McLAGAN FACT-BASED ADVICE | AON Hewitt

199 Water Street
12th Floor
New York, NY 10038

T 212.441.2000
F 212.441.1967
www.mclagan.com

May 31, 2011

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington, D.C. 20219
Docket Number OCC-2011-0001

Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket Number R-1410
RIN Number 7100-AD69

Robert E. Feldman, Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN Number 7100-AD69

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW.
Washington, DC 20552
Docket Number OTS–2011–0004

Dear Sirs and Mesdames:

McLagan is providing this letter with our comments on the proposed rule addressed under "Incentive-Based Compensation Arrangements" as called for under Section 956 of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and published in the Federal Register on April 14, 2011.

Thank you for considering our comments in finalizing this important new regulatory framework. Please do not hesitate to contact either Todd Leone or Gregory Loehmann at the numbers provided below.

Regards,

Todd A. Leone
Principal
Office: 952.893.6711
Mobile: 952.456.1048
todd.leone@mclagan.com

Gregory Loehmann
Vice President
Office: 212.441.2163
Mobile: 347.302.4774
gloehmannn@mclagan.com

<u>Proposal</u>: [p.21174, Overview of the Proposed Rule] The Agencies propose to make the terms of the Proposed Rule, if adopted, effective six months after publication of the final rule in the Federal Register, with annual reports due within 90 days of the end of each covered financial institution's fiscal year.

> **<u>McLagan Comment</u>**: We recommend the final rule explicitly state that, for purposes of the annual reporting requirement, the first annual reporting period be any <u>*fiscal year ending at least six-months after*</u> the publication of the final rule. For example, if the final rules are published September 30, 2011, the annual reporting requirement would be for an institution whose fiscal year end occurs after March 31, 2012. In this case, an institution with a calendar year fiscal year would have their first annual reporting requirement due by March 31, 2013, for their 2012 fiscal year.

<u>Proposal</u>: [p. 21175, Executive Officer]: The Proposed Rule defines ''executive officer'' of a covered financial institution as a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line. The Agencies seek comment on whether the types of positions identified in this proposed definition are appropriate, whether additional positions should be included, or if certain positions should be removed. Should the Agencies define ''head of a major business line?''

> **<u>McLagan Comment</u>**: If the final rule continues to include a list of positions in the executive officer definition, we recommend that "chief credit officer" be included in the list. In addition, we do recommend that "head of a major business line" be defined within the final rule. In determining the definition of a head of a major business line we recommend that the Agencies provide asset and/or revenue threshold levels for the determination of a major business line as well as factors relative to overall risk that will aid in determining if a business line is a "covered" major business line for purposes of the final rule. For example, a business line may have a certain level of assets, for example, over $10 billion; however, the business line may not have any "risk" to the organization from an overall credit perspective, i.e., no long-tail risks. To facilitate a common understanding, we recommend that the Agencies provide examples of executive officer lists for both a typical large banking organization (over $50 billion) and small community bank ($1 to $10 billion in assets).

<u>Proposal</u>: [p. 21175 Incentive Compensation] Consistent with section 956 of the Dodd-Frank Act, the Proposed Rule would apply only to incentive-based compensation arrangements. The Proposed Rule defines ''incentive-based compensation'' to mean any variable compensation that serves as an incentive for performance. Comment is also requested on the following questions: Are there any other forms of compensation that the Agencies should clarify are not incentive-based compensation?

McLagan Comment: We recommend that nonqualified deferred compensation arrangements be excluded from this proposal. When we discuss nonqualified deferred compensation we refer to defined contribution or defined benefit nonqualified arrangements which are based upon either a fixed benefit amount, or a benefit based solely upon base salary and the passage of time.

Proposal: [p. 21176:21177 Required Reports] [(1) clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements applicable to covered persons, (2) a succinct description of policies and practices for governing said arrangements, (3) for larger institutions specific descriptions of arrangements for executive officers and other covered persons identified by the board, (4) any material changes to said arrangements and (5) specific reasons why the institution believes the arrangements to not encourage inappropriate risk by providing excessive compensation or arrangements that could lead to material financial loss.] The Agencies request comment on all aspects of the reporting provisions in the Proposed Rule. Specifically, the Agencies request comment on the following: Is the language in the Proposed Rule sufficiently clear in describing the kinds of information the Agencies intend to solicit from covered financial institutions? Are there simpler and less burdensome methods of reporting to the Agencies that would still be sufficiently robust to help the Agencies assess whether the institution's compensation arrangements appropriately balance risk and financial rewards? For example, would setting up an electronic means of filing the required disclosure lessen the burden on covered financial institutions, and are there specific factors the Agencies should consider in developing such a disclosure mechanism?

McLagan Comment #1: We recommend that there be further clarification relative to (1) under this section specifically related to "A clear narrative description of the components of the covered financial institution's incentive-based compensation arrangements…" In particular, how are the Agencies defining "components?" Do the Agencies desire an enumerated list of each incentive-based compensation arrangement for each covered person or covered group? Or in contrast, do the Agencies desire a list of the types of compensation vehicles that are being used for covered persons or covered groups, e.g., we use annual cash incentives, long-term cash incentives and annual restricted stock?

McLagan Comment #2: We recommend clarification regarding the reporting of incentive compensation plans that are for one person. It is not clear how covered institutions should approach such plans given the prohibition on disclosing individually based information. This would include, for example, an employment agreement that covers one individual who is a covered person.

