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July 22, 2016

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In re: OCC Docket ID OCC-2011-0001, Incentive-Based Compensation Arrangements

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In re: Comments/RIN 2590-AA42, Incentive-Based Compensation Arrangements

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In re: Docket No. 1536 and RIN No. 7100 AE-50, Incentive-Based Compensation Arrangements

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In re: Comments on Notice of proposed rulemaking for Incentive-Based Compensation Arrangements

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In re: RIN 3064-AD86, Incentive-Based Compensation Arrangements

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In re: File Number S7-07-16, Incentive-Based Compensation Arrangements

MERCER
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RE: Proposed Rule on Incentive-Based Compensation Arrangements

Dear Messrs. Tierney, Frierson, Feldman, Pollard, Poliquin and Fields:

Mercer has reviewed the proposed rule on Incentive-Based Compensation Arrangements (the "Proposed Rule") and we appreciate the opportunity to share our comments.

We agree with the general principle that incentive pay arrangements should not encourage taking inappropriate risks (i) by providing excessive compensation or (ii) that could lead to a material financial loss. However, we believe some provisions of the Proposed Rule are too prescriptive and would have unintended consequences. For example:

- The more prescriptive provisions — such as incentive plan maximums and long minimum deferral and clawback requirements — could reduce pay-for-performance alignment because they might encourage institutions to increase the ratio of fixed pay to incentive pay or raise incentive plan target opportunities. As discussed under "Incentive pay maximums" below, according to a Mercer Snapshot Survey, in response to the cap on the ratio of variable to fixed pay in Capital Requirements Directive (CRD) IV, financial institutions in the European Union increased fixed pay and reduced variable pay.

- It could be harder for covered institutions to recruit and retain key employees who could seek employment at companies that are not subject to the rule, such as hedge funds and other independent money managers with assets below the proposed Level 1 and Level 2 thresholds.

About Mercer

Mercer is a global consulting leader in talent, health, retirement, and investments. We help clients around the world advance the health, wealth, and performance of their most vital asset — their people. Mercer's more than 20,000 employees are based in 43 countries, and the firm operates in over 140 countries. Mercer is a wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC), a global team of professional services companies offering clients advice and solutions in the areas of risk, strategy, and human capital.

Mercer has extensive experience designing and implementing executive and broad-based compensation programs as well as assisting public companies with their executive compensation disclosures. Our Global Financial Services Network of consultants advises many financial services institutions around the world. In addition to assisting with compensation program design, we regularly conduct compensation risk-assessments. We host roundtables among major financial institutions and conduct surveys to gauge their responses to regulatory developments and the changes they are making to their talent and reward programs. We also provide insights on market practices and implications of regulations to the Financial Stability Board.

Summary of recommendations

Our recommendations are summarized in the following table:

Provision	Recommendation
Covered institutions by level	Eliminate the Level 1 category and base requirements on those currently proposed for Level 2 institutions.
Covered persons	Eliminate the relative compensation test proposed for identifying significant risk-takers.
Defintiion of incentive-based compensation	Clarify whether ordinary course grants of service-based cash or equity awards are considered incentive-based compensation for purposes of the rule and, if yes, how the prescriptive provisions applicable to senior executive officers and significant risk takers at larger institutions would apply.
Performance measures	Allow long-term incentives to be based solely on financial measures and solely on relative measures. If the restrictions are retained for both annual and long-term incentives, consider all of an employee's incentive arrangements together rather than each arrangement separately.
Incentive pay maximums	Eliminate the cap on maximum opportunities as a percentage of target awards.
Deferrals	Eliminate the distinction between Level 1 and Level 2 institutions and: • Adopt the minimums currently proposed for Level 2 institutions. • Clarify that equity awards can remain in the category of equity awards (vs having to be converted into a combination of cash and equity) during the deferral period. • Allow for acceleration on termination without cause and a change in control, and clarify that awards would be permitted to continue to vest upon other types of termination.
Clawbacks	Offset the length of the clawback period by the number of years an award is required to be deferred.

Detailed explanation of recommendations

I. Covered institutions by level

The Proposed Rule divides covered institutions into three levels.

Recommendation: The final rule should eliminate the Level 1 category and base requirements on those currently proposed for Level 2 institutions.

