STATEMENT OF

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ON BEHALF OF

THE FINANCIAL SERVICES ROUNDTABLE

ON

EXECUTIVE COMPENSATION

BEFORE THE

SENATE BANKING

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

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Chairman Brown, Ranking Member Corker, and Members of the Subcommittee: thank you for the opportunity to address the subject of "*Pay for Performance: Incentive Compensation at Large Financial Institutions*." My name is Mike Melbinger and I Chair the Employee Benefits and Executive Compensation practice group at the law firm of Winston & Strawn LLP. I am also an Adjunct Professor of Law at Northwestern University School of Law, and I write extensively on the topic of executive compensation. I have practiced exclusively in the area of executive compensation for 29 years.

I appear today on behalf of The Financial Services Roundtable (the "Roundtable"). The Roundtable is a national trade association that represents 100 of the nation's largest integrated financial services companies. Member companies of the Roundtable provide banking, insurance and investment products and services to millions of American consumers.

I will provide observations about the current state of management members' and boards of directors' approaches to compensation plans and the significant improvements made since 2008. I will then review the range of recent laws and regulations that impose new requirements in the areas of executive compensation and corporate governance, and how they have affected compensation policies for better. Finally, I will provide my thoughts on whether the enforcement and monitoring of the laws in place will be sufficient or whether additional laws and regulations are needed in this area.

Observations on the Evolution of Compensation Policies Since 2008

First, I would like to offer my observations as to financial industry compensation trends and describe how financial institutions have transformed their compensation practices in response to the financial crisis, the Dodd-Frank Act, board oversight requirements, and other recent regulations.

All of the members of the Roundtable and, indeed, other of my clients which are not in the financial services industry, have been working very hard to design and implement best practices and compensation programs that reflect appropriate incentives to motivate employees to achieve defined corporate objectives.

Large financial institutions have embraced principles of safety and soundness and profoundly changed their executive compensation practices. Today, financial institutions have become the thought leaders in corporate America on issues such as pay for performance and mitigating the potential risks created by incentive compensation programs.

Aligning executive pay with company performance has been an objective of the boards of directors and compensation committees of financial institutions and other public companies for decades. However, the economic crisis—beginning with 2008 and continuing to today—surprised even the most experienced leaders of business with how close to the brink that our economy and businesses came. From that experience came difficult but not easily forgotten lessons—particularly for those who were convinced that "that could never happen." Many companies have responded, even those that are not in the financial services industry, by adopting a more balanced and comprehensive view of compensation philosophies with a view to align employees compensation to a more conservative risk profile and to align corporate goals with investor priorities.

In addition, since 2008 Board Compensation Committees have sharpened their focus on pay for performance as part of good corporate governance. While no silver bullet exists to align executive pay to company performance perfectly, significant efforts are being made. However, several challenges exist in aligning long-term compensation plan components to performance priorities. For example, during highly volatile economic times, multi year priorities may change

dramatically and indeed, external changes may heighten rather than mitigate risks in compensation plans. Management and Board Compensation Committees must be vigilant to recognize these changes and have plans that can be appropriately changed. One effective way to align pay for performance is to design plans to avoid paying for short-term gains at the expense of true long-term performance. In the financial institutions area, various forms of risk mitigation are applied to incentive compensation policies, and have become a significant component of pay for performance.

For example, Section 165 of the Dodd-Frank Act, , would require large financial institutions designated as systemically important to establish a separate Board-level "Risk Committee" consisting of independent directors, with at least one risk expert on it.[1] Most large bank holding companies have established separate risk committees of the board. Risk management and oversight have become a major component of the work of financial institution Boards and Compensation Committees. In much the same way that Say on Pay proxy proposals moved from being a financial institution only issue to one that effects most public companies, non-financial companies have established separate board level risk committees.

Roundtable Survey

Financial institutions have led the way in designing plans with reduced risks attributable to incentive compensation, greater transparency, better correlation between pay and performance, and just plain lower compensation. One hundred percent (100%) of surveyed Roundtable companies reported that they had significantly reformed their executive compensation practices since 2008, according to a 2011 Financial Services Roundtable membership survey. In part, the Survey found:

[1] Dodd-Frank Act Section 165, "Enhanced Supervision and Prudential Standards for Nonbank Financial Companies Supervised by the Board of Governors and Certain Bank Holding Companies."

