

April 30, 2012

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

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (File Number RIN 7100-AD-86)

Dear Ms. Johnson:

This letter is being submitted in response to the request for public comment (“NPR”, “Proposed Rule”) issued by the Board of Governors of the Federal Reserve System (“Board”) with regard to its proposed implementation of Sections 165 and 166 of the Dodd-Frank Act.¹

While the Board has creditably proposed highly detailed and largely effective prudential standards for systemically important financial institutions (“SIFIs”, “covered companies”), it has not adequately addressed the risks that excessive compensation can pose to liquidity, stability and risk-mitigation at these institutions.

A. The Board’s has Broad Authority to Impose Prudential Standards Relating to Compensation

We urge the Board to utilize one of several jurisdictional bases to impose constraints on employee compensation at covered companies.

First and foremost, Section 165 of the Dodd-Frank Act itself affords the Board very wide latitude to impose any additional prudential standards that it deems to be appropriate.²

The Board of Governors may establish additional prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), that include—

¹ I am an attorney in private practice, a FINRA arbitrator, and a co-founding member of Occupy the SEC, a working group within Occupy Wall Street. However, this letter is being submitted in my individual capacity and expresses only my personal opinions.

² 12 U.S.C. § 5365(b)(1)(B) (2011).

(iv) such other prudential standards as the Board or Governors, on its own or pursuant to a recommendation made by the Council in accordance with section 115, determines are appropriate.

Similar latitude can also be found under the rubric of other Board regulations.

For instance, it should be noted that the Board already has authority under Section 956 of the Dodd-Frank Act to prohibit incentive-based compensation that is excessive and encourages risky behavior.³ The Board should integrate that authority more explicitly into its implementation of the enhanced prudential standards for covered companies under this Rule.

Also, the Board's Capital Plan Rule⁴ seeks to safeguard a bank holding company's capital adequacy by placing restrictions on certain covered distributions of capital, including stock repurchases and dividends. However, stock repurchases and dividends are not the only conceivable drain on capital. The Fed has recognized in its Supervision and Regulation Letter SR 09-4 that capital plans "should take into account the potential drain on a BHC's resources posed by the payment not just of cash dividends, but also of non-cash dividends, which can take many different forms."⁵ Wasteful compensation schemes, especially in the form of stock options or dividends, should qualify as dividends that fall within the ambit of the Capital Plan Rule. Under this view, the Capital Plan Rule would be yet another jurisdictional basis that the Board could utilize as authority for the imposition of compensation restrictions.

B. The Unfairness and Inefficiency of Bank Bonuses Militates in Favor of Prudential Compensation Restrictions

Recent history has demonstrated that large financial institutions are prone to dissipating exorbitant amounts of capital on employee compensation. In most industries, bonuses are not issued if a particular company has experienced financial distress or a recent history of losses. Banks and other major financial institutions are different. At these institutions, the inquiry is not whether to issue employees exorbitant bonuses, but how large a bonus to give. Former Attorney General of New York Andrew Cuomo's investigation into Wall Street bank bonuses found that "when the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well."⁶

For instance, a February 2012 report by New York State's comptroller found that total payouts to finance industry employees in New York in 2011 only dropped 14 percent during bonus season, even though profits had plunged by a whopping 51 percent.⁷ Securities firms in New York

³ 12 U.S.C. § 5641.

⁴ See Capital Plans, 76 Fed. Reg. 74631 (Dec. 1, 2011).

⁵ SR Letter 09-4 (revised March 27, 2009), available at <http://www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm>.

⁶ Andrew M. Cuomo, N.Y. State Office of the Att'y Gen., No Rhyme or Reason: The "Heads I Win. Tails You Lose" Bank Bonus Culture 1 (2009).