Imposing more stringent requirements on Level 1 institutions than Level 2 institutions would introduce unnecessary complexity and create an unlevel playing field for recruiting and retaining talent.

The preamble to the Proposed Rule explains the distinction between Level 1 and Level 2 institutions by pointing to federal capital rules which establish a $250 billion threshold for coverage and international standards under which banks with consolidated assets of $250 billion or more are subject to enhanced capital and leverage standards. While it may be appropriate to subject institutions to different capital and leverage standards based on asset size, applying the same thresholds to regulate incentive pay for employees — unique and individual assets — is arbitrary and creates inequity among institutions competing for talent.

II. Covered persons

The most stringent requirements of the Proposed Rule apply to senior executive officers (SEOs) and significant risk-takers (SRTs) of larger institutions. SEOs would include anyone who performs the functions of the president, CEO, executive chairman, COO, CFO, 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 of a major business line or control function. SRTs would include individuals who:

- Receive incentive pay equal to at least one-third of their salary plus incentive pay ("initial screen") *and*

- Meet either:
  - A "relative compensation test" (the most highly paid 5% excluding SEOs (for Level 1) or 2% excluding SEOs (for Level 2)) *or*
  - An "exposure test" (has authority to commit or expose 0.5% or more of the institution's capital)

Recommendation: The final rule should eliminate the relative compensation test.

We agree that an initial screen based on incentive pay as a percentage of salary plus incentive pay is appropriate. However, we recommend that the relative compensation test be eliminated.

We believe the Proposed Rule's primary purpose is to manage risk exposure and that pay (whether relative to other employees or as an absolute dollar level) shouldn't be a criterion for identifying SRTs. Instead, after the initial screen, SRTs should be those individuals who have the capacity to commit or expose a significant percentage of the institution's capital.

III. Definition of incentive-based compensation

The Proposed Rule defines incentive-based compensation as variable compensation, fees, or benefits that serve as an incentive or reward for performance, whether in the form of cash, equity, equity-like instruments, or any other form of payment. The preamble includes examples of compensation that wouldn't be considered incentive pay, including retention awards conditioned solely on continued employment and signing or hiring bonuses not conditioned on performance. However, it is not clear whether service-based cash and equity awards that are part of an institution's regular annual pay program would be covered.

Recommendation: The final rule should clarify whether ordinary course grants of service-based cash or equity awards are considered incentive-based compensation for purposes of the rule and, if yes, how the prescriptive provisions applicable to SEOs and SRTs at larger institutions would apply.

The Proposed Rule is ambiguous as to whether service-based awards that are part of an institution's regular annual pay program are "variable compensation … that serve as an incentive or reward for performance" or retention awards conditioned solely on continued employment. The final rule should be explicit as to whether such awards are included or excluded.

If the decision is made to treat service-based awards as incentive pay, the final rule should clarify how the provisions regarding downward adjustments during an award's performance period and mandatory deferrals after the performance period ends would apply to awards without a performance period. We recommend the following:

- Performance period: As service-based awards don't have a performance period, the provisions of the Proposed Rule that come into play during the performance period wouldn't apply.

- Deferral period: Awards subject to service-based vesting requirements would count toward minimum deferral requirements applicable to short-term incentive plans (referred to in the Proposed Rule as "qualifying incentive-based compensation"). Amounts would be subject to forfeiture during the deferral/vesting period.

- Clawback period: After awards are settled, they would be subject to the clawback provisions.

IV. Performance measures

The Proposed Rule would require *each* incentive pay arrangement to, among other things, include financial and nonfinancial performance measures and allow nonfinancial measures to override financial measures when appropriate. In addition, larger institutions wouldn't be able to provide incentive pay to any covered person based (i) on performance relative to peers unless the plan also incorporated absolute measures or (ii) solely on transaction revenue or volume without regard to transaction quality or compliance with sound risk management.

Recommendation: The final rule should:

- ***Allow long-term incentives to be based solely on financial measures.***

- ***Allow long-term incentives to be based solely on relative measures.***

If the restrictions are retained for both annual and long-term incentives, the final rule should consider all of an employee's incentive arrangements together rather than each arrangement separately.

