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COMMENTARY ON REGULATION OF INCENTIVES AT FINANCIAL INSTITUTIONS

May 31, 2011

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, Northwest
Washington, D.C. 20551
Attention: Jennifer J. Johnson, Secretary
Via Electronic Mail; Docket No. R-1410, RIN No. 7100-AD69

Dear Ms. Johnson:

I am submitting this letter in response to the request of the Board of Governors of the Federal Reserve System and six other federal agencies (the "Agencies") for comments on the Agencies' proposed rules under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Proposed Rules"). As a law professor who has researched and written on, among other matters, executive compensation and corporate governance, I write to comment on the Proposed Rules.[1]

In light of the short timeframe in which the Agencies are required to adopt the Proposed Rules, I have limited my comments to two issues raised by Section 956. In sum, I suggest that the Agencies' final rules under Section 956:

- ***Provide clear rules governing incentive compensation for all employees who take substantial risk at large financial institutions***, rather than only the institution's executive officers; and

- ***Require financial institutions to provide the Agencies with meaningful quantitative data on pay practices,*** rather than the qualitative descriptions required by the Proposed Rules.

Clear Rules on Incentive Pay for All Significant Risktakers

Consistent with Section 956's requirement that the Agencies prohibit incentive compensation arrangements that encourage inappropriate risks, the Proposed Rules require that, at large financial institutions, at least 50% of each executive officer's incentive pay be deferred for at least three years. For employees who are not executive officers, the Proposed Rules require only that the board of directors identify employees who "individually have the ability" to cause losses "that are substantial in relation to the institution's size," and then approve any such employees' incentive pay as appropriately "balanced."

Many commentators have debated whether the 50% deferral requirement provides an optimal balance of risk-taking incentives for executive officers. I agree with the Agencies' view, set forth in the Proposed Rules, that deferral is a "useful balancing tool" that "allows a period of time for risks not previously discerned . . . to ultimately materialize," and allows for adjustments to incentive pay "on the basis of observed consequences and actual performance as opposed to only predicted results." Whether or not deferral is perfectly optimal, as the Agencies have stated, the practice provides important benefits in the regulation of bankers' pay. My comments focus on a different question: Why should these deferral rules be limited to the group of executive officers, rather than all employees who take significant risks?

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[1] Although I served as an advisor to senior officials at the Department of the Treasury on matters related to executive compensation during 2009 and 2010, the views reflected in this letter are solely my own. I write solely in my individual capacity; my institutional affiliation is given here solely for purposes of identification.

For three reasons, limiting these deferral rules to the group of executive officers is inadvisable. First, as a practical matter, this limitation renders the Proposed Rules redundant to existing law and practice. Securities law already requires extensive disclosure of executive pay, so executives' incentives are already subject to extensive scrutiny by regulators, shareholders, and the public. Moreover, compensation standards voluntarily adopted by most large financial institutions already require deferral of more than 50% of executive officers' incentive pay.[2] Thus, limiting the deferral rules to the group of executive officers renders them redundant to standard, current practices at large financial institutions.

Second, the definition of "executive officer" does not capture the group of employees whose incentives would benefit from the deferral requirement. The Proposed Rules borrow, with some modification, the definition of "executive officer" from the securities-law context, where the definition governs a wide range of matters, from disclosure to insider trading.[3] But this definition was not designed to address, nor does it address, matters related to risktaking. Thus, the "executive officer" definition does not capture all employees for whom a "period of time for risks . . . to ultimately materialize," and for pay adjustments to be made "on the basis of . . . actual performance," would be appropriate.[4]

Third, limiting these rules to executive officers is inconsistent with both the text of Section 956 and international standards on compensation. Section 956(b), which requires the Agencies to prohibit incentives that encourage inappropriate risks, expressly applies not only to payments to any "executive officer," but also to any other "employee." And although, as the Proposed Rules note, requiring deferral is consistent with international standards on compensation developed by the Financial Stability Board, limiting the deferral rules to the group of executive officers is *not* consistent with those standards. The standards state clearly that variable compensation should be deferred for "senior executives *as well as other employees whose actions have a material impact on the risk exposure of the firm*," and deferral rules recently adopted by the European Parliament expressly apply "at least" to "senior management, risk takers, staff engaged in control functions and any employee whose total remuneration . . . takes them into the same remuneration bracket as senior managers and risk takers."[5]

It might be argued that, although the 50% deferral requirement applies only to executive officers, the Proposed Rules *do* meaningfully regulate the incentives of non-executives who take substantial risk by requiring boards of directors to identify these employees and approve their pay. For two reasons, however, we should expect this requirement to have a limited effect on the incentives of non-executives.

First, it is unlikely that large financial institutions will identify many employees who "individually have the ability" to expose the institution to losses that are substantial in relation to the institution's size. For one thing, most large financial institutions limit employees' formal authority to act

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[2] *See, e.g.,* JPMorgan Chase & Co., Definitive Proxy Statement (Form DEF 14A), at 64 Appx. E (April 7, 2011) (describing standard, voluntary compensation principles under which "[s]enior executives receive at least 50% (and in some cases, substantially more) of their incentive compensation in stock" that vests over three years).

