July 22, 2016

Submitted electronically via the Federal Rulemaking portal @ www.regulations.gov

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Attention: Comments
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Attention: Comments / RIN 2590-AA42
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Proprietary & Confidential

Dear Sir or Madam,

Subject: Proposed Rules Relating to Implementation of Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)

McLagan, a business unit of Aon plc, appreciates the opportunity to submit for consideration our comments relating to the solicitation by the joint agencies for comments on the proposed rules under Section 956 of Dodd-Frank.

Aon Hewitt is the world’s preeminent human resources consulting and outsourcing firm with the resources, expertise, and global reach to solve the most pressing and complex people challenges that organizations face today. McLagan, a subsidiary of Aon Hewitt, is the leading Performance / Reward consulting and benchmarking firm for the financial services industry. We work across the financial services industry representing virtually all of the joint agencies’ identified Level 1 and Level 2 banking organizations and approximately 1/3 of the Level 3 banking organizations. Interaction with these groups forms the basis for our comments within this letter.

We hope the joint agencies find our observations and recommendations useful in developing final rules. Our comments are limited to those sections of the Proposed Rules that we believe have the most significant implications across the industry.

Sincerely,

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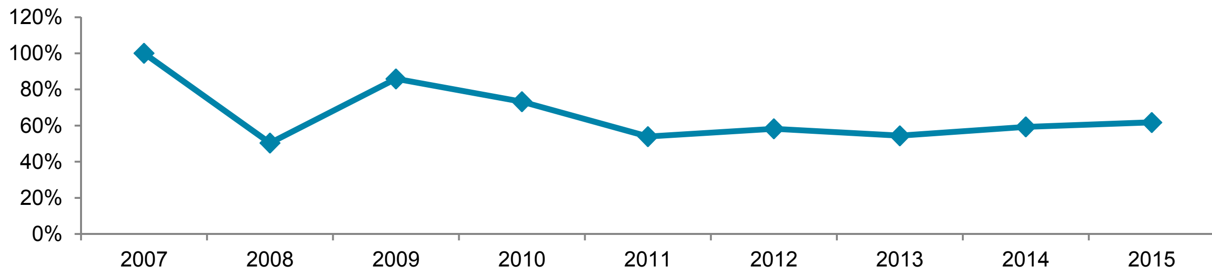
Overview

Since the global financial crisis, regulatory bodies around the globe have taken varying approaches to implementing oversight and governance of incentive compensation arrangements in the financial services industry. While some international regulators have approached compensation governance through specific rules and requirements, the United States regulators have taken a thoughtful, principles-based position (e.g., Sound Incentive Compensation Policies or "SICP"). The principles have focused on balancing incentive compensation arrangements against the potential risks that may be incented. In order to achieve balance, the principles emphasize strong risk processes, controls, and integrated corporate governance frameworks as well as compensation adjustments for risk events. The principles-based approach has resulted in significant changes to the way incentive compensation is designed, approved, delivered, and governed within the banking sector. Evidence of these changes can be found through:

- Enhanced involvement of control functions in assessing incentive design and risk
- Significantly higher levels of pay deferred over time
- More deferred compensation in the form of performance units
- Decreased leverage in incentive plans and a dramatic decrease in the use of stock options
- The use of broader forfeiture and clawback provisions
- Increased board oversight for senior executive compensation
- Increased board oversight for all incentive-based compensation arrangements for employees who have the ability to expose the firm to risk

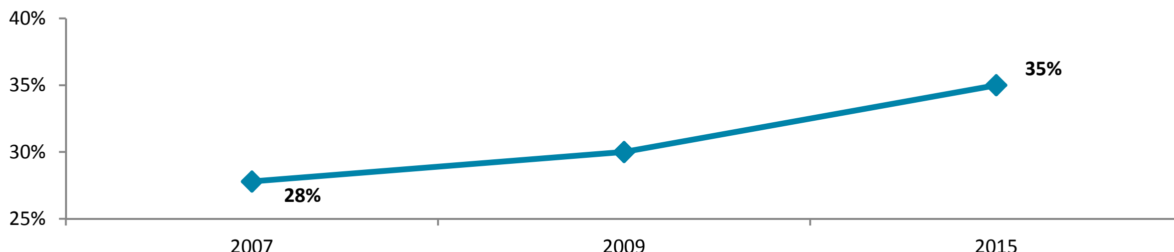
Pay Levels have been reset. As shown in the following example of managing directors (MDs) from Level 1 firms, total compensation is down approximately 40% since 2006 / 2007:

