American Federation of Labor and Congress of Industrial Organizations

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May 31, 2011

Sent via Electronic and U.S. Mail

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Incentive-Based Compensation Arrangements (File Number S7-12-11)

Dear Mr. Feldman and Ms. Murphy:

On behalf of the American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO"), I am writing to provide comment on the proposed rule on incentive-based compensation arrangements under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The AFL-CIO is the country's largest labor federation and represents 12.2 million union members. Union-sponsored pension and employee benefit plans hold more than $480 billion in assets. Union members also participate directly in the capital markets as individual investors and as participants in pension plans sponsored by corporate and public-sector employers. The retirement savings of America's working families depend in part on financial institutions having responsible compensation practices for their executives and other employees.

We commend the Federal Reserve Board, Federal Deposit Insurance Corporation, other banking regulators, and the Securities and Exchange Commission for taking steps to ensure that incentive compensation does not undermine the safety and soundness of financial institutions.

It is important to remember the toll of the financial crisis would have been far greater had the financial institutions not been rescued by the federal government through a $700 billion taxpayer-funded program. The Troubled Asset Relief Program not only bailed out banks but also insurance companies and broker-dealers.

Various experts and panels, including the Financial Crisis Inquiry Commission, have concluded that compensation practices contributed to the collapse of such storied names as the Bear Stearns Companies, Lehman Brothers Holdings, Merrill Lynch & Co., Countrywide Financial, Wachovia Bank and Washington Mutual. Indeed, the Federal Deposit Insurance Corporation has cited compensation practices as a factor at some of the troubled banks that had to be bailed out.[1]

The Financial Crisis Inquiry Commission notes that "Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences."[2] Such pay practices were not limited to the top executives. Rather, as the Financial Crisis Inquiry Commission says, "This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street."[3]

Professor Lucian A. Bebchuk of the Harvard Law School found that the asymmetry in the compensation arrangements at the financial institutions encouraged the executives to act recklessly in the hopes of collecting a huge payoff without any downside.

Angelo Mozilo, the former chairman and chief executive officer of Countrywide Financial, is a classic example of this problem. For years, he was among the highest-paid executives in America and received total compensation of $521.5 million between 2000 and the time he left the company in 2008.[4] He was charged by the Securities and

[1] *See e.g.* FDIC Cease and Desist Order against One United Bank, Boston, October 9, 2008, *available at* http://www.fdic.gov/bank/individual/enforcement/2008-10-09.pdf

[2] Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, page XIX.

[3] Ibid.

[4] "Lending Magnate Settles Fraud Case," The New York Times, October 15, 2010.

Exchange Commission for illegally selling nearly $140 million in Countrywide stock while possessing inside information about the company's troubles. He agreed to pay $67.5 million in penalties to settle civil fraud and insider trading charges.[5]

What's more, as Professor Bebchuk has documented, the top executives of Bear Stearns and Lehman Brothers regularly unloaded shares and stock options, and thus were able to cash out much of their equity before the stock price of their firms plummeted. Indeed, Professor Bebchuk's study notes that top executives at Bear Stearns and Lehman Brothers sold more shares—$1.1 billion and $860 million respectively—than they held when the music stopped in 2008.[6]

While Bear Stearns and Lehman Brothers collapsed, the asymmetry in executive compensation at financial institutions continues to be a problem at the surviving firms. Not only were many of these firms bailed out but, in some cases, the executives were able to preserve their equity in their companies.[7]

That is why these rules proposed under Dodd-Frank Section 956 are especially important. The proposal gives regulators the authority to prohibit incentive-based compensation arrangements that encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss. The proposal requires financial institutions to disclose the structure of incentive pay arrangements but does not require disclosure of the actual incentive compensation paid to particular individuals.

We are concerned with the definition of incentive compensation arrangements in the proposal. The proposal defines incentive-based compensation as "any variable compensation that *serves* as an incentive for performance." While this definition appears to be broad, it does not name specific forms of incentive compensation. We urge that the final rule add the following language to the definition of incentive compensation: "including, but not limited to, cash bonus plans, stock options, restricted stock, and all other forms of compensation linked to the price of any security issued by the institution, any accounting measure, or any financial measure."