- Overall levels of compensation were down for the last few years.
- Annual bonuses have come down.
- The benefits, perquisites and other contractual protections contained in the employment agreements of the senior executives – things like golden parachutes and supplemental executive retirement plans - have been reduced significantly since 2008.

Roundtable member companies reported many other executive compensation reforms they had undertaken over the last three years, all without legislative or regulatory mandates, including:

1. Instituting maximum payout caps (87% of companies)
2. Having clawback provisions in place (83% of companies)
3. Improving risk management (77% of companies)
4. Introducing new performance metrics (69% of companies)
5. Restricting stock awards (52% of companies)
6. Instituting new performance reviews (45% of companies)
7. Creating stock holding requirements (41% of companies)
8. Developing new bonus formulas (38% of companies)
9. Increasing base salary and linked performance to stock (31% of companies)

Federal Reserve Board Report

In October 2011, the Board of Governors of the Federal Reserve (the "Federal Reserve") released its report "Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations," as mandated by the Dodd-Frank Act. The Horizontal Review was a supervisory initiative, under the Federal Reserve's Proposed Guidance on Sound

Incentive Compensation Policies (the "Proposed Guidance"),[2] to perform a multidisciplinary, horizontal review of incentive compensation practices at 25 large, complex banking organizations ("LCBOs").[3]

The Federal Reserve observed that "every firm in the review has made progress during the review in developing practices and procedures that will internalize the principles of the interagency guidance into management systems at each firm."

> With the oversight of the Federal Reserve and other banking agencies, the firms in the horizontal review have implemented new practices to make employees' incentive compensation sensitive to risk.

In its 2011 Report, the Federal Reserve concluded that:

1. The largest banks are already at or above Dodd-Frank proposed guidelines for executive compensation (to defer 50% for 3 years);
2. Senior executives have more than 60% of their incentive compensation deferred on average;
3. Some of the most senior executives have more than 80% deferred;
4. Deferral periods generally range from three to five years, with three years the most common.

Finally, for last year's proxy season, and again this year, most financial institutions, and other public companies generally, directly address pay for performance in their proxy statements. Institutions and other corporations generally took this step to address the need to seek

[2] Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55227 (Oct. 27, 2009).

[3] The financial institutions in the Incentive Compensation Horizontal Review were Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; Capital One Financial Corporation; Citigroup Inc.; Discover Financial Services; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; Northern Trust Corporation; The PNC Financial Services Group, Inc.; State Street Corporation; SunTrust Banks, Inc.; U.S. Bancorp; and Wells Fargo & Company; and the U.S. operations of Barclays plc, BNP Paribas, Credit Suisse Group AG, Deutsche Bank AG, HSBC Holdings plc, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Societe Generale, and UBS AG.

shareholder approval of the executives' pay packages – shareholder say on pay. The financial industry directly took on this issue in both the Compensation Discussion and Analysis CD&A section of the proxy – usually with an executive summary - and in a supporting statement for the shareholder say on pay resolution. Last year financial institutions and other public companies provided investors with heightened transparency through detailed charts showing companies' performance compared to executive pay, and as well as better explanations in the text of proxy statements.

Recent Laws and Regulations Imposing New Requirements on Executive Compensation and Corporate Governance

Dramatic changes in financial institutions' compensation programs since 2008 have occurred. To begin with, financial institutions dramatically changed their executive compensation programs in reaction to lessons learned from the financial crisis. Other changes were prompted by the various laws passed by Congress and regulations promulgated by the financial regulatory agencies. However, financial institutions not only have complied with new regulatory strictures; institutions have actively embraced the role as thought leaders nationwide in how to balance risk with reward, implement appropriate compensation clawbacks, compensation holdbacks, and other needed changes.

These new attitudes can be seen in the way that the industry responded to significant changes required under the Troubled Asset Relief Program ("TARP"), the 2010 Interagency Guidance, the Horizontal Review process, and the Dodd-Frank Act.

TARP

In October 2008, President Bush signed into law the Emergency Economic Stabilization Act (EESA),[4] creating the Troubled Assets Relief Program (TARP). In February 2009, President Obama signed into law the American Recovery and Reinvestment Act (ARRA),[5] which included amendments to the executive compensation provisions of EESA. Section 111 of EESA, as amended by ARRA,[6] imposed a variety of new limitations and restrictions on the executive compensation plans and arrangements of any entity that received financial assistance under TARP. These restrictions and standards applied throughout the period during which any obligation arising from financial assistance provided under TARP remained outstanding (the "TARP obligation period").