A. General

Mercer believes institutions should have the flexibility to select measures that best fit their business objectives, while maintaining proper governance and risk processes. Prescriptive provisions on measure selection — particularly for long-term incentives — are unnecessary because other provisions in the Proposed Rule provide adequate protection against the risk that employees will be incentivized to manipulate financial results, including:

- The principles-based provision requiring that incentive pay be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures of financial and nonfinancial performance

- The downward adjustment, deferral, and clawback provisions applicable to SEOs and SRTs at larger institutions

If the requirements to use nonfinancial and financial measures and relative and absolute measures in long-term incentive plans are retained, we recommend that the final rule consider all incentive arrangements together and not each arrangement separately in determining whether there is an appropriate balance. For example, if an employee receives incentive pay based on a combination of financial and nonfinancial measures — even if through more than one plan — it would balance risk and rewards appropriately. Well-designed compensation programs should appropriately balance short- and long-term horizons, fixed and variable pay, and performance goals in total, rather than piecemeal. Attempting to balance each plan individually — particularly through the prescriptive provisions of the Proposed Rule — could result in employee behavior contrary to the overall strategic goals of the company.

B. Nonfinancial measures in long-term incentive plans

Many institutions use a combination of financial and nonfinancial measures in their annual incentive plans but use purely financial measures in their long-term incentive plans. Financial measures are often perceived to be more transparent and measurable, and for publicly-traded companies, receive better tax treatment under the Internal Revenue Code Section 162(m) cap on deductibility. Also, it may be difficult to objectively assess performance against long-term nonfinancial goals if, for example, the board members who approved the goals are no longer serving on the board when the performance period ends. Given the potential challenge to objective assessment, it might be hard to gauge the impact of nonfinancial measures on potential risk-taking behavior.

C. Relative measures in long-term incentive plans

Some institutions use purely relative measures in their long-term incentive plans. In some cases, it may be difficult for institutions to forecast and set goals over a multi-year timeframe with reasonable certainty. Also, some institutions may conclude that assessing results relative to peers is the best method to gauge performance while others have specific financial objectives that need to be achieved to carry out their strategy regardless of relative performance.

V. Incentive pay maximums

The Proposed Rule would limit the maximum payout for each incentive pay award to 125% of an SEO's target opportunity and 150% of an SRT's target opportunity. Institutions couldn't exercise discretion to increase an award above these caps, even in cases of extraordinary performance.

Recommendation: The final rule should eliminate the cap on maximum opportunities as a percentage of target awards.

Capping maximum opportunities as a percentage of target awards could have an unintended consequence of increasing target incentive pay opportunities at institutions where maximum opportunities for SEOs are frequently 150%-200%, which could adversely affect the alignment between pay and performance. According to a Mercer Global Financial Services Executive Compensation Snapshot Survey conducted in 2015, banks increased fixed (more or less guaranteed) pay by at least 5% (63% of organizations) and reduced variable pay by at least 5% (59%) in response to the variable to fixed compensation cap set out by CRD IV in the EU — rather than reducing aggregate pay.

The cap would also force companies that don't use a target approach to adopt one. (In our experience, many financial institutions don't establish target and maximum incentive opportunities. Instead they use bonus pools and allocate awards based on performance and comparisons to prior years.)

Finally, limits on maximum payments could adversely affect recruiting and retention efforts and, as described under "Performance measures" above, other provisions of the Proposed Rule provide adequate protection against excessive risk-taking.

VI. Deferrals

Under the Proposed Rule, SEOs and SRTs at larger institutions would be required to defer a minimum percentage of their incentive pay for a minimum deferral period. Deferrals would have to meet strict standards.

Recommendation: The final rule should eliminate the distinction between Level 1 and Level 2 institutions and:

- ***Adopt the minimums currently proposed for Level 2 institutions.***
- ***Clarify that equity awards can remain in the category of equity awards (vs having to be converted into a combination of cash and equity) during the deferral period.***
- ***Allow for acceleration on termination without cause and a change in control, and clarify that awards would be permitted to continue to vest upon other types of termination.***

A. Deferral period and amounts

Under the Proposed Rule, minimum required deferral amounts would range from 40% to 60% of total incentive pay, and minimum required deferral periods would range from one to four years as follows regardless of the length of the performance period:

Category	Minimum % deferred		Minimum deferral period	
	SEOs	SRTs	Short-term incentives*	Long-term incentives*
Level 1	60%	50%	4 years	2 years
Level 2	50%	40%	3 years	1 year

*The Proposed Rule refers to incentives with performance periods of less than three years as "qualifying incentive-based compensation" and those with performance periods of three or more years as "long-term incentive plans."

