles such as current cash, restricted stock, and performance share plans. The distinction between short term qualifying compensation and long-term compensation adds unnecessary complexity to the rules, will require companies to make significant and unnecessary changes to their programs and will not result in a change in the amount of compensation actually deferred (see Exhibit I for example of current compensation structure vs. proposed rule)
- **Required Deferral Levels:** Current deferrals are currently at significant levels. Senior executives, particularly CEOs, often receive more than 50% of their total compensation in deferred vehicles
  - Compensation Committees and investors believe that executive management should be aligned with long-term shareholder interests through their participation in equity plans and share ownership
  - There is no compelling need to increase the size of deferrals above the 50% of incentive compensation level for senior executives
  - Given the disparity in pay levels among other significant risk takers it would make sense to permit institutions to set an appropriate range (e.g., 30-40% of incentive compensation) to recognize these differences
- **Deferral Period:** Three years remains the most common deferral period. There are companies that use longer periods (e.g., 4-5 years), but they are in the minority
  - Where longer deferral periods are used, the rationale for longer periods is generally to increase alignment with shareholders or increase retention, not to identify/mitigate risk
  - We do not believe that vesting periods need to extend beyond current practice. We are not aware of any empirical evidence that demonstrates that longer deferral periods will enhance risk mitigation
  - Given current complementary program features (e.g. risk management, downward adjustments, etc.) in place, there is little evidence that longer deferrals would significantly increase risk mitigation and there is potential that it will lead employees to greatly discount the value of deferred incentive compensation

- Compensation Committees and management already have tools available to adjust/forfeit awards or to clawback vested awards
- In addition, covered institutions have monitoring processes put in place to scrutinize individual behaviors and transactions
- Additional vesting may be attractive to regulators but weakens the tie between pay and performance and may result in other unintended consequences as these institutions move further and further away from broader market compensation practices

Use of Substantial Amounts of Cash and Stock (7.14)

The introduction of a substantial amount of deferred cash in the proposed rules is a new concept and comes somewhat out of the blue. In the 2011 proposed rules, deferrals were considered to be primarily in the form of equity. Although some covered institutions use cash in their deferral program, the overwhelming practice for senior executives is to use equity for several reasons:

- Provides alignment with company performance during the deferral period and the opportunity for appreciation if the company performs (or depreciation) plus dividends
- Fixed accounting treatment for the company
- Encourages employees to retain an (after tax) ownership interest post-vesting
- Deferred cash is generally only used when stock is not available as a tool or for employees below the senior executive level primarily due to dilution concerns

To mandate the use of deferred cash in any significant amount would likely require all companies to make significant changes to their programs and would run counter to the objective of aligning management with shareholder interests.

Maximum Leverage (7.12)

The proposed rule would limit maximum payouts to 125% to 150% of pre-set targets to discourage covered persons from taking inappropriate risks. Our view is that this will put covered institutions at a disadvantage relative to other industries.

- The most common practice among large, public companies has long been to set maximum incentive payouts at 200% of target for achievement of appropriate stretch (but attainable) performance
- In practice, companies tend to pay close to target and rarely reach the maximum payout level
- A pay for performance philosophy is based on rewarding executives for meeting/outperforming their pre-established goals and penalizing them when they underperform
- To allow a maximum of 150% of target for some covered employees and 125% of target for senior executives is counter to how these plans are generally structured
  - Executives are generally viewed to have the most influence over the results and participants generally share in the same goals and maximum incentive opportunities

- If the proposed rules go into effect, we suspect that companies may respond by increasing target incentive opportunities, and use negative discretion to achieve the desired pay for performance relationship

We recommend that the Agencies allow a maximum payout more in line with general industry practices. This would allow companies to continue to provide pay for performance while other mechanisms of the program (e.g., downward adjustments, forfeitures, non-financial measures, etc.) can be used to provide ample balance. In addition, it is not clear to us why it enhances the effectiveness of incentive compensation design to not allow deferred amounts to move up or down with long-term performance of the covered financial institution over the deferral period.