[3] *Compare* Office of the Comptroller of the Currency et al., Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170, 21,175 (April 14, 2011) *with* Securities and Exchange Commission, Ownership Reports and Trading By Officers, Directors and Principal Security Holders, 56 Fed. Reg. 7242 (Feb. 21, 1991); *see also* 17 C.F.R. § 240.3b-7 (defining "executive officer" generally for securities-law purposes).

[4] Notably, many employees whose risktaking contributed to the financial crisis were not executive officers. For example, no employee of American International Group's Financial Products division was an executive officer during the crisis. Thus, the Proposed Rules' deferral requirements would not apply to bonuses paid to employees working in the Financial Products division—even if those employees were engaged in substantial risktaking activity.

[5] FINANCIAL STABILITY BOARD, PRINCIPLES FOR SOUND COMPENSATION PRACTICES: IMPLEMENTATION STANDARDS 3, Basel Switzerland (September 2009) (emphasis added); EUROPEAN PARLIAMENT, Directive 2010/76/EU (Dec. 14, 2010), at ¶ 3.

unilaterally.[6] For another, these rules apply only to large financial institutions—that is, institutions with $50 billion or more in assets. While the Proposed Rules do not define the phrase "substantial in relation to the institution's size," suppose that the Agencies conclude that the phrase includes losses equal to 5% or more of the institution's assets. On this interpretation, this requirement will apply only to employees who can individually cause losses of at least $2.5 billion. The boards of directors of large financial institutions are unlikely to identify many employees who individually have that ability.[7]

Second, even if directors *do* identify many employees in this situation, the Proposed Rules require only that the board approve the employees' incentives as "effectively balanc[ing] the financial rewards to the [employee] and the range and time horizon of risks." The Proposed Rules offer no definition of an "effective balance," leaving the standard for director approval open to a wide range of interpretations. Given the vagueness of this standard, directors' tendency to defer to the judgment of management in employee-related matters, and directors' interest in boardroom collegiality, the Agencies should not expect directors to have significant influence on incentives for non-executives—even those who take very significant risk on behalf of large financial institutions. Thus, clear rules are needed to govern the incentive pay of non-executive risktakers.

To be sure, the 50% deferral rule may not be appropriate for every employee who takes substantial risk on behalf of a large financial institution. But the Proposed Rules provide the 50% deferral rule for executives—and *no* rule for non-executives, even those who take very significant risks. While the precise scope of an appropriate rule for non-executive risktakers is beyond the scope of these preliminary comments, consistent with the Proposed Rules, the Agencies might consider a deferral requirement with a lower percentage threshold as a framework for such a rule.[8]

Limiting the deferral requirement to the group of executive officers renders the rule redundant to current practice and inconsistent with Section 956 and international standards on incentive pay. The Proposed Rules' board-approval requirement is unlikely to influence incentives of non-executive risk-takers at large financial institutions. Thus, as proposed, the Agencies' rules likely leave incentive pay unregulated for many risk-taking employees at large financial institutions. Because a rule governing incentives for these employees would be more consistent with the statute and the Agencies' rulemaking objectives, I suggest that the ***final rules under Section 956 provide clear rules governing incentives for non-executive employees who take significant risk on behalf of large financial institutions.***

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[6] Elsewhere, the Proposed Rules acknowledge that, despite these limits, the aggregate effects of individual actions can give rise to substantial risk, and therefore the Agencies have applied many standards in the Proposed Rules to "[g]roups of . . . persons who . . . in the aggregate, could expose" the financial institution "to material financial loss, *even if no individual . . . person in the group could expose*" the institution to such losses. Incentive-Based Compensation Arrangements, *supra* note 3, 76 Fed. Reg. at 21,178 (emphasis added). But the requirement that directors identify and approve specific employees' incentive pay contains no such qualification; it applies only to employees who are individually capable of causing significant losses.

[7] To see this, consider the SEC's rules requiring disclosure of situations where "compensation programs . . . raise material risks." Securities and Exchange Commission, Proxy Disclosure Enhancements, 74 Fed. Reg. 68,834, 68,335 (Dec. 23, 2009). These rules have generally given rise to very few disclosures. One reason may be that, given the rules' use of the materiality standard, boards of directors are not inclined to recognize many circumstances in which compensation plans give rise to risks of enterprise-level magnitude. For the same reason, the Agencies should not expect that directors will identify many situations in which an employee individually has the ability to cause losses that are significant in relation to the institution's overall size.

[8] The Agencies could also choose from a wide range of methods for identifying the non-executives who would be subject to the rule. As noted in the Proposed Rule, these employees could include those who receive the highest annual compensation, an approach consistent with Congress's framework for regulating incentive pay in firms that received assistance during the financial crisis. Alternatively, the boards of directors of these institutions could be invited to identify a specified number of non-executive risktakers who will be subject to the rule.

