MERIDIAN
COMPENSATION PARTNERS, LLC

July 22, 2016

Via Electronic Mail

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, DC 20551
Docket No. 1536
RIN No. 7100 AE-50

Legislative and Regulatory Activities Division
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Docket ID OCC-2011-0001; RIN 1557-AD39

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Attention: Comments, Federal Deposit Insurance Corporation
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RIN 3064-AD86

Alfred M. Pollard
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Attention: Comments/RIN 2590-AA42
Federal Housing Finance Agency
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Gerard S. Poliquin
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RIN 3133-AE48

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549
File Number S7-07-16
RIN 3235-AL06

Re: Notice of Proposed Rulemaking on Incentive-Based Compensation Arrangements (OCC Docket ID OCC-2011-0001 and RIN 1557-AD39; FRB Docket No. 1536 and RIN 7100 AE-50; FDIC RIN 3064-AD86; NCUA RIN 3133-AE48; FHFA RIN 2590-AA42; SEC File Number S7-07-16 and RIN 3235-AL06)

Ladies and Gentlemen:

Meridian Compensation Partners, LLC ("Meridian") appreciates the opportunity to respond to the Notice of Proposed Rulemaking and Request for Comment on Incentive-Based Compensation Arrangements (Proposal) by the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Credit Union Administration and the U.S. Securities and Exchange Commission (SEC) (collectively, the "Agencies").[1]

Meridian is one of the largest independent executive compensation consulting firms in North America. We provide trusted counsel to Boards and Management at hundreds of large public and private companies, consulting on executive compensation design issues, corporate governance matters and related disclosures. Our consultants have decades of experience in developing pay solutions that are responsive to regulators and shareholders, reflect good governance practices and align with company performance.

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[1] 81 Fed. Reg. 37,670 (proposed June 10, 2016).

Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") requires the Agencies to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at certain financial institutions (referred to as "covered financial institutions"). Specifically, section 956 of the Dodd-Frank Act requires that the Agencies prohibit any types of incentive-based compensation arrangements, or any feature of any such arrangements, that the Agencies determine encourage inappropriate risks by a covered financial institution: (1) by providing an executive officer, employee, director or principal shareholder of the covered financial institution with excessive compensation, fees or benefits; or (2) that could lead to material financial loss to the covered financial institution. Under the Dodd-Frank Act, a covered financial institution also must disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements sufficient to determine whether the structure provides excessive compensation, fees or benefits or could lead to material financial loss to the institution.

We appreciate the challenge associated with implementing regulations across such a broad range of financial institutions. The complexity of the proposed rules certainly illustrate the Agencies attempt to capture the different sizes, structures and risk profiles of the financial institutions they regulate. However, effective compensation programs need to support each financial institution's unique business strategy and pay philosophy within their own competitive market. The prescriptive approach in the Proposed Rule reduces such flexibility and may constrain financial institutions' ability to attract and retain the talent they need to prosper in an increasingly competitive market. The prescriptive rules included in the proposal could drive talent from the financial services industry and limit the large financial institutions' ability to attract talent necessary to fill critical emerging roles in areas such as cyber security and risk control, where talent may come from other industries not encumbered by such restrictions.

I. Meridian's Recommended Changes to the Proposed Rule

Appropriate and reasonable regulations and regulatory oversight of financial institutions serves the critical public interest of maintaining the safety and soundness of individual financial institutions and the health of the entire national financial system. We appreciate that the underlying goal of the Proposed Rule is to address this public interest in regards to the proper oversight and regulation of incentive-based compensation at covered financial institutions. However, given the progress that financial institutions have made in the area of incentive-based compensation, we believe that safety and soundness can best be ensured through a principles-based approach and that the prescriptive rules applicable to Level 1 and Level 2 covered financial institutions under the Proposed Rule are not required. Additionally, we believe the cost and administrative burden of the proposed prescriptive requirements could outweigh its benefit and that they may drive unintended consequences. Accordingly, the following summarizes Meridian's recommendations to the Agencies with regard to the Proposed Rule:

1. Retain a principles-based approach similar to that which has been in effect over the last six years since the Agency Guidance was published in 2010. The existing principles-based approach and oversight from regulators has proven effective at driving significant change, while allowing for the necessary flexibility for financial institutions (and their regulators) to assess pay programs in consideration of each institution's size, business complexity and risk profile.

