

American Federation of Labor and Congress of Industrial Organizations



815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000
www.aflcio.org

EXECUTIVE COUNCIL

RICHARD L. TRUMKA
PRESIDENT

Gerald W. McEntee
Michael Goodwin
Elizabeth Bunn
Joseph J. Hunt
Leo W. Gerard
William Hite
Warren George
Nancy Wohlforth
Rose Ann DeMoro
Fred Redmond
Fredric V. Rolando
Newton B. Jones
John P. Ryan

ELIZABETH H. SHULER
SECRETARY-TREASURER

Michael Sacco
William Lucy
Michael J. Sullivan
Clyde Rivers
Ron Gettelfinger
John J. Flynn
Gregory J. Junemann
James C. Little
Mark H. Ayers
Matthew Loeb
Diann Woodard
D. Michael Langford
DeMaurice F. Smith

ARLENE HOLT BAKER
EXECUTIVE VICE PRESIDENT

Frank Hurt
Robert A. Scardelletti
Harold Schaitberger
Cecil Roberts
James Williams
John Gage
Laura Rico
Alan Rosenberg
Ann Converso, R.N.
Randi Weingarten
Patrick D. Finley
Robert McEllrath
Baldemar Velasquez

Patricia Friend
R. Thomas Buffenbarger
Edwin D. Hill
William Burrus
Vincent Giblin
Larry Cohen
Robbie Sparks
Capt. John Prater
Richard P. Hughes Jr.
Rogelio "Roy" A. Flores
Malcolm B. Futhy Jr.
Roberta Reardon
John W. Wilhelm

Sent via Electronic and U.S. Mail

November 25, 2009

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington DC 20551

Re: Proposed Guidance on Sound Incentive Compensation Policies (Docket OP-1374)

Dear Ms. Johnson:

The American Federation of Labor and Congress of Industrial Organizations ("the AFL-CIO"), welcomes this opportunity to comment on the proposed guidance, OP-1374, on sound incentive compensation policies.

The AFL-CIO is the country's largest labor federation, representing 11 million members who participate in benefit plans with more than \$4 trillion in assets. Union-sponsored pension plans own around \$450 billion in assets, and union members also participate directly in the capital markets through 401(k) retirement plans and Individual Retirement Accounts.

The AFL-CIO is pleased that the Federal Reserve Board (the "Fed") under Chairman Ben S. Bernanke is taking steps to ensure that the incentive compensation policies of banks and bank holding companies do not undermine the safety and soundness of those institutions. We also welcome the Fed's solicitation of additional recommendations on enhancing transparency beyond the proposal.

We wholeheartedly concur with Chairman Bernanke that "Compensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability."¹ Former Federal

¹ *Federal Reserve Press Release*, accompanying proposed guidance on sound incentive compensation policies, Oct. 22, 2009.

Reserve Chairman Paul Volcker also noted in recent speech that one of the causes of the financial crisis “was the ultimately explosive combination of compensation practices that provided enormous incentives to take risks (just as new financial products) seemed to offer assurance—falsely, as it has turned out—that those risks had been diffused.”²

Indeed, in the spring of 2008, the AFL-CIO, on its Executive PayWatch website, highlighted the link between pay and excessive risk at financial firms.³ The 2008 Executive PayWatch website was among the first to expose asymmetric pay practices at financial firms such as the excessive stock option grants that rewarded executives for taking inordinately large risks without any downside. Four of the seven financial institutions highlighted on the Executive PayWatch site where such pay practices were particularly problematic—Bear Stearns, Merrill Lynch, Wachovia and Washington Mutual—subsequently failed and were acquired by other companies. The remainder either required billions of dollars in taxpayer assistance or fled into the arms of acquirers.⁴

The Fed’s guidance should be viewed as the first step, not the only one, which regulators need to take to correct the deep flaws in the pay structures at financial companies that were exposed in the financial crisis. And while the AFL-CIO strongly believes that executive pay practices at financial institutions must be reformed—particularly those deemed too big to fail—we anticipate that it will take many years of rigorous and sustained supervision from regulators to overcome the resistance to change from financial firms.