Total Compensation – Managing Director Banking & Capital Markets



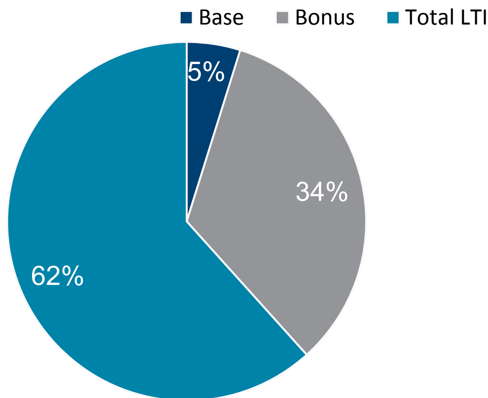
Furthermore, deferrals have increased at these same firms, despite less pay (data from McLagan's proprietary database:

Deferral as a % of Total Incentive (~$1 million Tcomp)

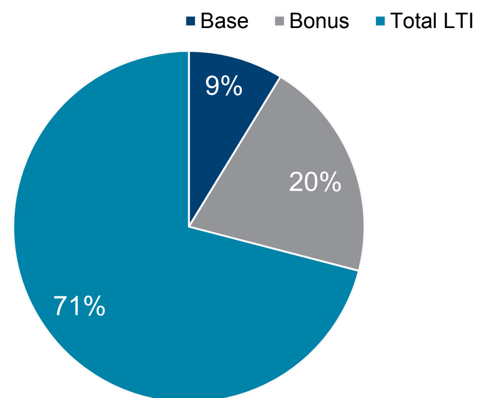


For CEOs, on top of reduced pay levels, data collected from public proxy statements (as reported) Fshows a marked change to pay mix, i.e., less in the form of immediate cash and more in the form of long-term incentives.

Level 1 Pay Mix - 2006

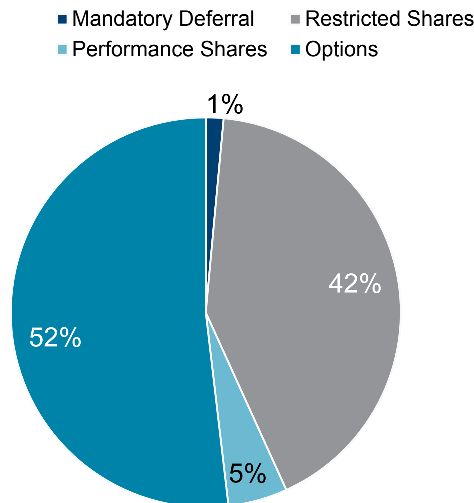


Level 1 Pay Mix - 2015

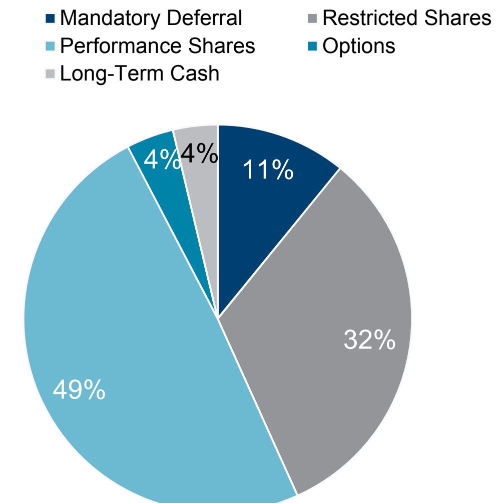


When looking more closely at CEO long-term incentives over this time period, we also see a significant change in the abandonment of stock options in favor of performance shares:

Level 1 LTI Mix - 2006



Level 1 LTI Mix - 2015



The financial industry has made significant changes to mitigate compensation designs that, historically, may not have fully accounted for risk. However, the critical question is whether additional restrictions on compensation will bring greater risk to the overall financial system by discouraging talent from remaining in the industry? We suggest the proposed rules, left unadjusted, would potentially result in the inability to attract and retain key individuals when, for many of them, there will be better opportunities among other non-regulated financial services firms and non-regulated industries. Given the significant improvements the banking industry has made in developing compensation programs that balance risk and reward, we

strongly encourage the joint agencies to both continue to leverage a principles-based approach in the implementation of Section 956 and to apply that approach to the broader financial industry.