Accelerated Vesting (7.10)

Under the proposed rules, it would be appropriate to clarify that deferred awards may continue to vest for terminated employees. This is of particular concern under scenarios where many companies either accelerate or continue vesting for terminated employees (e.g., retirement, termination without cause following a change in control, etc.) In these cases, the company generally retains the ability to cancel unvested awards under criteria similar to normal forfeitures as well as other criteria including non-competition/non-solicitation.

Accelerated vesting should be allowed in the event of a change in control (the covered institution is acquired) and loss of position (double trigger).

- This is the most common approach and considered best practice for most public companies
  - Protects terminated employees from "bad faith" on the part of acquiring company
  - Protects terminated employees from exposure to risks taken by acquiring company employees
- The separation of service is generally initiated by the acquirer and not under the control of the individual or his/her prior employer
- Acceleration should also be allowed in any situation where the acquirer does not provide equivalent value for existing, unvested equity awards, even if the employee is not terminated

Acceleration of awards for terminations without cause should also be considered where the termination was part of a redundancy program and the company's equity program provides specific relief for these situations.

Clawbacks (7.30-7.32)

Covered institutions, following Dodd Frank and earlier guidance have led the way in introducing clawbacks in both their equity and cash incentive programs to broad groups of employees. The standard for the period to be covered is a 3-year look back, consistent with the SEC proposals to date. The factors outlined in the proposed rules are consistent with those being considered and fortunately provide flexibility to the covered institution to determine how to recover the compensation. Companies are wrestling with the legalities/means of clawing back compensation even within a relative short time-frame. The addition of a possible seven-year period is well outside competitive norms and highly unlikely to be invoked. As proposed, the clawback rule raises concerns among Compensation Committees and management on how they would administer such a requirement or communicate this feature to employees without raising unnecessary concerns.

Long Term Incentives/Equity Vehicles (7.17)

The most common approach to long-term incentive compensation today is to have a portfolio of vehicles. Until recently, the portfolio would include options, restricted shares and performance-based incentives in somewhat differing amounts across institutions. Regulators have taken a very negative position on options in practically any amount, leading most covered institutions to cutback or drop (on average 10% of long-term incentive compensation) stock options from their programs.

We believe there has been an over-reaction to options as an incentive vehicle based on practices that no longer exist. Covered institutions do not provide outsized option awards. They use 3-5 year vesting periods and many require additional holding periods on shares received at exercise.

- As part of a 'balanced' program options can be an effective form of incentive compensation and would not have any negative impact on the institution
- With a ten-year term, stock options are an effective incentive for rewarding executives for long-term performance
- The percent of stock options that can be used to meet deferral requirements should be increased

Finally, it should be noted that there is little evidence that stock options contributed to the financial crisis. For example, Bear Stearns and Lehman Brothers were actually heavy users of restricted stock at the time of the financial crisis and stock options were not a major part of their equity program for senior executives.

Relative Performance (8.8)

We are unclear on the restrictions being placed on relative performance programs, and strongly believe in conjunction with absolute performance metrics, the use of relative measures can add balance to an incentive program, especially at times when goal setting is extremely difficult due to macroeconomic conditions (e.g., interest rate environment). It would be helpful if the proposed rules provided guidance on what constitutes balance or allow companies the flexibility to use relative metrics in conjunction with absolute metrics in a manner that provides balance within their overall program.

Level Playing Field (7.5)

The proposed rules have significant features that will ensure that there is not a 'level playing field' between covered and non-covered institutions. Over time, we suspect that this will limit the ability for covered institutions to attract and retain talent.

Specific features that disadvantage covered institutions are:

- Mandated levels of deferral across all covered positions, some of whom would have significant equity based/deferral programs and others that would have some equity but likely not as large an amount
- The length of the deferral period: deferrals in excess of three years are not common and although clawbacks have been widely introduced, the possibility of negative adjustments and forfeitures or look-backs periods longer than 3 years generally do not exist outside of the banking environment

While the proposed design features may make sense to regulatory agencies in light of the greater focus on risk management across our economy and the financial services industry, our view is that a principles-based approach would be superior. It would allow companies (with the concurrence of their regulators) to meet the deferral requirements in a way that works for them (and their shareholders), recognizing that significant risk takers cannot be identified by formulaic means. Instead, a principles-based approach would hold senior management and boards of directors responsible for risk-outcomes. Our view is that a there needs to be flexibility in customizing the program to a covered institution's specific needs, and only a principle-based approach allows that flexibility.