⁷ *Executive Pay*, N.Y. Times, Apr. 20, 2012, at http://topics.nytimes.com/top/reference/timestopics/subjects/e/executive_pay/index.html.

earned \$13.5 billion in 2011, down from \$27.6 billion in 2010. Nevertheless, these firms paid roughly \$20 billion in year-end cash bonuses, averaging \$121,150 per person. A.I.G. famously issued multi-million-dollar bonuses to employees even though it was relying on a \$100 billion lifeline to stay solvent. As noted above, excessive compensation can also take the form of shares and share options, which can have a dilutive effect on equity, not to mention revenues and retained earnings.

Certain banks may attempt to justify outlandish compensation structures on the basis of recent profitability. However, one must recognize that profitable banks owe their successes largely to government subsidies and intervention over the last few years. Earning a profit on financial services should not be used as justification for exorbitant bonuses when those bonuses are essentially derived from banks' access to free money through innumerable Fed monetary programs, such as quantitative easing and the "discount window." To make matters worse, many economists have expressed credible concerns that these bank-coddling policies have contributed to burgeoning headline inflation, which only serves to hamper the ability of the average person to pay for food, fuel and other necessities. These difficulties are compounded by the lingering effects of the recent bank-induced recession. Such effects include recalcitrant rates of unemployment and massive numbers of discouraged workers.⁸ Income inequality in the United States is at an all-time high, surpassing levels seen during the Great Depression.⁹

In the face of this sad reality, the unabated proliferation of lavish bonuses for the privileged few at Fed-subsidized banks is not just unseemly -- it is reminiscent of pre-Revolution France in its profoundly undemocratic nature.

Aside from their fundamental unfairness, lavish bonuses also pose palpable risks to overall financial stability. Excessive employee compensation is a drain on a financial institution's resources, and is therefore a liquidity/capital issue just as dividends and share repurchases are. One can easily anticipate the bank lobby's retort: that exorbitant compensation is (ostensibly) necessary for retention of qualified employees. This argument rings hollow when one compares bank compensation in the United States to that in overseas markets.

[Financial institutions] have claimed it is impossible to recruit people without paying such compensation. Yet, if you look at the pay levels in Europe and in a lot of Asian countries, somehow they manage to find people who can run major global firms while making a fraction of what they make in the U.S.¹⁰

The fact is that employee compensation at major U.S. banks and other large-scale financial institutions is largely unmatched world-wide, especially for higher level employees. Non-pareto-optimal compensation is essentially equivalent to wasted capital that could have been better utilized for the purposes of financial stability, liquidity and capital adequacy.

⁸ U.S. Dep't of Labor, Bureau of Labor Statistics, Economic News Release, Employment Situation Summary – The Employment Situation – March 2012, <http://www.bls.gov/news.release/empsit.nr0.htm> (last visited Apr. 30, 2012).

⁹ *Income Inequality Is at an All-Time High: STUDY*, Huffington Post, Sep. 14, 2009, http://www.huffingtonpost.com/2009/08/14/income-inequality-is-at-a_n_259516.html.

¹⁰ Steve Eder, *Study Shows U.S. Bank CEO Pay Dwarfs Rest of World*, Reuters, Sep. 23, 2009, available at <http://www.reuters.com/article/2009/09/23/us-compensation-exclusive-idUSTRE58M2QU20090923>.

C. Bonus Schemes at Financial Institutions Present Agency Problems in Need of a Solution

The American financial system suffers from an agency problem that can be partly addressed by the Board's imposition of compensation standards. The NPR recognizes that the actions taken by the government in recent years have "solidified" the market view that major financial companies will receive government assistance if they become troubled.¹¹ This creates a classic agency problem whereby financial companies are incentivized to engage in risky activities that reflect an orientation towards short-termism.