SEC Reporting Rules

The influence of the executive compensation provisions affecting financial institutions receiving TARP funds were further extended on December 15, 2009, when the U.S. Securities and Exchange Commission (SEC) issued a new Final Rule on executive compensation disclosure and corporate governance that imposes risk assessment requirements similar to those under TARP to all publicly traded companies, beginning in 2010.[7] The SEC's Final Rule requires all public companies to assess their compensation policies and practices to determine if they are reasonably likely to have a material adverse effect on the institution.

[4] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

[5] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

[6] 12 U.S.C. § 5221 (2010).

[7] Proxy Disclosure Enhancements, 74 Fed. Reg. 68334 (Dec. 23, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249 and 274).

Horizontal Review

In late 2009, the Federal Reserve initiated a multidisciplinary, horizontal review of incentive compensation practices at 25 LCBOs, to foster implementation of improved practices.[8] The Horizontal Review was a supervisory initiative, under the Federal Reserve Board's 2009 Proposed Guidance on Sound Incentive Compensation Policies,[9] which preceded the Interagency Guidance described below. The Horizontal Review was designed to assess:

- the potential for incentive compensation arrangements or practices to encourage imprudent risk-taking;
- the actions an institution has taken or proposes to take to correct deficiencies in its incentive compensation practices; and
- the adequacy of the organization's compensation-related risk-management, control, and corporate governance processes.

One goal of the horizontal review was to assist the Federal Reserve's understanding of incentive compensation practices across financial institutions and categories of employees within institutions. The second, more important goal was to guide each financial institution in implementing the interagency guidance on sound incentive compensation policies.

In four key areas of the Horizontal Review, the Federal Reserve concluded that:

- Effective Incentive Compensation Plan 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. The

[8] The financial institutions in the Incentive Compensation Horizontal Review were Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; Capital One Financial Corporation; Citigroup Inc.; Discover Financial Services; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; Northern Trust Corporation; The PNC Financial Services Group, Inc.; State Street Corporation; SunTrust Banks, Inc.; U.S. Bancorp; and Wells Fargo & Company; and the U.S. operations of Barclays plc, BNP Paribas, Credit Suisse Group AG, Deutsche Bank AG, HSBC Holdings plc, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Societe Generale, and UBS AG.

[9] Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55227 (Oct. 27, 2009).

most widely used methods for doing so are risk adjustment of awards and deferral of payments.

- Progress in Identifying Key Employees. At most large banking organizations, thousands or tens of thousands of employees have a hand in risk taking. Yet, before the crisis, the conventional wisdom at most firms was that risk-based incentives were important only for a small number of senior or highly paid employees and no firm systematically identified the relevant employees who could, either individually or as a group, influence risk. 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.

- Changing Risk-Management Processes and Controls. Because firms did not consider risk in the design of incentive compensation arrangements before the crisis, firms rarely involved risk management and control personnel when considering and carrying out incentive compensation arrangements. 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.

- Progress in Altering Corporate Governance Frameworks. At the outset of the horizontal review, the boards of directors of most firms had begun to consider the relationship between incentive compensation and risk, though many were focused exclusively on the incentive compensation of their firm's most senior executives. Since then, 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.

2010 Interagency Guidance

In June 2010, the Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System, (Federal Reserve); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision, Treasury (OTS) issued Guidance on Sound Incentive Compensation Policies in final form (the "2010 Interagency Guidance").

The 2010 Interagency Guidance describes four methods that are "often used to make compensation more sensitive to risk": (i) risk adjustment of awards; (ii) deferral of payment; (iii) longer performance periods; and (iv) reduced sensitivity to short-term performance. (In February 2011, new interagency rules were proposed, as described below. These new rules, when finalized, may make the 2010 Interagency Guidance obsolete.)

The Dodd-Frank Act

In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act[10] (the "Dodd-Frank Act"). The Dodd-Frank Act technically became effective on July 21, 2010. However, many of the provisions relating to executive compensation are not self-executing, in that they require the SEC to modify its requirements for maintaining an effective registration under the Securities Exchange Act of 1934 (the "Exchange Act") and/or require the national securities exchanges to modify their listing standards.

