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Ideas into Action

July 22, 2016

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### In Memoriam

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## ***Re: Proposed implementation of incentive compensation rules as provided under Dodd-Frank Sec. 956***

Dear officers,

I appreciate the opportunity to comment on the Proposed Rule on incentive compensation standards under Dodd-Frank Section 956.

The key question to ask about this regulation is whether it would have significantly reduced the reckless behavior that led us into the 2008 financial crisis if it had been in place in the years leading up to the crash. Unfortunately, while there are some areas of improvement over the 2011 proposed rule, I think the answer to this question is still no.

We support a comment letter submitted by Americans for Financial Reform and more than 30 other public interest organizations that concisely summarizes our four main areas of concern. These four points are included in this comment letter in italics, followed by additional analysis.

## **1. Requirements regarding the deferral of bonuses are too weak**

*The proposal requires 60 percent of bonus pay to be deferred for only four years for the most senior executives at the largest banks, with even lower levels of deferral for other employees whose activities could put the financial institution at risk and executives at midsize banks. The proposal also allows pay to vest in equal (pro rata) shares each year. Thus, even the very highest-ranking executives could receive 70 percent of their pay within two years and 85% within three years. To curb short-term, reckless behavior, deferral periods must be significantly longer, ideally more than five years, to cover the typical length of a credit cycle, with cliff vesting.*

The proposed rule would not have done much to deter the reckless behavior that led to the financial crisis. Examples:

- Former Countrywide CEO Angelo Mozilo would be living no less large today if the proposed rule had been in force during his subprime-mortgage golden years. Mozilo annually raked in huge payouts over eight years — accumulating [more than half a billion](#) dollars — before the housing market bubble burst. Requiring Mozilo to spread 60 percent of his incentive pay out over four years would have made only a marginal dent in that fortune.
- The top five executives at Bear Stearns pocketed [\\$1.1 billion](#) in “performance shares” between 2000 and 2008 before their venerable financial institution went down in flames. A four-year wait with pro rata vesting would not have changed their behavior.

U.S. regulators should consider adopting a deferral period that is at least as long as the UK rules, which require British banks to stretch out bonus payments over seven years for senior managers.

## **2. The proposal gives management too much discretion over clawbacks and other adjustments to pay for misconduct**

*The Dodd-Frank law requires regulators to ban forms of incentive compensation that induce inappropriate risk-taking. Yet even in a circumstance where such risk-taking or misconduct is clearly found, this proposed rule requires only that companies “consider” reducing bonus pay. Firms are required to have “clawback” policies for pay already awarded, but again, implementation is left to management discretion. Such policies should be mandatory and firms should be required to disclose publicly the individuals subject to the clawback and the amounts involved. The triggers for clawbacks should also be stronger and cover systematic failures of supervision within the individual’s sphere of managerial responsibility, not simply actions of the single individual in question. We also ask that the firm’s board identify a class of senior*

*executives whose pay will be subject to being clawed back to satisfy regulatory penalties imposed on the firm.*

We should have learned by now not to rely on Wall Street managers to voluntarily “do the right thing” to correct pay perversity. Even the worst financial crisis since the Great Depression did not significantly alter behavior. Examples:

- TARP bailout recipient banks paid out billions in performance bonuses in 2008.<sup>1</sup>
- In 2010, Citicorp allowed the alleged ringleader of the giant Libor interest-rate rigging scheme to keep a \$3.4 million signing bonus. That was *after* they accused him of trying to manipulate markets.
- In 2013, JPMorgan Chase gave CEO Jamie Dimon a 74 percent raise to \$20 million. That was *after* the bank paid more than \$20 billion in fines and penalties in the wake of the “London Whale” trading scandal.

New York Federal Reserve President William Dudley has proposed an innovative idea that could help change the reckless bonus culture on Wall Street.<sup>2</sup> A portion of senior executives’ pay would be held in a “performance bond.” If the bank is slapped with a large fine, Dudley explains, “the senior management and the material risk-takers would forfeit their performance bond. This would increase the financial incentive of those individuals who are best placed to identify bad activities at an early stage, or prevent them from occurring in the first place.” He added that this would also “create a strong incentive for individuals to monitor the actions of their colleagues, and to call attention to any issues.”