The Fed’s guidance is especially timely because many large U.S. financial institutions are on track to give employees record pay this year—including year-end bonuses—despite curbs from lawmakers and regulators in the aftermath of the worst global crisis in the past century.⁵ Goldman Sachs Group, Morgan Stanley and JP Morgan Chase & Co., the three biggest banking institutions that have repaid federal assistance, are set to pay around \$30 billion in bonuses this year.⁶

But, while Wall Street celebrates, Main Street continues to suffer. More homeowners than before are having trouble paying their monthly mortgages, and five million households—nearly one in 10 homeowners with mortgages—were at least one payment behind in the third quarter of 2009.⁷ Little wonder that the average American is outraged at the shameless, eye-popping pay of Wall Street—the institutions largely responsible for the worldwide recession. Almost two-thirds of Americans, in a recent

² “Bankers Face Sweeping Curbs on Pay,” *The Wall Street Journal*, Sept. 18, 2009.

³ AFL-CIO 2008 Executive PayWatch website can be accessed here:
<http://web.archive.org/web/20080501081724/www.aflcio.org/corporatetwatch/paywatch/>

⁴ AFL-CIO 2008 Executive PayWatch, which can be accessed here:
<http://web.archive.org/web/20080501081724/www.aflcio.org/corporatetwatch/paywatch/>

⁵ “Wall Street on Track to Award Record Pay,” *The Wall Street Journal*, Oct. 14, 2009.

⁶ “Wall Street Bonuses Rise as Big 3 May Pay \$30 Billion,” *Bloomberg News*, Nov. 9, 2009.

⁷ “U.S. Mortgage Delinquencies Reach a Record High,” *The New York Times*, Nov. 19, 2009.

Time magazine poll, say Wall Street executive pay is completely out of sync, and more than seven in 10 want the government to limit this compensation.⁸

Implementation is Key

Against this background, we believe that the Fed's use of supervisory power to regulate compensation at financial institutions, if properly implemented, is likely to be more effective than such outright curbs as the \$1 million dollar limit on tax-deductibility of compensation, enacted in 1993, which had the unintended effect of *increasing* the salaries of chief executive officers to \$1 million. A similar limit on the deductibility of severance packages had the same effect—making the ceiling the floor.⁹

We have little doubt that the Fed will need to be vigilant to ensure full compliance with its guidance; examples abound of financial recipients under the Troubled Asset Relief Program skirting the pay curbs enacted into law in February 2009 in the American Recovery and Reinvestment Act.¹⁰ One common maneuver by TARP banks to sidestep the limits on bonuses to one-third of total pay is to simply give senior executives more base pay on which the equity awards are based.¹¹ As Nell Minow, co-founder of The Corporate Library, testified before Congress earlier this year, there is no template for compensation structure offered by lawmakers and regulators “that cannot and will not be immediately subverted.”¹²

Even some top financial executives, such as John Mack, Morgan Stanley's chief executive officer, now admit to their inability to keep their hands away from the proverbial “cookie jar” and are practically begging for regulators to step up enforcement: “We cannot control ourselves—[regulators] have to step in and control the Street.”¹³

Too Big to Fail

But, even while the Fed's guidance on incentive compensation and its relationship to the safety and soundness of financial institutions is essential, a more fundamental question the Fed needs to address is why have financial industry profits grown to such a disproportionately large percentage of the U.S. economy compared to the historic standard, and what can be done about it?

Between 1940 and 1985, the financial sector contributed to less than 16 percent of total domestic corporate profits. In the 1990s, it rose to as high as 30 percent, and this

⁸ “Geithner is Stalking Horse for Rage at Wall Street,” Al Hunt column in *Bloomberg News*, Nov. 23, 2009.

⁹ “The Right Way to Determine Executive Pay” op-ed by Richard Floersch, *The Wall Street Journal*, March 5, 2009.

¹⁰ “Wells Fargo Skirts TARP to Raise Pay,” *The Wall Street Journal*, Aug. 7, 2009.

¹¹ Wells Fargo & Co., Form 8-K dated Aug. 3, 2009; Fifth Third Bancorp, Form 8-K dated Sept. 25, 2009; KeyCorp 8-K dated Sept. 17, 2009; and PNC Financial Services 8-K dated Aug. 19, 2009.