Our comments focus on three primary areas that we believe have significant implications for the industry and / or carry a significant compliance burden as proposed:

- The approach for identifying covered persons and risk-takers across all firms
- Key compensation design elements to apply to the identified risk takers
- Recordkeeping requirements

Lastly, we request some areas of clarification; mainly, the intended interplay of 956 with current regulatory oversight, legal, accounting, and taxation laws.

Identification of covered persons

Risk-based framework

The current proposal does not fully consider the riskiness of each role and may miss some risk taking functions while simultaneously impacting functions that do not expose the firm to material risk, e.g. cyber security or financial advisors. Working with their primary regulators, the large banks have leveraged the key principles outlined in both the SICP regulatory guidance as well as the 2011 proposed Section 956 rules to develop a methodology for identifying individuals in specific roles that individually, identified as Category 1 and 2, or in the aggregate, Category 3, e.g., commercial lenders, could pose risk to the institution. For individuals identified, their incentive compensation is generally subject to heightened controls, increased deferrals, and broader forfeiture / claw-back provisions. Therefore, these firms and their primary regulator have already made a significant investment in developing methodologies and systems to support the identification of risk by individual role and responsibilities. The resulting outcome has been that Category 1, 2, and 3 employees within these institutions have had impactful changes made to how their compensation is decided and ultimately delivered.

Suggested Approach

Consolidated approach for Senior Executive Officers (SEOs)

The current proposal would require SEOs be identified by legal entity, e.g., both the enterprise CFO and a CFO of a subsidiary would be SEOs based on title. In some cases, a non-enterprise SEO position would not even qualify as a Significant Risk Taker (SRT) under either the Relative Compensation or Exposure Tests. In addition, it could be argued that subsidiary titles, such as CFO, may be less relevant as the person may or may not be in an actual policy making position and compensation will certainly be significantly different from an individual with the identified title at the enterprise-wide level. Therefore, we suggest a consolidated approach where the title of SEO is reserved for a person holding the title at the enterprise level; affiliate individuals with the same title would then get captured, if at all, as an SRT.

Redefine “Covered Employee”

Given that the focus of Section 956 is to ensure that effective controls are in place so that incentives do not encourage excessive risk-taking, we feel that having a risk-based framework as the foundation for identifying covered individuals and the incentive arrangements in which they participate is essential. Therefore, we strongly encourage the agencies to consider leveraging the existing approach that the large banks have developed and implemented since 2010. The covered employee process results in identified individuals that have been assessed on a role by role basis against the risks they might pose to the individual institution, which can be unique and vary by firm. The determination of the roles / individuals

that are covered would be subject to approval by a firm's regulator. Utilizing this approach would also eliminate the need for and complexities of the Exposure Test.

Relative Compensation Test

Compliance burden

For institutions with tens and hundreds of thousands of employees, identifying the top 5% (Level 1) or 2% (Level 2) could be challenging as current systems and processes have not been built to calculate incentive-based compensation as defined by the proposed rules. We also believe the proposed Relative Compensation Test, without any additional qualifiers, will result in fluctuations of persons in and out of the deferral requirements year over year. This will result in peers who make similar amounts and may take on equal risk being treated differently.

Implications

The construct of the Relative Compensation Test has significant implications for firms based upon business mix and the firm's resulting employee population. For firms with significant retail operations, the top 5% / 2% may impact employees making significantly less than their 5% and 2% counterparts at other institutions. Additionally, it seems counterintuitive that the 5% / 2% may miss certain positions that take on risk and pick up others that are paid to mitigate risk and have very limited risk profiles.