German economists have developed a theoretical model demonstrating that financial companies (and their shareholders) react to bail-out expectations by designing bonus schemes that reward managers for taking higher levels of risk.¹² Where bailout expectations are high, the potential downside of speculative activity is stripped away, leaving only the upside. However, this situation hurts the overall economy, as society-at-large ends up bearing the costs of inefficient speculation. According to that model, "ceilings on bonus payments can be welfare-increasing, especially if bail-outs are expected with a high probability."¹³ Admittedly, the study finds that ceilings on bonus payments may not be efficient where bail-out expectations are not present, because such ceilings serve as disincentives to productivity. However, it reconfirms that "a sufficiently large increase in bail-out perceptions *always* makes it optimal for a welfare-maximizing regulator to impose ceilings on bank bonuses."¹⁴ Therefore, if bail-out expectations have become "solidified," as the NPR admits,¹⁵ it behooves the Board to maximize economic welfare by increasing the role of compensation restrictions in its implementation of Sections 165 and 166. The interests of overall financial stability demand this action, even if it comes at the detriment of a select few.

Another sort of agency problem derives from the corporate structure of the typical financial conglomerate. In decades past, many of our major financial institutions companies operated as partnerships.¹⁶ If the company lost money, that loss was directly borne by its partners. Thus, company managers, as partners, had strong incentives to minimize risk and pursue sound financial practices. Today, most systemically important financial institutions are corporations, and the managers who decide on risk levels are less likely than before to have an equity stake in the company. As a result, managers do not necessarily "feel the pinch" of risky bets gone bad. Further complicating matters is that shareholders typically have no direct decisionmaking-authority over director, officer or employee compensation levels. Consequently, company employees can continue to extract rents in the form of lavish bonuses even when shareholders lose money. The bonus statistics cited above corroborate this observation. The imposition of compensation standards would re-align the interests of managers and shareholders, thereby promoting safe and sound market conditions.

¹¹ NPR at 595.

¹² Hendrik Hakenes & Isabel Schnabel, *Bank Bonuses and Bail-outs* (Feb. 8, 2012), http://www.financial.economics.uni-mainz.de/Dateien/Hakenes_Schnabel_Bonus.pdf.

¹³ *Id.* at 2.

¹⁴ *Id.* at 3 (emphasis in original).

¹⁵ NPR at 595.

¹⁶ Claire A. Hill & Richard W. Painter, *Another View: A Simpler Rein Than the Volcker Rule*, Oct. 28, 2011, available at <http://dealbook.nytimes.com/2011/10/28/another-view-a-simpler-rein-than-the-volcker-rule/>.

Moreover, the Proposed Rule's restrictions on the issuance of dividends do not go far enough in safeguarding a covered company's liquidity. If covered companies operated under the old partnership model, the Board's prudential restrictions on dividend distribution would adequately address the unjust enrichment of both shareholder and employee (often the same person). However, since most covered companies are now corporations, dividend restrictions only account for wastage of resources on shareholders. The Proposed Rule and the Capital Plan Rule fail to address the equally significant (and possibly more significant) risk of wastage on employees.

A principal role of financial regulators is to address these types of agency problems through the means of regulation, and we urge the Board to take up this task in its final formulation of this Rule.

D. The Link Between Excessive Compensation and Systemic Risks

One might argue that compensation issues are unrelated to the risk management issues presented in Sections 165 and 166. However, that argument loses sight of the approach taken by overseas regulators and the necessary connection between liquidity, company efficiency and risk.

As noted above, major foreign banks have been able to compete on the world financial stage despite paying their executives a fraction of what is paid to their counterparts in the United States. This disparity suggests that foreign banks are able to operate in a more efficient manner, producing similar output with lower labor costs.¹⁷ This increased efficiency frees up capital, which can then be used for reinvestment, liquidity buffers and capital reserves. The availability of excess capital is obviously a relevant consideration for purposes of the implementation of Sections 165 and 166.

Conversely, as a financial institution's liquidity decreases, the risk of the government or the Board having to bail out that institution concomitantly increases. If the institution continues to provide gratuitous bonuses to its executives despite decreases in liquidity (as has proven to be the case in recent history) then the necessary outcome is that the government or the Board, by virtue of its monetary authority, is ever more likely to end up paying for those bonuses directly. When managers are rewarded industry-wide for activities that hurt bank productivity and liquidity and imperil overall stability, perverse incentives are created for the agglomeration and expansion of market risk.