¹² *Testimony before the House Financial Services Committee Hearing on Compensation Structure and Systemic Risk*, June 11, 2009.

¹³ “Morgan Stanley CEO Calls for More Regulation of Wall Street at Vanity Fair-Bloomberg Event,” *Huffington Post*, Nov. 18, 2009.

decade it surpassed 40 percent.¹⁴ Pay in the financial sector rose in tandem. Between 1948 and 1982, average compensation in the financial sector ranged between 99 percent and 108 percent of the average for all domestic private industries. From 1983 it shot up reaching 181 percent in 2007.¹⁵ This begs the question of what to do about financial institutions that are too big to fail, and whether the Fed needs to set into motion a plan to restructure the financial sector to ensure that no institution is large enough to cause systemic risk. As Paul Krugman noted in *The New York Times* recently: “Make banking boring again.”¹⁶

The gap between the pay of financial chief executive officers and CEOs of non-financial companies is so wide as to require immediate attention. A recent study by the Institute for Policy Studies found that the CEOs of the top 20 financial recipients of taxpayer assistance were paid 37 percent more in 2008 than CEOs of other S&P 500 companies.¹⁷ The fact is that Wall Street simply pays too much. No other segment of industry pays out 50 percent of its revenue in bonuses.¹⁸

Two-Tiered Approach

We laud the Fed’s two-tiered approach to addressing incentive compensation and risk, and we agree with the Fed’s determination to conduct “horizontal review” examinations of the 28 largest banks and bank holding companies that can cause systemic risk. The smaller banks, in particular, the community banks, pose little threat to the system and the Fed should be mindful of the benefits versus the cost of expending resources on the smaller banks.

Principles 1 and 2: Balanced Risk-Taking Incentives; Compatibility with Effective Controls and Risk Management

The AFL-CIO believes that there are risks inherent in incentive compensation. We are pleased to learn that the Fed intends to work with the U.S. Securities and Exchange Commission to improve the disclosures of financial institutions to shareholders in ways that will promote the safety and soundness of these organizations. However, we consider it essential that financial institutions must be held to a higher standard regarding the discussion of risk and its relationship to incentive compensation.

Thus, financial institutions must do more than what the proposed SEC rule would require—a section in the compensation discussion and analysis section of the proxy statement on how compensation policies and practices create risk that may have a “material” impact on the company.¹⁹ Financial regulators must be able to easily assess, using a standardized measure, whether compensation—both at the senior executive level,

¹⁴ “The Quiet Coup” *The Atlantic Magazine*, May 2009.

¹⁵ *Ibid.*

¹⁶ “Making Banking Boring,” Paul Krugman op-ed in *The New York Times*, April 10, 2009.

¹⁷ “America’s Bailout Barons,” *Institute for Policy Studies*, Aug. 2009.

¹⁸ “Bailouts and Bonuses,” *The New York Times*, Oct. 23, 2009

¹⁹ *Securities and Exchange Commission Proposed Rule on Proxy Disclosure and Solicitation Enhancements*, Federal Register 35076, July 17, 2009

and company-wide—is linked to short-term gains or long-term value creation. We believe that the Fed should take the lead in developing such a standardized measure, akin to the “duration” of a bond, to measure the sensitivity of compensation packages for both senior executives and line officers to time and risk, against that of their industry-wide peers.

Additionally, the oversight of risk and its relationship to company-wide pay practices must be an integral part of the oversight functions of the board of directors. The board’s oversight of risk should begin with assessing the appropriateness of the company’s strategy, and the risk that is inherent in that strategy. This includes understanding and agreeing on the amount of risk the organization is willing to accept or retain—“its risk appetite.”²⁰

It is apparent that current practices with regard to risk appetite are inadequate—There is “insufficient evidence of board involvement in setting and monitoring adherence to firms’ risk appetite,” as noted in the October 21, 2009 report of the Senior Supervisors Group, comprised of U.S. and international regulators.²¹ And, risk appetite statements, where they exist, are “generally not sufficiently robust.”²² Accordingly, we recommend the following to manage incentive compensation risk:

- The full board of directors should have primary responsibility for risk oversight, with the board’s standing committees—including compensation—addressing the risks inherent in their respective areas of oversight.²³
- The board of directors should closely monitor the potential risks in the company’s culture and its incentive compensation.²⁴
- Compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit, and phased over time, where possible, to coincide with the risk time horizon of such profits.²⁵
- Compensation must be adjusted for all types of risk, including difficult to measure risks such as liquidity risk and reputation risk.²⁶
- Incentive compensation should have a component reflecting the impact of business units’ returns on the overall value of related business groups, and the organization as a whole.²⁷

²⁰ “Risk Governance: Balancing Risk and Reward,” *Report of the NACD Blue Ribbon Commission*, Oct. 2009.