Suggested approach

We believe our proposed definition of a covered employee should serve as the starting point for the Relative Compensation Test and include a compensation threshold to lessen the compliance burden and other implications mentioned above. We propose, as an example, excluding anyone in the top 5% / 2% of covered employees that makes less than $1 million in total compensation, adjusted for inflation. By creating a compensation threshold above which an SRT must earn, the rules would alleviate the implication of employees being subject to significant compensation deferrals when their overall level of pay is not excessive.

If the agencies choose to disregard our covered employee definition, we recommend that firms be allowed discretion to carve out certain employees who were identified by the relative compensation test. Covered institutions should be given the opportunity to demonstrate to their regulator that such individuals should not be viewed as significant risk-takers due to their inability to expose the covered institution to material amounts of risk. This need becomes most acute when considering certain positions where the inability to attract and retain carries more risk than the inherent risk of the role itself, e.g., cyber security or financial advisors. This approach helps eliminate the additional risk to the industry that may occur if these key individuals choose to leave critical roles to work for non-financial services / non-regulated competitor firms where significant compensation restrictions are not imposed.

Exposure Test

Compliance burden

The Exposure Test's proposed 0.5% threshold of Tier 1 capital based on daily limits is both impractical and inconsistent with existing practices in the banking industry. Firms do not use market or lending authority in the way in which the proposed rules are articulated, i.e., by having a limit set on an annual basis for an individual in a lending capacity. In addition, it would be incredibly complex to apply this on a legal entity by entity basis as businesses are instead run by business units and divisions, some of which may contain multiple legal entities. A firm might have 30 legal entities that make up one division or business with individual employee roles having involvement with several legal entities.

Implications

The test does not differentiate by the risk profile of the asset / transaction and has the ability to pick up employees that have approval authority with no impact on risk. For example, an individual with the authority to approve capital purchases for the firm would automatically be an SRT if an annual limit were not instituted. Additionally, the proposed exposure test provides for an unequal application to covered firms and it specifically negatively impacts smaller firms who have a lower Tier 1 capital base. For example, on average 0.5% of Tier 1 for Level 1 and 2 firms is approximately $450 million and $50 million, respectively. For Level 2 firms the $50 million level equates to approximately $192,000 of a daily loan limit for a commercial or residential lender. This has the effect of capturing significantly more Level 2 firm employees solely due to construction of the rule.

We recommend removal of the Exposure Test as risk facts and circumstances should be assessed by role. A one-size fits all requirement cannot account for the variances in operational policies and procedures that exist on a firm by firm basis. The aforementioned covered employee assessment process does just that and eliminates the need for an additional exposure test. However, if the joint agencies believe the proposed exposure test is the most appropriate approach, we ask for a more detailed example of how it might actually work in practice.

Compensation Design Components

Forfeiture / Clawback Timeframe

Suggested approach

As the rules are currently stated, for a Level 1 firm, a SEO or SRT may have to wait 12 years until a long-term incentive is free of all restrictions – for example, a three year long-term incentive arrangement, a two year mandatory deferral, plus a seven year clawback. This time horizon seems excessive due to the fact that empirical evidence suggests that a typical business cycle in the United States is generally 5 - 6 years.[1]

We would recommend a seven year timeframe from the pay date for annual cash and the grant date of long term / deferred compensation where forfeiture and clawback provisions would apply. This timeframe aligns to the recordkeeping requirement being proposed and ensures that firms have sufficient documentation on record for use in making the forfeiture / clawback determination. The seven year time period also aligns to the rules in the United Kingdom where the seven year clawback applies from the grant date and can be extended to 10 years only if triggered by an ongoing investigation.

Examples

Level 1 Firm: Cash / time based equity deferral with a performance year of 2015

The immediate cash payout has a seven year clawback while the deferred cash is subject to forfeiture over the four year vesting period (100% in year one, 75% in year two, 50% in year three, 25% in year four). Once a tranche of the deferral vests (and is no longer subject to forfeiture), it would remain eligible for clawback through the original seven year period prescribed to the immediate payout.