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CAP is submitting commentary on its own behalf and not on behalf of any specific clients.

Sincerely,

COMPENSATION ADVISORY PARTNERS LLC

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EXHIBIT I

Current vs. Example of Approach Compliant with New Rules – Level 2 Senior Executive ($000s)

Current Compensation Structure

Variable Compensation
$3,000

Paid Currently | Deferred (payable when awards vest / performance ends)

Cash Inc. (20%)	RSUs (15%)	Options (15%)	Perf. Shares (50%)
$600	$450	$450	$1,500
2016 Perf. Period	*Granted in Mar. '17 3-Yr Vesting*	*Granted in Mar. '17 4-Yr Vesting*	*Granted in Mar '17 3-Yr Perf. Period*

Current Payout Structure

	Amounts Granted For '16 Perf. Yr.	Payout Timing Mar-17	Mar-18	Mar-19	Mar-20	Mar-21
Cash Inc.	$600 *Payable Mar. '17*	$600				
RSUs	$450 *Granted in Mar. '17*		$150 *1/3 vested*	$150 *1/3 vested*	$150 *1/3 vested*	
Options	$450 *Granted in Mar. '17*		$113 *1/4 vested*	$113 *1/4 vested*	$113 *1/4 vested*	$113 *1/4 vested*
Perf. Shares	$1,500 *Granted in Mar. '17*				$1,500 *100% Vested*	
Total	*$3,000*	*$600*	*$263*	*$263*	*$1,763*	*$113*

- Current Compensation Structure - Common approach among financial institutions and well understand
- Proposed Compensation Structure - Adds complexity with two forms of compensation, more calculations and steps and introduces a new vehicle (deferred cash)
- The deferred amount is unchanged, however, the participant would receive more vehicles and a longer vesting period

Proposed (Interpretation)

Variable Compensation
$3,000

Short Term: Qualifying Incentive Comp. (Cash + RSUs+ Options) $1,500

Long-Term: Long-Term Incentive Comp. (Perf. Shares) $1,500

Deferred

Paid In Mar. '17	Deferred over 3+ years		Max 15%	Paid In Mar. '20	Paid In Mar. '21 50% Deferred	50% Deferred
Cash Inc. $600	Def. Cash $450	RSUs $225	Options $225	Perf. Shares $750	Perf. Shares $375	Cash $375

Dodd-Frank Proposed (Payout Structure)

	Amounts Granted For '16 Perf. Yr.	Payout Timing Mar-17	Mar-18	Mar-19	Mar-20	Mar-21
Cash Inc.	$600 *Payable Mar. '17*	$600				
Deferred Cash	$450 *Granted in Mar. '17*		$150 *1/3 vested*	$150 *1/3 vested*	$150 *1/3 vested*	
RSUs	$225 *Granted in Mar. '17*		$75 *1/3 vested*	$75 *1/3 vested*	$75 *1/3 vested*	
Options	$225 *Granted in Mar '17*		$56 *1/4 vested*	$56 *1/4 vested*	$56 *1/4 vested*	$56 *1/4 vested*
PSUs	$1,500 *Granted in Mar. '17*			*Payable in shares*	$750 *50% Vested*	$375 *Deferred**
				Payable in cash		$375 *Deferred**
Total	*$3,000*	*$600*	*$281*	*$281*	*$1,031*	*$806*
Total Current Structure	*$3,000*	*$600*	*$263*	*$263*	*$1,763*	*$113*

Variance: Dodd-Frank Proposed vs. Current Payout Structure				
$0	*$19*	*$19*	*($731)*	**$694**

* 50% of the LTIP award (performance shares) is deferred.