Foreign regulators have recognized the risks that excessive compensation at systematically significant institutions can pose for financial markets. For instance, the United Kingdom's Financial Services Authority ("FSA") has recognized that:

Market discipline has not been effective in limiting the adverse effect of poor remuneration practices on risk management, particularly at large systemically relevant

¹⁷ American financial institutions that overpay their employees vis-à-vis their foreign counterparts therefore actually create a competitive disadvantage for themselves.

institutions. In many cases shareholders have allowed management to introduce compensation policies that in effect subordinate the interests of shareholders to those of employees, particularly senior employees engaged in trading businesses. Bonuses in many firms are accrued before taking into account the risk-adjusted return that shareholders should receive in return for providing the capital to the firm that allows management to take risk.¹⁸

The FSA has taken action to address this issue by issuing Policy Statement 09/15 of the FSA, which restricts the remuneration policies of certain large banks and financial institutions with the goal of promoting risk management. In instituting these restrictions, the FSA has explicitly recognized that certain types of compensation not only drain capital but also encourage risky behavior:

If remuneration consists predominantly of cash bonuses that are paid out immediately without any deferral or claw back mechanism, and are based on a formula that links bonuses to current year revenues rather than risk-adjusted profit, there are strong incentives for managers to shy away from conservative valuation policies, strong incentives to ignore concentration risks, strong incentives to rig the internal transfer pricing system in their favour and strong incentives to ignore risk factors, such as liquidity risk and concentration risk, that could place the institution under stress at some point in the future. These strong incentives could undermine effective risk management.¹⁹

The FSA has incorporated compensation issue quite explicitly into its regulatory regime for systemically important financial institutions, and the Board should do the same in the instant Rule.

E. Suggestions for Compensation Restrictions that can be Implemented as Part of the Proposed Rule

The Proposed Rule contains many provisions that can be modified to incorporate prudential restrictions on excess compensation. As noted above, the Board enjoys wide jurisdictional authority to make these modifications.

Early Remediation. The NPR currently phases in limits on executive compensation at Level 3 of its four-part early remediation framework. However, invoking these limits at Level 3 is akin to closing the barn door after the horse has bolted. Level 2 remediation presents an opportunity to address the initial stages of financial difficulties. Incorporating prudential compensation provisions at Level 2 would reduce the likelihood of a covered company's financial position deteriorating to Level 3 in the first place. In addition, management may find the imposition of compensation restrictions at Level 2 to be more favorable than at Level 3, given that a Level 2 action plan is memorialized in the form of a non-public memorandum of understanding. In

¹⁸ Financial Services Authority. Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules, Policy Statement 09/15 at 11 (Aug. 2009), available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf.

¹⁹ *Id.*

contrast, the terms of a Level 3 action plan are to be made public, and are relatively more likely to invite public scrutiny.

The Board should require that any covered company that reaches Level 2 insert a clawback provision in its employment contracts to the effect that any bonuses earned or accrued by an employee shall be forfeited or repaid if the company reaches Level 3.

Contingency Funding Plan. Each covered company should be explicitly required to incorporate compensation restrictions into its contingency funding plan (CFP). The current Proposed Rule requires a covered company to “identify alternative funding sources that may be used during the liquidity stress events.”²⁰ Unpaid compensation should be incorporated as a possible “alternative funding source.” For instance, a covered company can be required to delay payment of bonuses or incentive-based commissions above a certain amount (e.g. anything in excess of \$100,000 in annual W-2 compensation) over a period of 5 years.²¹ The resignation of the affected employee should not accelerate the repayment obligation. During those 5 years, unpaid bonuses or commissions should be subject to reclamation should the covered company experience liquidity stress events or require bailout funds from the Treasury or the Board.²² Instituting this sort of internal “skin in the game” regime will create real incentives for SIFIs to organically eschew risk at all levels of their operations.