²¹ “Risk Management Lessons from the Global Banking Crisis of 2008,” Senior Supervisors Group, Oct. 21, 2009.

²² *Ibid.*

²³ “Risk Governance: Balancing Risk and Reward,” *Report of the NACD Blue Ribbon Commission*, Chapter 4, Oct. 2009.

²⁴ *Ibid.*

²⁵ “Final Report of the Institute of International Finance Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations,” July 17, 2009.

²⁶ Financial Stability Forum Principles for Sound Compensation Practice, April 2, 2009.

²⁷ *Ibid.*

- Evaluation of a person’s judgment and exercising that judgment in terms of risk in all its forms should be made on a multi-year basis to get a fuller picture of the effect of an individual’s decisions.²⁸
- Stock option compensation should be prohibited. Stock options promise executives all of the gain of stock price increases with none of the risk of stock price declines. As a result, they can encourage excessive risk-taking and prompt executives to pursue corporate strategies designed to promote short-term stock price gains to the detriment of long-term performance and stability. For these reasons, stock options are not an appropriate form of compensation for senior executives. Instead, senior executives should receive performance-based alternatives to stock options such as long-term performance-vesting restricted stock.
- When there are restatements, financial institutions should discuss—in their compensation discussion and analysis (“CD&A”) section of their proxy statement—the impact of those on executive compensation, if any. If the restatements have no impact on executive compensation, the company should discuss why not. In case of mergers, the financial institutions should explain to shareholders compensation decisions made relative to the merger date, such as grants outstanding, new grants, change-in-control provisions and other executive pay decisions.
- The approach, principles and objectives of incentive compensation should be transparent to shareholders, regulators and other stakeholders.²⁹
- Risk and control functions should be completely independent from the business units, and clarity as to whom the risk and control managers report is crucial to maintaining that independence.³⁰
- Risk managers should have equal stature with their counterparts in revenue producing divisions of the financial institution.³¹

All financial institutions must implement the best practices for incentive compensation, as articulated in the Aspen Principles, the Special Report on Regulatory Reform issued by the Congressional Oversight Panel in January 2009, by Professors Lucian Bebchuk, of the Harvard Law School and Jesse Fried of UC Berkeley Law School, Nell Minow, co-founder of The Corporate Library, as well as other corporate governance experts, and supported by the AFL-CIO. Although not an exhaustive list, these include:

- The bulk of total pay for senior executives must be variable, incentive, performance-vested equity awards that are deferred for five years after they are earned.
- Base salaries paid in cash should be only a small amount of total compensation for senior executives.

²⁸ Remarks of Lloyd C. Blankfein, chairman and CEO, Goldman Sachs Group, to the Council of Institutional Investors, April 7, 2009.

²⁹ Ibid

³⁰ Ibid.