We recommend that the final rule eliminate the distinction between Level 1 and Level 2 institutions and apply the Level 2 proposed provisions to all SEOs and SRTs. This would create a more level playing field, be less complicated, and be more consistent with standards already adopted by most larger US banks.

B. Form of deferral

Under the Proposed Rule, incentive pay must be deferred in cash and "equity like" instruments. While no specific allocation is required, the preamble says the agencies expect "substantial amounts" (not defined) of both cash and equity and a balance between the two. How this requirement would apply to long-term incentives that consist solely of equity isn't clear.

We recommend that equity incentives be permitted to retain their character as equity awards during the deferral period, and that cash be permitted to retain its character as cash as long as there is an adequate balance between cash and equity in the aggregate.

The final rule should also provide examples as to what constitutes “substantial amounts” and an acceptable “balance”.

C. Accelerations

Under the Proposed Rule, institutions would be prohibited from accelerating deferrals in circumstances other than death or disability or if income taxes become due before vesting. However, it is unclear whether payments would have to be forfeited or could continue to be made over the deferral period.

In our experience, institutions often provide for acceleration or continued vesting on a termination of employment (particularly in the case of retirement or an involuntary termination without cause or for good reason) or a change in control. We recommend that the final rule clarify that payments of deferred amounts could continue to be made over the deferral period upon a termination of employment. During the deferral period, amounts would continue to be subject to any forfeiture provisions. In addition, we recommend that the final rule permit acceleration of deferrals upon a change in control if the successor employer refuses to assume the awards on an equivalent basis. These changes would allow employees to realize the value of awards they have already earned on the same basis as active employees. These amounts would continue to be subject to any clawback provisions.

VII. Clawbacks

Under the Proposed Rule, incentive pay arrangements must include provisions allowing recovery of vested incentive pay from current or former SEOs or SRTs for seven years after the award is settled.

Recommendation: The final rule should offset the length of the clawback period by the number of years an award is required to be deferred.

We recommend that the clawback period be reduced by the number of years an award is deferred. Under the Proposed Rule, when performance periods, deferral periods, and clawback periods are combined, awards could be at risk for as long as 12 years. We believe seven years following the end of the performance period should be enough time to uncover major problems, and would be consistent with the approach taken by the UK's Prudential Regulatory Authority in its July 2014 Policy Statement in response to public comment:

> "Some respondents were concerned about the cumulative impact of clawback in combination with deferral and/or similar policies, and the possibility that firms would be discouraged from adopting longer deferral periods as a consequence. The final rule therefore requires variable remuneration to be subject to malus and clawback for an overall period of seven years from the date of an award. This will make the period of clawback marginally longer in relation to the undeferred part of awards, but will reduce its application for most of the deferred portions. This amendment will enable firms to adopt longer deferral periods, lengthening the period subject to malus, but reducing correspondingly the period for which clawback applies. This is in line with the expectation that firms may wish to apply clawback only to the extent that the scope for malus is exhausted or deemed insufficient."

The following examples illustrate how this would work assuming our recommendations to eliminate the distinction between Level 1 and Level 2 institutions and apply the deferral percentages and time periods currently proposed for Level 2 institutions are adopted (50% deferred for SEOs, 40% for SRTs; minimum deferral of three years (short-term) and one year (long-term)):

- *Short-term incentive example:* Institution grants an SEO a short-term incentive with a one-year performance period:
  - 50% of the amount earned will be paid at the end of the performance period and be subject to a seven-year clawback period
  - 16.66% will be deferred for one year and be subject to a six-year clawback period
  - 16.66% will be deferred for two years and be subject to a five-year clawback period
  - 16.67% will be deferred for three years and be subject to a four-year clawback period
- *Long-term incentive example:* Institution grants an SEO a long-term incentive with a three-year performance period:

- 50% of the amount earned will be paid at the end of the performance period and be subject to a seven-year clawback period
- 50% will be deferred for one year and be subject to a six-year clawback period

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Thank you for the opportunity to comment on the Proposed Rule. Let us know if you have any questions or comments.

Regards,

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