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[1] *According to the National Bureau of Economic Research, there have been 11 business cycles from 1945 to 2009, with the average length of a cycle lasting about 69 months, or a little less than six years. The average expansion during this period has lasted* ***58.4 months****, while the average contraction has lasted only* ***11.1 months****.*

	Immediate Payout	Deferral			
2015	--	Tranche 1	Tranche 2	Tranche 3	Tranche 4
2016	Clawback	Forfeiture	Forfeiture	Forfeiture	Forfeiture
2017	Clawback	Clawback	Forfeiture	Forfeiture	Forfeiture
2018	Clawback	Clawback	Clawback	Forfeiture	Forfeiture
2019	Clawback	Clawback	Clawback	Clawback	Forfeiture
2020	Clawback	Clawback	Clawback	Clawback	Clawback
2021	Clawback	Clawback	Clawback	Clawback	Clawback
2022	Clawback	Clawback	Clawback	Clawback	Clawback

Level 1 Firm: LTIP with a 2016 grant date, in line with the award above

100% of the LTIP is subject to forfeiture during the three year performance period. The immediate payout at the end of the performance period would then be subject to clawback for an additional four years. The mandatory deferral is subject to forfeiture over the two year vesting period, 100% in year 1 and 50% in year 2. Once a tranche of the deferral vests and is no longer subject to forfeiture, it would remain eligible for clawback through the original four year period prescribed to the immediate payout.

		Immediate Payout	Deferral	
2015	Performance Period	--	Tranche 1	Tranche 2
2016	Forfeiture	--	--	--
2017	Forfeiture	--	--	--
2018	Forfeiture	--	--	--
2019	--	Clawback	Forfeiture	Forfeiture
2020	--	Clawback	Clawback	Forfeiture
2021	--	Clawback	Clawback	Clawback
2022	--	Clawback	Clawback	Clawback

Open-ended Forfeiture / Downward Adjustment

Suggested approach

As proposed, the forfeiture and downward adjustment process does not have an explicit time period or stated limit. In theory, a review could be triggered by a regulatory matter with roots in activities or behaviors that occurred ten years prior and for which all compensation paid for that activity has already vested. To effectively accomplish the joint agencies' principle that the level of compensation earned should be aligned to the performance and risk taken, an alternative approach would be to limit the value of compensation that is forfeited for an adverse risk outcome to the amount of compensation awarded for the year in which the event took place. This approach would ensure that the forfeiture is appropriately linked to compensation that was awarded for the performance that resulted in the adverse risk event. Additionally, having an open-ended timeframe for forfeitures is excessive. Therefore, the time frame for the forfeiture would be limited to the seven year forfeiture / clawback timeframe previously discussed.

This alternative approach is an effective way to ensure that compensation is aligned to the risks taken to earn that level of pay.

We propose a simplified approach to more closely align compensation impacts on incentive compensation to the performance period for which it was earned:

- A review for forfeiture / downward adjustment can only occur if the violation event occurred within the last seven years, aligned to clawback and record keeping requirements
- If an adjustment is recommended, it can be no greater than the incentive amount actually paid for the performance year in which the violation event occurred
- The adjustment can be in the form of a reduction to in year pay or forfeiture of any unvested equity, i.e., unvested amount does not have to align to the performance year in which the violation event occurred
- In some cases, upon review of the facts and circumstances, a company may decide that no compensation impact is necessary – the rules should explicitly state this to be an acceptable outcome when documented appropriately
- Also, in some cases, termination of employment may be recommended which will cause the employee to forfeit any current year incentive compensation as well as all unvested deferred incentive compensation; we believe this should also be acknowledged as an acceptable outcome

Forfeiture / Downward Adjustment Impact on Equity Accounting

Suggested approach

Under the proposal, a Long-Term Incentive plan must be eligible for downward adjustment while the awards are being earned. Given that the list of items that could trigger a downward adjustment is not formally defined, there is not a grant date under the Financial Accounting Standards Board's accounting for stock compensation ("ASC") topic 718. For example, given the undefined nature of events triggering a downward adjustment, there can be no mutual understanding of the key terms by both the employer and the employee. This lack of a mutual understanding could result in firms being prohibited from utilizing equity-based accounting. The result is a change to mark-to-market accounting treatment for equity compensation which could result in significant fluctuations in the quarterly financial results that firms must report. Given the significant impact the proposed rules may have on firms that use equity-based accounting for a material portion of their employee population, we suggest modifying this proposal to allow each firm to work with their primary regulator to develop a finite list of events that could trigger a downward adjustment in order to preserve equity-based accounting treatment. It is also important to note that the equity would still be subject to forfeiture or clawback after the initial vesting period.