³¹ Ibid

- Companies should consider tying pay to the value of a basket of securities beyond common stock, especially at poor performing companies with very low stock prices, where equity does not provide much of an incentive. Moreover, it could also be useful to tie the executive's payoff to changes in a measure—possibly based on the price of credit default swaps reflecting the probability of default—that reflect changes in the expected cost to the government from the prospect of having to bail out the bank in the future.³²
- Incentive awards must be subjected to “claw backs,” that ensure a downside, should the performance metrics not be met or if the performance turns out to be illusory.
- Incentive compensation should be based on more than one performance metric.
- Different incentive awards should measure different kinds of performance.
- Adjustments to financial goals for compensation for “extraordinary” or “one-time” events that affect results should not be allowed as they can encourage certain behavior that could increase inappropriate long-term risk. For example, the exclusion of acquisition costs when determining profit for bonus plans may encourage acquisitive activity. Shareholders and other stakeholders would benefit from an explanation and discussion of how the board's Compensation Committee considers these factors when making or approving adjustments to goals.³³
- Bonuses should not be guaranteed as they can create a perverse incentive to take excessive risks as they eliminate some of the downside risk, but leave the bonus compensation sensitive to performance on the upside.³⁴
- Severance should be limited to a single year's base salary and benefits, plus any unvested equity awards should continue to vest on their normal schedule, only for that 12-month period.
- Any compensation for senior executives that exceeds the tax-deductible limits of the Internal Revenue Code Section 162(m) must be disclosed in the company's annual proxy statement to shareholders.
- Companies must discuss, in their CD&A, historical targets (such as in the 2009 proxy statement for 2008) and why they were or were not met. Also, some companies have delayed equity and other incentive awards to just after the end of the fiscal year so that they do not have to report them in the summary compensation table of the proxy statement for that particular year. To avoid this abuse, companies should be required to disclose these as well as any other actions taken between the end of the previous fiscal

³² Testimony of Lucian A. Bebchuk, Friedman Professor of Law, Economics and Finance, Harvard Law School, before the House Financial Services Committee on Compensation Structure and Systemic Risk, June 11, 2009.

³³ *Comment letter, RiskMetrics Group*, to the SEC on Proxy Disclosure and Solicitation Enhancements, Sept. 10, 2009.

³⁴ “Bonus Guarantees Can Fuel Risky Moves,” *The Wall Street Journal op-ed* by Lucian Bebchuk, Friedman Professor of Law, Economics and Finance, Harvard Law School, Aug. 27, 2009.

year to the time the proxy statement is disclosed, such as new equity awards, changes in base salary and other actions affecting compensation.

- Companies should conduct regular self-assessments of their compensation programs and consider simplifying their incentive compensation structures. A review by one firm found that it had “more than 150 different plans.”³⁵

Principle 3: Strong Corporate Governance

It is essential that financial companies must be held to the highest level of good corporate governance practices. The AFL-CIO believes that good governance practices must be an integral part of the Fed’s rating system for evaluating the soundness of financial institutions in examinations. Key among these good governance practices are:

- An independent chair. The chairman of the board should be a non-executive who holds no position at the bank or bank holding company. It is not acceptable for the CEO of a bank or bank holding company to also be the chairman of the board.
- Majority Voting. Directors must be elected by a majority of votes, and those who fail to receive the majority of the votes must step down.
- Declassified Board. All directors must be elected annually.
- Annual Say on Pay. All financial institutions, not just those that received taxpayer assistance, must allow shareholders to cast a non-binding vote on the CEO pay, as well as the compensation policies for senior executives discussed in the company’s annual proxy statement.
- Independent compensation committee. All directors of the compensation committee must be independent, and have no financial ties to the company.
- Following the practice prevalent in Canada, CEOs of other publicly traded companies should not have a seat on the compensation committee. The compensation committee should be able to hire and fire its own independent advisers, including pay consultants, counsel and others, who perform no other services for the company, in line with the Treasury’s draft regulations on compensation, which would give compensation committees the authority to hire independent legal counsel.³⁶
- In-house counsel, if they advise the board compensation committee, especially if they work on recommendations to the company on the chief executive’s employment contract, draft a change-in -control agreement, and other compensation-related issues, would be subject to the same standards of independence.
- Companies should also disclose to shareholders in their annual proxy statement the nature of consulting arrangements with former chief

³⁵ Risk Management Lessons from the Global Banking Crisis of 2008,” Senior Supervisors Group, Oct. 21, 2009

³⁶ “Fact Sheet: Administration’s Regulatory Reform Agenda Moves Forward: New Independence for Compensation Committees,” *July 16, 2009*.

executives, describing in detail what the retired CEO is going to do for the company and the fees for such consulting work.

We appreciate the opportunity to comment on this proposed guidance. If we can be of further assistance, please do not hesitate to contact the AFL-CIO Office of Investment at (202) 637-3900.

Sincerely,

A handwritten signature in black ink, appearing to read "Elizabeth H. Shuler". The signature is fluid and cursive, with a long horizontal stroke at the end.

Elizabeth H. Shuler
Secretary-Treasurer