2. If the Agencies choose to retain the prescriptive requirements for Level 1 and Level 2 covered financial institutions under the Proposed Rule, we would suggest those requirements be modified as follows:

    a. Modify the definition of Significant Risk-Taker to focus on covered persons who are actually engaged in risk-based activities. Large financial institutions have spent the past several years identifying employees who have the potential to expose the organization to material amounts of risk based on their actual job functions. The Proposed Rule does not consider the actual responsibilities of employees when identifying Significant Risk-Takers. The relative compensation test assumes that compensation and risk are directly correlated, but this is not always the case. The proposed definition will be cumbersome to implement and most importantly will not effectively identify risk-takers. Additionally, an overly broad group of employees will be captured in this definition creating potential for loss of talent for some business segments. In many cases, those captured in this definition will be different than those carefully identified over the past several years. The approach in the proposed rules may also result in disparate treatment for individuals with the same responsibilities in different organizations. If a prescriptive process as proposed is maintained, we suggest adding a threshold total compensation amount (such as $1,000,000) be added to prevent inclusion of lower-level employees who do not expose the organization to material amounts of risk.

b. Shorten the deferral period to one year for both annual incentive and long-term incentive awards and shorten the clawback period to three years from the end of the performance period. The multiple deferral periods create unnecessary complexity and the lengthy deferral and clawback periods (effectively up to 12 years) could hinder financial institutions' ability to attract and retain talent, or may require a compensation premium to do so.

c. Provide consistent and reasonable caps on maximum payouts under short-term and long-term incentive-based compensation arrangements to provide payout opportunities that are more reasonable and more closely aligned with market practice. Requiring a cap of 150% of target balances the need to effectively reward top performance with appropriately controlling the incentive to take risk. A consistent cap for both senior executive officers (SEOs) and significant risk-takers (SRTs) would also allow for uniform incentive design within an organization. This approach would also align with the designs currently approved by regulators at a number of large financial services companies today. The current limit of 125% for SEOs reduces the incentive potential compared to other financial institutions and other industries. In conjunction with deferrals, forfeitures and clawbacks, such a restrained cap seems unnecessary and overly restrictive.

3. We also suggest the following changes to the Proposed Rules that are generally applicable to all covered financial institutions:

   a. Limit the applicability of the requirements for all covered institutions to Covered Persons" whose incentive-based compensation exceeds $250,000. The Proposed Rule defines "Covered Person" as any executive officer, employee, director or principal shareholder who receives incentive-based compensation at a covered institution. The proposed definition is overly broad and by definition will include entry level personnel and their incentive programs, causing smaller institutions undue administrative burden and potentially lead to the elimination of some incentive plans, which we believe is not the intended focus for the Proposed Rules. Incentive plans with payouts less than $250,000 are unlikely to result in material financial loss.

   b. Eliminate the requirement that incentive-based compensation requirements must include financial and non-financial measures of performance. We support the concept that incentive payouts should include considerations of risk-taking, but this can be accomplished without requiring all plans to include both financial and non-financial measures. Many incentive plans throughout financial institutions do not have specific financial measures that drive payouts. We suggest an approach that requires consideration of risk-taking with the potential to reduce or eliminate payouts for inappropriate risk-taking without specifying that both financial and non-financial measures must be used.

II. Rationale for Modifying The Proposed Rule as Applicable to Level 1 and Level 2 Covered Financial Institutions

We believe that there are compelling reasons for the Agencies either to (i) adopt a principles-based rule equally applicable to all covered financial institutions in lieu of the prescriptive rules applicable to Level 1 and Level 2 covered financial institutions under the Proposed Rule or (ii) modify such prescriptive rules to mitigate their potentially adverse consequences on Level 1 and Level 2 covered financial institutions.

Set forth below is Meridian's rationale underlying our recommendations to the Agencies.

A. Covered Financial Institutions Have Already Made Significant Progress in Adjusting Pay Programs to Take Account of Risk Lessening the Need for Prescriptive Regulation

Large financial institutions have already made significant and material changes to their incentive-based compensation system motivated, in part, on current principles-based guidelines and supervisory work of Federal regulators. In this regard, the Agencies have expressed the following view on these changes:

"Prior to the recent financial crisis, many institutions had no effective risk adjustments to incentive-based compensation at all. Today, the Board has observed that incentive-based compensation arrangements at the largest banking institutions reflect risk adjustments, the largest banking institutions take into consideration adverse outcomes, more pay is deferred, and more of the deferred amount is subject to reduction based on failure to meet assigned performance targets or as a result of adverse outcomes that trigger forfeiture and clawback reviews."[2]

The Agencies further acknowledge this progress by citing to findings in the Board's horizontal review of large banking organizations.[3] The review's key findings are summarized below:

1. "Effective Incentive Compensation Design. All firms in the horizontal review have implemented new practices to balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.

2. Progress in Identifying Key Employees. All firms in the horizontal review have made progress in identifying the employees for whom incentive compensation arrangements may, if not properly structured, pose a threat to the organization's safety and soundness. All firms in the horizontal review now recognize the importance of establishing sound incentive compensation programs that do not encourage imprudent risk taking for those who can individually affect the risk profile of the firm.

3. Changing Risk-Management Processes and Controls. All firms in the horizontal review have changed risk-management processes and internal controls to reinforce and support the development and maintenance of balanced incentive compensation arrangements. Risk-management and control personnel are engaged in the design and operation of incentive compensation arrangements of other employees to ensure that risk is properly considered.

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[2] 81 Fed. Reg. 37675 (proposed June 10, 2016)
[3] Id.