Acceleration of Vesting

Suggested approach

The proposed rules limit the acceleration of vesting of long-term and deferred compensation to the events of death or disability only. The rules indicate this limitation is appropriate due to a concern that in current practice an individual may be able to influence the timing of the acceleration. However, we would argue that there are several other events when an individual does not have the ability to influence acceleration (e.g., involuntary termination, change in control, and required/mandated divestitures as is typically required with transition to government service). Additionally, in certain international jurisdictions, taxation occurs at grant and prohibiting the acceleration of vesting to cover this tax liability is burdensome on the recipient of the award. Furthermore, the current proposal runs counter to current practice across all

industries[2] which could result in a competitive disadvantage for covered firms in recruiting and retaining talent. Not to mention these practices are memorialized in legal documents, i.e., equity plans, award agreements, and change in control contracts. Given the proposed rules impose a seven year clawback on all incentive compensation earned at a covered firm, accelerating the vesting of unvested compensation does not materially affect the firm's ability to recover compensation if an adverse risk outcome is identified post termination / change in control. Allowing equity vesting to be accelerated in the event of these additional circumstances aligns with the joint agencies view that individuals should not have influence on the event resulting in the acceleration.

Volume-based Incentives

Implications

The proposed rules prohibit covered institutions from using transaction or revenue volume as the sole performance measure in determining an individual's incentive award. Firms would be required to have additional metrics included in the plan to consider risk. Given that certain roles do not expose firms to material risk, it may not be practical to include a risk balancing metric within the plan. For example, employees responsible for processing checks earn an incentive based upon the volume of checks that they are able to process accurately. Under the current construct of the proposed rules, this type of efficiency-based incentive would be prohibited. Additional roles that are typically compensated based upon volume are call center representatives and customer support specialists. Firms typically use volume driven plans for these types of roles as a way to drive cost efficiencies within their organization. Given the intent of 956, to ensure effective balancing of risks, the prohibition should not apply to roles that do not expose firms to material risk.

Limitation on Leverage

Implications

The proposed rules impose limitations on the amount of leverage that can exist within target-based incentive plans to either 125% or 150% depending on whether an individual is an SEO or SRT, respectively. This creates potential for an SRT to out-earn an SEO based on the additional leverage, yet be required to defer less. In addition, it may deter qualified employees from wanting to step into an SEO role.

Suggested approach

If required, we believe the limitation should be applied consistently throughout a firm's employee population and should be 150%. The difference between 125% and 150% is negligible when considering all of the other safeguards, i.e., better governance processes, control function engagement, deferrals, and forfeiture / clawback provisions. Also, by having a single limit on leverage, employees participating in incentive plans with targets are not impacted by changing roles.

Substantial Portions of Deferred Cash and Equity

Suggested approach

We recommend that the deferral and substantial portion be measured at the aggregate level of incentive compensation, rather than on a plan-by-plan basis. It is incredibly complex to award in cash and equity on a plan-by-plan basis. Therefore, in terms of meeting the requirements, we recommend including the

[2] *Aon Hewitt analysis of 247 firms with restricted stock – 87% of these firms provided some form of acceleration upon a change in control.*

current year target value of LTI. The following example shows how it might work for a CEO at a level 1 firm that simultaneously received a $6 million incentive payout for the prior performance year and a $2 million LTI award at target (total of $8 million):

	Hypothetical Payout Components	Hypothetical Payout Amounts
	Immediate Payout (Cash)	Up to 40% of the $8m or $3.2 million
	Total Deferral	At least 60% of the $8m or $4.8 million
Deferral Components	Deferred Cash	$1.8 million or 37.5% of the deferral
	Time-based RSUs	$1 million or 20.833% of the deferral
	3 Year LTI @ Target	$2 million or 41.667% of the deferral

In the example, when earned, the three year LTI would still be subject to the 60% deferral for two years, however, per the above, we recommend it not carry the requirement of being settled in both cash and stock; if a three year LTI award had to be settled in both cash and equity, firms would be forced into liability accounting on the cash portion.