McLagan Comment #3: We recommend that the Agencies develop an electronic means for covered institutions to fulfill requirement (1) under this section of the proposed rule. The electronic means would provide for a covered institution to list the various incentive compensation arrangements that are required to be submitted. This submission should provide for a consistent set of descriptors including but not limited to the following for each incentive compensation arrangement: name of plan, type of plan (cash, equity, agreement, nonqualified benefit plan), number of individuals covered, types of individuals covered as well as if there were any material changes in the previous fiscal year. This will ensure a common set of submissions on this requirement of the proposed rule. This is similar to what the Treasury requested under the Special TARP Master Review of Past Compensation Payments as of March 23, 2010.

Proposal: [p. 21178 Excessive Compensation] The Proposed Rule would establish a general rule that a covered financial institution must not establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the covered financial institution by providing a covered person with excessive compensation…. Specifically, under the Proposed Rule, incentive-based compensation for a covered person would be considered excessive when amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed by the covered person. The Agencies request comment on these standards, including comment on the appropriate factors to consider when evaluating comparable compensation practices at comparable institutions. Should additional factors be included, such as the nature of the operations at the comparable institutions?

McLagan Comment #1: We recommend that the Agencies provide further clarification with respect to standards that it will utilize to determine what is explicitly "excessive". In particular, given the nature of market analyses, some institutions will be at the upper end of the analysis. Thus how will an organization determine a consistent set of rules that the Agencies regulators will utilize to determine what is excessive. For example, will an institution which is at the 75th or 90th percentile of the market automatically be viewed as potentially excessive solely as a result of a statistical distribution of data? Clarification and examples of the evaluation rules will help provide a common understanding among covered institutions and it will help set a consistent set of enforcement rules among the Agencies field regulators.

McLagan Comment #2: If the Agencies determine that a compensation arrangement is deemed excessive, how will it move to address the arrangement if it is embodied in a legally binding contract between the institution and the covered employee? What legal basis will be utilized for enforcement of a change in a legally binding contract that is embodied in contract law?

Proposal: [p. 21178 Inappropriate Risks that May Lead to Material Financial Loss] …Accordingly the Agencies have considered the language and purpose of section 956, existing supervisory guidance that addresses incentive-based compensation arrangements that may encourage excessive risk-taking, the Principles for Sound Compensation Practices and the related Implementation Standards adopted by the Financial Stability Board, and other relevant material in considering how to implement this aspect of section…. Such covered persons include: Executive officers and other covered persons who are responsible for oversight of the covered financial institution's firm-wide activities or material business lines; Other individual covered persons, including non-executive employees, whose activities may expose the covered financial institution to material financial loss (*e.g.*, traders with large position limits relative to the covered financial institution's overall risk tolerance); and Groups of covered persons who are subject to the same or similar incentive based compensation arrangements and who, in the aggregate, could expose the covered financial institution to material financial loss, even if no individual covered person in the group could expose the covered financial institution to material financial loss (*e.g.,* loan officers who, as a group, originate loans that account for a material amount of the covered financial institution's credit risk).

> **McLagan Comment**: Our comment relates to clarification relative to how covered persons will be classified by the Agencies. How will the Agencies evaluate inherent versus residual risk of covered persons, specifically groups of individuals who in aggregate could expose the covered financial institution to material financial loss? How will the Agencies evaluate if a group of employees is covered with respect to inherent versus residual risk? If the group of employees has sufficient control mechanisms on their risk-based activity such that the group cannot by itself pose risk to the institution, based on residual risk concepts, will this group be a "covered group". Examples are requested to ensure there is consistency within the covered institutions as well as consistency among the Agencies in applying this important standard.

Proposal: [p. 21179 Risk-Adjustment of Awards] Under this method of making a covered person's incentive-based compensation appropriately risk-sensitive, the amount of the person's incentive-based compensation award is adjusted based on measures that take into account the risk the covered person's activities pose to the covered financial institution….The greater the potential incentives that an arrangement creates for a covered person to increase the risks borne by the covered financial institution, the stronger the effect should be of the methods applied to achieve balance.

> **McLagan Comment**: The proposal discusses risk-adjustment of awards and specifically how the award can be reduced if risks are realized with respect to losses. A question to the Agencies is, what if over the long-term the risks are less than anticipated, should the awards be reviewed for potentially upward revision? The proposal is explicitly focused on reducing long-term risk vis-à-vis negative adjustment to awards. However, this is also a one-sided risk discussion with respect to negative adjustments. What if the organization manages its risks over a long-period of time such that actual results are better than anticipated? Should the award be reviewed for positive adjustments as the covered person achieved a better than expected result relative to both risk and long-term profit?

Proposal: [p. 21181 Special Review and Approval Requirement for Other Designated Individuals] … Is it sufficient that, as under the proposal, such covered persons are not subject to mandatory deferral but instead are separately identified by the institution's board and the board is required to approve the incentive-based compensation arrangement for the covered person after ensuring it is balanced and sensitive to risk? Should further guidance be provided as to the meaning of the phrase ''substantial in relation to the institution's size, capital, or overall risk tolerance?''

> **McLagan Comment**: We do believe that it is sufficient that the institution's board approve the incentive-based compensation arrangement for the covered person. However, we do recommend that the Agencies provide further clarification with respect to "substantial in relation to the institution's size, capital, or, overall risk tolerance." We request that clarification be provided so that this phrase is not a subjective term that is interpreted differently by the Agencies as well as the covered institutions.