Specific Limits. The NPR envisions specific limits on potential sources of liquidity risk. To this end, the Board should consider setting certain compensation limits, as such limits would reduce liquidity risk. Major financial institutions have exhibited a tendency to continue paying exorbitant bonuses despite declines in productivity. For instance, the compensation-to-firm revenue for Goldman Sachs jumped from 39.3 percent in 2010 to 44 percent in 2011, even though the firm’s revenue dropped by 22 percent and its profit fell 7.2 percent during the same time period.²³ The same pattern has repeated itself across many SIFIs, which reflect an alarming predilection towards short-term profiteering instead of long-term growth and stability. The Board can ameliorate the fiscal health of SIFIs by setting compensation-to-revenue limits on all covered companies. The Board should consider various factors in defining these limits, including industry standards and theoretical assessments of Pareto-optimal compensation based on available data and metrics.

Risk Management Committee. The NPR mandates that each covered company and certain additional bank holding companies must establish a risk committee that is required to establish a risk management framework.²⁴ That framework must take into account various factors relating to the specifics of the company, including its particular risk limitations, policies and processes.²⁵

²⁰ Proposed Rule at § 252.58(b)(1)(iv).

²¹ See *Executive Compensation Oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the House Comm. on Fin. Services* (Sep. 24, 2010) [hereinafter *Executive Compensation*] (testimony of Martin Neil Bailey, Senior Fellow, Brookings Institution) (proposing various compensation restrictions to be implemented in Wall Street to reduce risk).

²² See *id.*

²³ Andrew Ross Sorkin, *A Paradox of Smaller Wall Street Paychecks*, N.Y. Times Dealbook, Jan. 9, 2012, <http://dealbook.nytimes.com/2012/01/09/a-paradox-of-smaller-wall-street-paychecks/>.

²⁴ Proposed Rule at § 251.126(c).

²⁵ *Id.*

One factor that is currently missing in the NPR's description of the risk management framework is the extent to which compensation obligations constitute a risk for the company. In addition to delaying the payment of bonus compensation beyond a certain wage level, as discussed above, the Board should require that any such bonuses be subjected to risk-weighting, both for current and future risks.²⁶ That is, the bonus compensation payable to an employee under the staggered payment system described above should be subject to ongoing haircuts that correspond to the level of risk produced by the employee's decisions, and the liquidity impact of those decisions. This framework would be particularly useful for traders whose buying and selling activities can be easily quantified and tracked using risk metrics. Under the current system, traders are paid bonuses typically on a yearly basis, even if the trades undertaken end up being disastrous to the company in the long term. For instance, assume an overly-ambitious trader threatens a bank's capital by engaging in trades that do not explode until years into the future. In such a scenario, any compensation bonus paid to that trader around the time of the trade would have been unwarranted. However, current compensation practices that exist across the industry provide the affected company with no real options to reclaim unjustly paid compensation, short of litigation for unusual events such as fraud or material breach of contract.

If a covered company instead delays bonus payments and discounts them based on ongoing risk and liquidity effects, that company would be better able to both deter excessive risk and manage its real-time consequences. The risk committee established by the Proposed Rule would be able to monitor the risk inherent to positions taken in the past, and apply deductions to bonus pools as appropriate, thereby saving the company valuable money that can be better allocated to more efficient uses.

F. Conclusion

The Board has been afforded broad permissive authority to craft regulations that promote sound risk mitigation practices. It should utilize this authority to strengthen the Proposed Rule by imposing prudential compensation restrictions that would promote liquidity and avoid the unjustified dissipation of capital.

Thank you for your attention to this matter.

Very truly yours,

/s/

Akshat Tewary, Esq.

Via Internet Submission

²⁶ See *Executive Compensation*, *supra* note 21.