Record Keeping Requirements

Suggested approach

In order to limit the burden of storing the amount of information being proposed, the joint agencies could achieve its objective of having appropriate information to allow for both internal and regulatory audits by requiring that firms maintain annually the proposed individual level information for SEOs and SRTs along with new or materially changed incentive plans. In the initial year of implementation of the rules, firms would be required to store all incentive plan documentation, a process that could be replicated every five years, and in subsequent years, firms would store all materially changed or newly implemented plans. This would alleviate firms having to duplicate unchanged plans annually in storage.

Additionally, the proposed record keeping requirements apply to all incentive plans at covered firms regardless of the risk or the amount of the incentive paid. This requirement is overly burdensome given it would result in an incentive plan that pays $25 referral bonuses to bank tellers be subject to record keeping requirements and board oversight. We recommend that the joint agencies modify the proposed rules to exclude the record keeping requirement for incentive plans for employees that do not expose the firm to material risk or, for Level 1 and 2 firms, limit the plans to those that only SEOs and SRTs participate in.

Recommended Areas of Clarification

Interplay with other regulations and the potential for accounting / tax issues

We note that the proposed rules may bring on additional implications as related to certain tax / accounting rules and offer very little clarity on how 956 will work in relation to existing regulatory oversight. We provide some examples below:

- Current Regulatory Oversight: As proposed, what would 956 mean for the firms that have already identified their risk takers as categories of covered employees? Would you have a category 3 covered employee that's also an SRT? Or, SRTs that, potentially, are not categorized "covered" pursuant to prior guidance?
- Tax: 956 may cause 409A and 162(m) compliance issues

- Accounting: As mentioned previously, there may also be implications related to equity accounting under ASC Topic 718

While we do not believe it was the joint agency's intention to cause firms undue burden under current tax and accounting rules, we believe there needs to be more clarity around the interplay of 956 with existing laws and regulations.

Qualified profit sharing plans

The proposed rule does not count as incentive compensation plans that are determined solely upon the covered person's fixed compensation and do not vary based on one or more performance measures, e.g., a company's 401(k) plan. Given this definition, we have assumed that this includes qualified profit sharing plans. If this assumption is true, qualified profit sharing plans would be included in the definition of incentive compensation. There are important ERISA questions related to how a mandatory deferral for Senior Executive Officers or Significant Risk Takers would work within a qualified performance-based plan. Therefore, we would recommend that profit sharing plans be excluded from the joint agencies' definition of incentive compensation.

Lastly, there is language in the proposal that suggests an institution could be held to the higher level 1 or 2 standards at the discretion of their regulator. We believe there needs to be more clarity, particularly for firms between $10b and $49.9b, as to whether the businesses they participate in will cause them to be subject to more onerous requirements.

Conclusion

We appreciate the opportunity to submit this comment letter to the joint agencies for consideration. At the largest of the covered institutions, i.e., the firms that pose the most systemic risk to the system, significant work has already been completed and should be leveraged. Particularly, we emphasize the foundation of assessing risk on a role by role basis – a process that accurately captures responsibilities and operational policies that vary by covered institution. These groups of already identified covered employees should be the starting point for the discussion of who should be impacted by the deferral structure as proposed. Adding a dollar threshold adjusted for inflation to the existing 5% / 2% test provides a more administrative friendly starting point for who should be impacted and simultaneously levels the playing field throughout the industry. We also call to attention the suggestion for a seven year forfeiture / clawback window from date of award; this would provide more alignment globally and still allow for a substantial time period in which to identify risk and impact pay appropriately. In terms of calculating the deferral and the substantial portions of cash and equity, we strongly advocate for an aggregate view which includes the target value of the most recent 3-year LTI award. Lastly, we ask the agencies to address the more technical implications of the proposed rules; nothing in the rule should interfere with a company's ability to abide by certain tax, e.g., 409A, 162(m), or accounting rules, e.g. ASC Topic 718.