Mr. Robert deV. Frierson
Deputy Secretary of the Board
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

November 24, 2009

Re: Docket No. OP-1374
Proposed Guidance on Sound Incentive Compensation Policies

Dear Ms. Frierson,

Pearl Meyer & Partners ("PM&P") is pleased to submit comments to the Board of Governors of the Federal Reserve System (the "Board") on its Proposed Guidance on Sound Incentive Compensation Policies (the "Proposal"). At the outset, we commend the principles-based approach taken by the Board in the Proposal, as well as its recognition that the level and complexity of review should be tailored to the size and complexity of the organization. While we acknowledge the need for appropriate incentive compensation practices in banking organizations, we urge the Board to consider balancing its safety and soundness goals with practical implications to the organizations, as well as the potential for unintended consequences.

This letter is intended to provide feedback that represents our views, as well as those expressed by many of our banking clients, with respect to the Proposal. We also take into consideration the real implications and potential burdens that would be placed on many organizations by certain requirements under the Proposal.

By way of background, Pearl Meyer & Partners is one of the nation's leading independent compensation consulting firms, serving Board Compensation Committees as independent advisors and assisting companies in the creation and implementation of innovative, performance-oriented compensation programs to attract, retain, motivate and appropriately reward executives, employees and Board Directors. As independent advisors, we help Boards and Committees establish and maintain sound governance practices, particularly as this relates to executive and director pay decision-making. Since its founding in 1989, PM&P's compensation professionals have advised hundreds of organizations in virtually every industry, ranging from Fortune 500 companies to smaller private firms and not-for-profit organizations. In particular, we provide service to hundreds of community banks across the nation and as their advisors, have a vested interest in ensuring sound compensation practices.

We appreciate the opportunity to comment and share our views. We note that PM&P is submitting this commentary on its own behalf, and not on behalf of any specific client. Please contact us at (212) 407-9517 or (508) 630-1493 if you have any questions regarding our comments.

Sincerely,

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The Proposal May Jeopardize Pay-for-Performance Principles

The Board seeks comment as to whether the three core principles described in the Proposal are appropriate and sufficient to ensure incentive compensation arrangements do not threaten the safety and soundness of banking organizations, and whether there are additional or different principles needed to achieve this goal.

At the outset, we want to be clear that compensation plans by themselves – and the resulting executive compensation payouts – were not the primary cause of the collapse of the financial markets in 2008, though clearly, compensation plans can contribute to excessive and/or unnecessary risk-taking. In fact, some compensation strategies, such as those that require long-term stock ownership, were not sufficient to deter excessive and/or unnecessary risk-taking.

Having said that, we believe that pushing organizations toward compensation programs with zero risk (i.e., 100% base salary and/or firm-wide profit-sharing programs) runs counter to the pay-for-performance linkage that investors and other stakeholders seek. Thus, some level of risk tied to performance is quite appropriate for compensation programs, and in a balanced program, it encourages innovation, opportunity and growth. We are particularly troubled by the example given on page 55233 of the Federal Register, which suggests that a plan may provide for undue risk-taking where incentive compensation payments are closely tied to business generated by the employee, rather than measures such as firm-wide profit that are only distantly linked to the employee. Incentive compensation is designed to incentivize behavior. Removing or obfuscating the line of sight between concrete actions and outcomes may eviscerate incentives to achieve important goals.

In sum, we are hopeful that in its review of incentive compensation programs, the Board and its supervisors will strike a careful balance between minimizing risk and preserving pay-for-performance principles. And as the Proposal aptly emphasizes, "balance" should be the prime focus of incentive compensation review. In our experience, sound compensation programs in aggregate seek to "balance" an individually tailored and appropriate mix of performance measures that include: (i) company and individual performance; (ii) financial and qualitative goals; (iii) short- and long-term performance horizons; (iv) absolute and relative (to peer company) perspectives; and (v) formulaic and discretionary considerations. Such a program is more likely to mitigate risk taking and ensure pay-for-performance alignment.

The Proposal Poses an Undue Hardship on Small and Regional Banks

The Board seeks comment on whether the Proposal would impose undue burdens on banking organizations, particularly regional and small organizations. Having worked with many smaller banking organizations that have reacted to the Proposal over the past month, we firmly believe that the proposed ongoing documentary, controls and review process for such smaller organizations (which, as the Proposal notes in footnote 9, typically have limited incentive programs in the first place) will

have an undue administrative and financial burden. These organizations do not have the resources or infrastructure to implement the proposed requirements, nor do they typically have the budget to outsource such tasks.

In addition, the benefits to be gained from this review for smaller organizations are limited. Many organizations of this size have a limited population participating in incentive compensation programs, and of those that participate, the incentives typically cover a minor portion of total compensation (i.e., less than 25% of total compensation). This is hardly the paradigm that would rise to the level of incentivizing employees to take risks that would jeopardize the safety and soundness of the institution. Moreover, we fear that the unintended consequences of these burdens will be abandonment of any incentive compensation programs whatsoever, and perhaps higher salaries and fixed compensation to make up for the difference. Once again, this outcome undermines the concept of pay-for-performance.

While we understand the need for a more comprehensive level of review for LCBOs, we believe that the exhaustive list of processes and tasks specified in Principles 2 and 3 of the Proposal will present certain organizations with undue financial and administrative burdens. While the core principles can and should serve as best practice guidance, we believe that the following organizations should not be required to comply with some of the more robust requirements enumerated in Principles 2 and 3:

- Banking organizations that have less than $1 billion in assets. Organizations smaller than this do not have the resources to conduct the formalized review processes suggested by the proposal, nor do they typically fit the profile of having incentive compensation programs that promote unnecessary risk at the expense of the institution.

- Banking organizations (other than LCBOs) that have programs whereby incentive compensation comprises no more than 25% of the employee's (or employee group's) total compensation. It is unlikely that incentives of this proportion will drive the type of risky behavior that jeopardizes an entire institution – they are simply not material.

We are not suggesting that the above organizations should be exempt from reviewing their incentive programs for undue risk. Rather, we believe a curtailed list of requirements (i.e., conduct a high level review the incentives, document the process and outcome of the review, and address any problem areas) would suffice. The frequent reviews and auditing of incentive compensation programs, hiring of outside independent resources to review the programs, and in-depth Board involvement in the process of such review, for example, is simply not necessary for these types of organizations and incentive plans. In addition, we are not suggesting that the incentive compensation programs of the above organizations should go unchecked. Rather, such programs can continue to be reviewed during the normal supervisory process, with the organizations above responding to supervisor inquiries and requests as needed and appropriate.

Formulaic Approaches Are Inappropriate and Should Not Be Considered

The Board seeks comment on whether a more formulaic approach for determining and paying incentive compensation would better promote the long-term safety and soundness of banking organizations. We believe such an approach would do more harm than good for such organizations.

As we stated in our cover letter, we commend the Board for recognizing that with respect to reviews of executive compensation, different approaches are needed for different sizes and types of organizations. A one-size-fits-all approach with pre-set caps or limits is a poor construct for any compensation program. In order to promote the long-term success (as well as the safety and soundness) of institutions, compensation programs should always be specifically tailored to the organization's goals as well as the particular individual filling the role. No two organizations or executives are the same. Trying to homogenize compensation across or among organizations will jeopardize attraction, motivation and retention of talent, as well as impede organizational growth and innovation. The principles-based approach of the Board's Proposal should be maintained.