### **3. Restrictions on stock options should be strengthened.**

*We appreciate the effort to discourage use of stock options, which can be especially problematic in encouraging short-term, reckless behavior. However, it would be more effective to either ban stock options entirely or limit them to no more than 15 percent of total compensation. The current proposal to limit options as a percentage of deferred incentive compensation could serve as an incentive to provide excessive amounts of other forms of compensation.*

Stock options and other forms of equity-based pay are by far the largest components of executive compensation, and thus a major factor in the explosion of executive pay in the past few decades. As long as such massive jackpots — often worth seven-, eight-, and even nine-digits — are sitting on the table, with little or no downside risk, Wall Street

executives and traders have a powerful incentive to make outrageous gambles that put us all at risk.

A University of Notre Dame survey of more than 1,200 bankers reveals the dangerous daredevilry bred by such massive rewards. A quarter of all banking professionals say they would break the law in order to make an extra \$10 million.<sup>3</sup> A full 32 percent of those with less than 10 years' experience would take the same risk.

Options are often touted as a means to align the interests of executives and shareholders. In practice, if a firm's shares decline in value over time, executives with stock options lose nothing. In fact, during stock slumps, executives often receive boatloads of new options with lower exercise prices. In 2007, for instance, Goldman Sachs gave executives options to purchase 3.5 million shares. In December 2008, after the crash had driven Goldman shares to record lows, the bank's top executives received nearly 36 million stock options, ten times the previous year's total.<sup>4</sup> This new grant positioned Goldman executives for massive new windfalls even if the bank's shares never regained their 2007 price level. On the upside, stock options gains have no limit, a reality that encourages reckless, short-sighted executive behaviors designed to jack up share prices by whatever means necessary.

U.S. regulatory agencies should consider harmonizing rules with the European Union, where since 2014 they have capped financial industry bonus pay at 100 percent of fixed compensation, or 200 percent if approved by shareholders. In other words, to give an executive a shot at hitting a \$10 million bonus, the bank would have to provide at least \$5 million in base pay.

#### **4. Hedging of incentive compensation should be banned for individuals as well as the firm.**

*Bonus deferral will not be effective in reducing inappropriate risk-taking if employees can use hedging strategies to reduce their risk to poor company performance. Because the current proposal does not limit hedging of bonus pay by individual employees, only by the bank itself, it will not be effective at preventing compensation hedging. The Bank of England already requires the banks it supervises to maintain policies that prohibit individual hedging, and several major U.S. banks have voluntarily instituted such anti-hedging policies. This rule should do so as well.*

As Professor Lucien Bebchuk has noted, if bankers are allowed to hedge against the risk of their incentive compensation, they will. In Congressional testimony, he highlighted the example of AIG CEO Hank Greenberg, who hedged about \$300 million worth of stock in 2005 and avoided millions of dollars in losses when the firm collapsed in 2008.<sup>5</sup>

## Conclusion

Before the financial crash that led to the Dodd-Frank legislation, it might not have seemed so necessary to adopt strict prohibitions on behavior many ordinary Americans would consider beyond the pale. Should we really have to pass laws, for example, to force financial institutions to recoup rewards that are undeserved and based on behavior that has caused widespread harm? Do we really have to worry about executives making a joke of pay restrictions by purchasing hedging contracts? Shouldn't they just know better?

Sadly, the crisis and the behavior of Wall Street firms in its aftermath have taught us that the answer is "no." Recall, for instance, how the leading bailout recipients rushed to pay back their TARP funding, not because they were ashamed to be relying so heavily on taxpayer support in a time of crisis, but because they were desperate to get out from under bailout-related executive pay restrictions.<sup>6</sup>

Wall Street is addicted to excessive compensation. And without a stronger set of regulations and strict enforcement, we will only be enabling continued reckless behavior that could have potentially catastrophic consequences for the economy.

Sincerely,



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<sup>1</sup> [http://money.cnn.com/2009/07/30/news/companies/bonuses\\_tarp/](http://money.cnn.com/2009/07/30/news/companies/bonuses_tarp/)

<sup>2</sup> <https://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html>

<sup>3</sup> <http://money.cnn.com/2015/05/19/investing/wall-street-ethics-worse-survey/>

<sup>4</sup> <https://www.theguardian.com/commentisfree/2011/jan/27/goldman-sachs-windfall-stock-issue>

<sup>5</sup> <https://www.gpo.gov/fdsys/pkg/CHRG-112shrg75026/html/CHRG-112shrg75026.htm>

<sup>6</sup> <http://www.wsj.com/articles/SB124223172335815695>