The Dodd-Frank Act included between 10 and 13 separate provisions directly or indirectly effecting executive compensation, depending on how you count, including two applicable to financial institutions only.

1. Dodd-Frank Act Section 951, added a new Section 14A to the Exchange Act, entitled "Shareholder Approval of Executive Compensation," which provides that, not less frequently than once every 3 years, a company's annual proxy statement must include a separate resolution, subject to non-binding shareholder vote, to approve the compensation of executives, as disclosed in the company's Compensation Discussion and Analysis (CD&A), the compensation tables, and any related material.

[10] Pub.L. 111-203, H.R. 4173

Dodd-Frank Act Section 951 also requires that, not less frequently than once every 6 years, the proxy statement must include a separate resolution subject to a non-binding shareholder vote to determine whether future votes on the resolutions required under the preceding paragraph will occur every 1, 2, or 3 years.

2. Dodd-Frank Act Section 951 added a new Section 14A to the Exchange Act, "Shareholder Approval of 'Golden Parachute' Compensation," which requires in any proxy solicitation material for a meeting of shareholders at which the shareholders are asked to approve an acquisition or merger, the party soliciting the proxy must disclose any agreements or understandings that the party soliciting the proxy has with any named executive officers of company concerning any type of compensation that relates to the transaction and the aggregate total of all such compensation that may be paid or become payable to or on behalf of such executive officer.

3. Dodd-Frank Act Section 952 added a new Section 10C(a) to the Exchange Act, "Independence of Compensation Committees," which requires the SEC to promulgate rules that direct the NYSE, NASDAQ, and other national securities exchanges and associations to prohibit the listing of any equity security of a company that does not have an independent compensation committee.

4. Dodd-Frank Act Section 952 added a new Section 10C(b) to the Exchange Act, "Independence of Compensation Consultants and Other Compensation Committee Advisers," which provides that the compensation committee, in its sole discretion, may obtain the advice of independent legal counsel, compensation consultants, and other advisers. If it does, the committee may only select a

compensation consultant, legal counsel or other adviser after taking into consideration factors identified by the SEC.

5. Dodd-Frank Act Section 954, "Recovery of Erroneously Awarded Compensation Policy," added new Section 10D to the Exchange Act, which requires the SEC to direct the national securities exchanges to prohibit the listing of any security of an issuer that does not develop and implement a clawback policy.

6. Dodd-Frank Act Section 955, "Disclosure of Hedging by Employees and Directors," added a new subsection 14(j) to the Exchange Act, which requires the SEC to require companies to disclose in their annual proxy statement whether the company permits any employee or director to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities (1) granted to the employee or director by the company as part of the compensation; or (2) held, directly or indirectly, by the employee or director.

7. Dodd-Frank Act Section 953(a), "Disclosure of Pay Versus Performance," added a new 14(i) to the Exchange Act, which requires each public company to disclose in its annual proxy statement "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer"

8. Dodd-Frank Act Section 972, "Corporate Governance," added a new Section 14B to the Exchange Act, which requires the SEC to issue rules that requires the company to disclose in its annual proxy statement the reasons why it has chosen the same or different persons to serve as chairman of the board of directors and chief executive officer (or in equivalent positions) of the company.

9. Dodd-Frank Act Section 953(b), "Executive Compensation Disclosures," requires the SEC to amend the proxy statement disclosure rules to require each public company to disclose the ratio of the median of the annual total compensation of all employees of the company, except the CEO to the annual total compensation of the CEO.

10. Dodd-Frank Act Section 957, "Elimination of Discretionary Voting by Brokers on Executive Compensation Proposals," amended Section 6(b) of the Exchange Act.

11. Dodd Frank-Act Section 956, "Enhanced Compensation Structure Reporting," applies only to financial institutions with assets of $1 billion or more.

12. Dodd-Frank Act Section 165, "Enhanced Supervision and Prudential Standards for Nonbank Financial Companies Supervised by the Board of Governors and Certain Bank Holding Companies," requires the Federal Reserve to establish prudential standards for non-bank financial companies supervised by it and bank holding companies ("BHCs") with total consolidated assets equal to or greater than $50 million, which are more stringent than the standards and requirements applicable to non-bank financial companies and bank holding companies that do not present similar risks to the nation's financial stability.