Requiring Meaningful Quantitative Reporting on Incentive Pay

Section 956(a) requires "enhanced disclosure and reporting of compensation" at financial institutions, including disclosure on the "structures of all incentive-based compensation arrangements." The Proposed Rules would have each financial institution provide a "clear narrative description" of its incentive-pay arrangements; a "succinct description of [the institution's] policies and procedures" governing incentive pay; a "succinct description" of incentive-pay plans for executive officers and employees identified as individually having the ability to cause substantial losses; and "specific reasons why the [institution] believes the structure of its [incentive pay] does not encourage inappropriate risks."

These reports would be largely redundant to existing disclosure long required by securities rules. Moreover, because they would exclusively consist of qualitative reports rather than quantitative data, they are unlikely to give the Agencies information that would be helpful in supervising incentive pay.

First, most large financial institutions are public companies subject to securities rules that have long required qualitative disclosure of exactly the kind required by the Proposed Rules, including a qualitative description of the company's "policies for allocating between long-term and currently paid out compensation" and a "narrative description" of incentive pay granted to executives.[9] In Section 956, Congress gave the Agencies robust authority to require extensive reports on pay practices at financial institutions. Congress's purpose is hardly met by duplicative qualitative reports of this kind.

Second, experience with the disclosures required under existing law shows that qualitative reports of this kind will give the Agencies little information that would be helpful in supervising incentive pay. In response to these rules, public companies generally provide shareholders with essays on pay practices that are difficult to compare either to each other or to prevailing best practices. It is difficult to see how the Agencies could use these reports to identify incentive pay practices at specific financial institutions that warrant closer regulatory attention.

In my view, the policy objectives of Section 956(a) can be achieved in a variety of ways, and the exact design of these enhanced reports is beyond the scope of these preliminary comments. What is clear even at this early stage, however, is that the reporting requirements of the Proposed Rule are inadequate both to the statutory purpose and the Agencies' policy objectives. Rather than duplicative qualitative reports, the final rules under Section 956(a) should require clear quantitative data. These reports should at least require financial institutions to provide the Agencies with quantitative detail on the percentages of compensation deferred and paid in equity instruments for all employees—whether or not executive officers—who take significant risk on behalf of the institution. And, consistent with the financial-economics literature on the relationship between pay and performance, the reports should include quantitative data on the amount of equity in the firm owned by these employees.[10]

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[9] 17 C.F.R. § 229.402(b)(2)(i); *id.* § 229.402(e)(1)(i-iv). The Proposed Rule's language on this reporting requirement is nearly identical to the language that has governed securities-law disclosure requirements since 2006, except for modifications designed to "streamline" reporting. Financial institutions subject to the Proposed Rule could thus be forgiven for concluding that this language permits them to use identical reports to comply with identical language in the Proposed Rules and securities rules. This might explain why a recent comment letter from the Financial Services Roundtable and Chamber of Commerce, although critical of some aspects of the Proposed Rule, offered only "applau[se]" in response to the "streamlined" nature of the reporting requirements. Letter from Center on Executive Compensation et al. to Elizabeth M. Murphy, Sec'y, SEC (May 25, 2011), at 10.

[10] This literature shows that equity ownership in the firm provides a far stronger pay-performance link than standard incentive payments such as bonuses. *See, e.g.*, Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 226 (1990). More recent work has suggested that substantial equity stakes may cause the managers of financial institutions to pursue levels of risktaking that is socially excessive. *See, e.g.*, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247

In sum, the reporting provisions of the Proposed Rules require financial institutions to provide qualitative information to the Agencies that is largely duplicative of information already required under existing law and is unlikely to assist the Agencies in monitoring incentives at financial institutions. These reporting requirements are inconsistent with the purpose of Section 956 and the Agencies' joint objective of ensuring that incentive-based pay does not threaten the safety and soundness of these institutions. Accordingly, I suggest that the final rules under Section 956 instead ***require financial institutions to provide the Agencies with clear quantitative data on the structure of incentive compensation for all employees who take significant risk on behalf of the institution.***

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I appreciate the opportunity to provide comments on the Proposed Rules. If further discussion of these comments would be helpful to the Agencies or their respective staff, I would be pleased to be of assistance. Please do not hesitate to contact me at your convenience at (212) 854-0409 or via electronic mail at robert.jackson@law.columbia.edu.

Robert J. Jackson, Jr.

Associate Professor of Law
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cc: Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (File No. S7-12-11)
Alfred M. Pollard, General Counsel, Federal Housing Finance Authority
Mary Rupp, Secretary of the Board, National Credit Union Administration
Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency (OCC-2011-0001)
Chief Counsel's Office, Office of Thrift Supervision (OTS-2011-0004)

(2010). Yet under the Proposed Rules the Agencies would require no quantitative data from financial institutions with respect to the equity ownership of any employees, regardless of their responsibility for the firm's risk profile.