We question whether it is appropriate to link the pay of financial industry executives to their institution's equity if there is an implicit government guarantee of the solvency of the financial institution. Professor Bebchuk argues that to the extent banks can expect to be bailed out, incentive compensation for financial executives should be

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[5] "Mozilo Agrees to Pay $67.5 Million," The Wall Street Journal, October 16, 2010.
[6] "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008," by Lucian Bebchuk, Alma Cohen and Holger Spamann.
[7] "As Citi Revives, Pandit Wins a Big Pay Package," The New York Times, May 18, 2011.

linked not to the value of the institution's securities, but rather to "the aggregate value of the bank's common shares, preferred shares and bonds minus any payments made by the government to the bank's depositors, as well as other payments made by the government in support of the bank during the specified time period."[8]

In our view, what makes incentive compensation for financial institution executives especially dangerous is the extent to which it involves risk asymmetries or short-term horizons. It is essential to ensure that the upside and downside risks in incentive compensation be symmetric and the time horizons for the payoffs are long enough that the executive must hold the incentive compensation through a business cycle. The Aspen Principles—which have been endorsed by business groups such as the Business Roundtable, as well as investors represented by the Council of Institutional Investors and the AFL-CIO, recommends that incentive compensation be based on the metrics of long-term value creation—over five or more years. [9]

To ensure that incentive compensation takes into account an institution's performance over an entire business cycle, and to prevent opportunities for gaming the payouts, we recommend that the deferral period for incentive awards made to executives should be at least five years or retirement age, whichever comes later.

Finally, these two principles—that the risks should be symmetric, and the payoffs should be tied to long-term value creation—should lead regulators to be deeply suspicious of stock options as a form of incentive compensation. As early as 2002, then Federal Reserve Chairman Alan Greenspan blamed stock options for the "infectious greed" of the 1990s that "created incentives to artificially inflate reported earnings in order to keep stock prices high and rising."[10]

More recently, Professor Bebchuk testified before the House Financial Services Committee that the ability to cash out large amounts of stock options and other equity based incentive pay—"provided executives with powerful incentives to seek short-term gains, even when doing so involves excessive risk-taking."[11]

Stock options promise executives all of the benefits of share price increases with none of the risk of share price declines. In other words, stock options provide

[8] "How to Fix Bankers' Pay," Lucian A. Bebchuk, William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics and Finance and Director of the Corporate Governance Program, Harvard Law School.
[9] The Aspen Institute, "Long-Term Value Creation: Guiding Principles for Corporations and Institutions."
[10] Testimony of Federal Reserve Chairman Alan Greenspan before the Senate Banking, Housing and Urban Affairs Committee, June 16, 2002.
[11] "Equity Compensation for Long-Term Results," The Wall Street Journal Op-Ed, June 16, 2009, by Professors Lucian Bebchuk and Jesse Fried, University of California at Berkeley Law School.

executives with asymmetric incentives to shoot for the moon. Stock options can also encourage short-term decision making because many stock options can be cashed out over short time frames—as little as one year. As a result, stock options 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.

Stock options also permit executives to inappropriately profit from share price volatility without creating additional value. For example, during the financial crisis many executives received stock option grants at depressed share prices. Executives at these companies profited handsomely when their companies' stock price rebounded. According to Brian Foley, a compensation consultant, "Large equity grants made at depressed share prices in late 2008 and early 2009 have become 'lottery tickets' for some."[12] For these reasons, stock options are not an appropriate form of compensation for executives and should be prohibited.

We appreciate the opportunity to comment on this proposed rule. If we can be of further assistance, please do not hesitate to contact the AFL-CIO Office of Investment at (202) 637-5379.

Sincerely,

D. F. Pedrotty

Daniel F. Pedrotty
Director, Office of Investment

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cc: Office of Comptroller
Jennifer J. Johnson, Federal Reserve Board
Chief Counsel's Office, Office of Thrift Supervision
Mary Rupp, National Credit Union Administration
Alfred M. Pollard, Federal Housing Authority

[12] "Options Given During Crisis Spell Large Gains for CEOs," The Wall Street Journal, April 26, 2011.