Interagency Rules under Dodd-Frank Act 956

In February 2011, the Office of the Comptroller of the Currency, Treasury (OCC), Federal Reserve System, FDIC, Office of Thrift Supervision, Treasury (OTS), National Credit Union Administration (NCUA), SEC, and Federal Housing Finance Agency (FHFA), proposed rules to implement Dodd-Frank Act Section 956, "Enhanced Compensation Structure Reporting." Section 956 requires the reporting of incentive-based compensation arrangements

by a covered financial institution, and prohibits incentive-based compensation arrangements that encourage inappropriate risks by covered financial institutions by providing a covered person with excessive compensation, or that could lead to material financial loss to the covered financial institution. These rules have not been finalized.

FDIC Final Rules

In July 2011, the FDIC issued final rules to implement certain provisions of its authority to resolve covered financial companies under Section 210(s)(3) of the Dodd-Frank Act, which directed the FDIC to promulgate regulations with respect to recoupment of compensation from senior executives or directors materially responsible for the failed condition of a covered financial company. The final rules adopt a rebuttable presumption that certain senior executives or directors are "substantially responsible" for the failed condition of a financial entity company that is placed into receivership under the orderly liquidation authority of the Dodd-Frank Act.

Current Laws and Regulation are Sufficient

The Dodd-Frank Act and Interagency Guidance on executive compensation and corporate governance promulgated since 2009 give financial institutions and other non-financial public companies, the mandates and tools they need to design appropriate compensation plans and give regulators the tools they need to monitor them. The Interagency final rules under Dodd-Frank Act Section 956 will complete the picture.

For financial institutions and their boards of directors, there is no turning back on the good governance reforms and best practices they have adopted since 2008. Boards of directors and compensation committee members are highly intelligent and experienced fiduciaries. They value their reputations. They want to do the right thing. They have learned important lessons

from the financial crisis and they have been further empowered by the legislation and regulation promulgated in its wake.

Boards of directors, compensation committee members and management at financial institutions are taking much more care in the design and implementation of their incentive plans. They are involving more outside independent experts in the process. These independent advisors have provided not only industry specific expertise that the boards or committee members may not possess, but also access to good benchmarking data and independent thought.

Roundtable Study on Incentive-Based Compensation Practices

Roundtable members are cognizant of the risk that faulty compensation practices may result in a material financial loss. In order to gauge what actions industry members are taking with respect to their incentive-based compensation practices, the Roundtable conducted a study of a portion of its membership. The Roundtable collected detailed information and commentary from numerous member companies regarding both their risk management strategies and their procedures for determining compensation.

Roundtable Members are Committed to Robust Planning and Oversight of Incentive-Based Compensation Plans. Each of the companies who participated in the study maintains a compensation committee of the board of directors that must approve all salary packages for the Chief Executive Officer and other high-level employees. The committee also must approve any material change in the compensation plans of the employees they monitor. At several companies, the compensation committee retains the discretion to reduce any award due to the overall financial performance of the company.

Roundtable members generally use detailed data to create their compensation plans for high-level executives. Nearly 90% of study respondents employ a board of director's

compensation consultant that conducts a peer-review analysis of the compensation plans put before the board, and 87% establish maximum payout targets for high-level executives.

Each of the companies surveyed also employ policies and procedures concerning the incentive-based compensation of mid-level and low-level employees, though these practices vary widely. Some companies report centralized oversight of all incentive-based compensation arrangements. Other respondents make use of external audits. Over 75% of companies employ claw-back agreements or holdback procedures for the vesting of incentive-based compensation beyond a certain level.

Industry members are actively monitoring and changing the content of their incentive-based compensation programs. All of the companies involved in the Roundtable study reported changes to their incentive-based compensation practices since 2008. An overwhelming majority of these companies, 83%, reported that the risk of material financial loss was a leading factor in instituting changes to their past incentive-based compensation systems.

The strategies used by Roundtable companies to address risk vary widely as each company attempts to devise and apply solutions that work for its circumstances. Study participants mentioned more than 15 different approaches that are currently being analyzed and implemented by either the compensation committee or their human resources departments. In all cases, a variety of three or more approaches is being used.

Finally, the statutory and regulatory changes provide great tools sufficient for regulators to examine for appropriate practices, to test for best practices implementation and review results through institution reports.

We appreciate the opportunity to provide this statement to the Subcommittee for its consideration. We would be happy to respond to questions the Subcommittee members may have.