4. Progress in Altering Corporate Governance Frameworks. All firms in the horizontal review have made progress in altering their corporate governance frameworks to be attentive to risk-taking incentives created by the incentive compensation process for employees throughout the firm. The role of boards of directors in incentive compensation has expanded, as has the amount of risk information provided to boards related to incentive compensation."[4]

5. Since the completion of the horizontal review, financial services institutions have made further changes to their programs under the current principles-based guidance. The horizontal review findings and the additional changes made by financial services institutions support the conclusion that a principles-based approach can be an effective means of accomplishing the stated objectives of section 956, without the potential pitfalls associated with the prescriptive approach of the Proposed Rule.

B. The Proposed Rule Would Impair the Ability of Covered Financial Institutions to Attract and Retain Top Talent

Covered financial institutions operate in a highly competitive environment for talent. This competitive environment is not limited to other covered financial institutions but includes both non-regulated financial institutions and non-financial firms. This is true for senior management employees who serve in functional positions, such as general counsel, chief financial officer, chief human resource officer, chief IT officer and the like. These employees possess skill sets that are highly transferable virtually across all industries. Traders, loan officers, underwriters, M&A specialists also possess skill sets that are highly sought by a broad variety of firms, including boutique investment and merchant banks, insurance companies, private lenders, hedge and equity funds, commodity firms and proprietary trading houses. Many financial institutions also include subsidiaries (e.g. insurance) that compete with companies that will not be covered by the Proposed Rule. These subsidiary employees would be covered by the Proposed Rule regardless of the level of risk their activities create for the institution creating potential competitive disadvantage for the financial institutions that have these business segments.

Given the keen competition for talent, covered financial institutions must maintain competitive compensation arrangements that will attract and retain a highly-talented but a highly-mobile work force. At large financial institutions, potentially thousands of employees will be impacted by the prescriptive requirements in the Proposed Rule. However, the following aspects of the Proposed Rule would substantially diminish the ability of Level 1 and Level 2 institutions to maintain competitive incentive-based compensation arrangements:

1. The mandatory deferral of a significant portion of short-term awards. Working with regulators, many financial services firms have reached an appropriate balance of immediate and deferred compensation through the use of long-term incentives, and the prescriptive approach of the Proposed Rule will require redefining what is considered annual and long-term compensation.

2. The mandatory deferral of a significant portion of long-term incentive awards. In the broader market, long-term incentives are generally viewed as immediately payable after the completion of a multi-year performance period.

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[4] Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations, Board of Governors of the Federal Reserve System (October 2011), p. 2.

3. Subjecting all vested incentive-based compensation awards to potential clawback over a seven-year period beginning on the date of clawback.[5] In the broader market, clawback policies are generally limited to a 3-year lookback period to the extent that they apply.

4. The limitation of maximum awards to 125% of target for SEOs and 150% of target for SRTs.[6] Outside of financial services, competitive market practice typically allows maximum payouts of at least 200% of target. Many large financial services firms have worked with their regulators to establish long-term incentive plans that cap payouts for all participants at 150% of target, and these have been viewed as effectively limiting the potential for excessive risk.

The Proposed Rule could cause an exodus of top talent at covered financial institutions, due to the previously described limitations, conditions and uncertainty placed on SEO's and SRT's incentive-based compensation arrangements. Similarly, the Proposed Rule will make it challenging for the industry to attract new talent. Holding all other considerations equal, there would be a significant disincentive for an individual to join or remain at a covered financial institution under the foregoing circumstances if a non-regulated entity offered the same dollar value incentive package.

C. <u>The Proposed Rule Could Result in Unintended Consequences</u>

If the Proposed Rule was adopted, covered financial institutions would likely modify SEO and SRT compensation packages to offset in whole or in part the adverse effects of the Proposed Rule. These modifications could include one or more of the following:

1. Increase in base salary and/or target incentive opportunity to offset reduction in maximum award opportunity.

2. Increase in the proportion of long-term incentive compensation granted in the form of non-performance-based equity awards (e.g., restricted stock units) to mitigate the effect of the deferral requirement.

3. Increase in the proportion of total compensation paid in the form base salary to mitigate the effect of the deferral requirement.

4. Increase in total compensation to reflect and mitigate potential risk of loss.

These changes, individually and collectively, would run counter to the current pay philosophy of aligning pay for performance, particularly for SEOs and SRTs. In addition, these changes would increase a covered financial institutions' fixed compensation costs. However, faced with the prospect of a potential exodus of high-performing senior employees due to the implementation of the Proposed Rule, covered financial institutions would be required to modify pay packages to head-off such an exodus.

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[5] The prevalence of clawback policies has increased dramatically over the past five years among publicly-held corporations. At Fortune 100 companies well over 90% maintain a clawback policy. However, the majority of clawback policies apply to key executive and employees. Only a relatively small minority of such clawback policies apply to all employees. Further, clawback periods are generally limited to a 3-year period.

[6] The prescribed maximum target opportunity for SEOs falls well-below competitive market practice, which typically is at least 200% of target in general industry.

We appreciate the opportunity to comment on the Proposed Rule implementing Section 956 of the Dodd-Frank Act. We welcome the opportunity to discuss our comments further with you at your request.

Sincerely,

Meridian Compensation Partners, LLC

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