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United States Senate

WASHINGTON, DC 20510

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To Whom It May Concern:

The recent revelation that JPMorgan Chase lost billions of dollars on a series of synthetic derivatives trades has once again highlighted the dangers and shortcomings of incentive-based compensation.¹ According to the Federal Reserve, “[r]isk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007.”² Many of the reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) will help indirectly rein in Wall Street pay, as financial sector deregulation played a dominant role in the outsized growth of pay Wall Street packages from the 1990s until 2006.³ But the Dodd-Frank Act also provides your agencies with specific authorities to address excessive pay. I write to you today to urge you to prescribe stronger rules to prohibit major financial institutions from providing compensation

¹ For example, the head of the office responsible for those trades, JPMorgan’s Chief Investment Officer Ina Drew, received \$14 million in compensation last year – of which nearly 95 percent was incentive-based. See Laura Marchinek, Donal Griffin & Dawn Kopecki, *JPMorgan Said To Consider Clawing Back Bonuses After Loss*, BLOOMBERG, May 15, 2012 (“Drew, 55, received \$14 million in compensation for 2011, including \$7.1 million in restricted stock, a \$4.7 million cash bonus and \$750,000 salary, according to the proxy.”).

² Board of Governors of the Federal Reserve System, *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations* 5, Oct. 2011.

³ See Thomas Philippon & Ariell Reshef, *Wages and Human Capital in the U.S. Financial Industry: 1909-2006*, NBER Working Paper No. 14644, at 30 (Jan. 2009).

packages that are excessive or expose the institutions to risks that could result in material financial loss, and to finalize these rules in a timely manner.

Federal Reserve Chairman Bernanke has said that Wall Street compensation structures “led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability.”⁴ Between 2000 and 2008, the top five executives at Bear Stearns and Lehman Brothers earned a total of \$2.4 billion.⁵ These compensation arrangements provided top bank officials with incentives to seek short-term profits while creating a risk of large long-term losses.⁶ In part because of these compensation packages, the largest banks and investment banks took on leverage as high as 40 to 1.⁷ As Nobel Prize-winning economist Joseph Stiglitz told the Subcommittee on Financial Institutions and Consumer Protection, “[t]he so-called incentive systems in place in the financial sector may have served the bank managers well, but they did not serve well shareholders or bondholders, let alone the rest of society.”⁸

The Federal Reserve should be commended for conducting an unprompted horizontal review of banks’ compensation practices, but those reviews provide little concrete guidance for specific reforms to bank compensation. Section 956 of the Dodd-Frank Act directs regulators to ensure that Wall Street’s incentive-based compensation practices are appropriately measured and disclosed in order to help prevent another financial collapse.⁹ In April 2011, federal regulators issued an initial proposal to regulative incentive-based compensation that would help prevent the practices that encouraged excessive risk-taking and short-term rewards.¹⁰ These proposals establish a baseline of rules to bolster our financial system, but the proposed rules must be strengthened and then implemented in a timely manner.

First, the proposed rules would require executive officers at large financial firms – those with at least \$50 billion in assets – to defer at least 50 percent of their incentive-based compensation for at least three years.¹¹ Unfortunately, the proposed rule does not depart significantly from the pay practices in place during the years preceding the financial crisis. Prior to the crisis, executives deferred an average of 53.6 percent of their compensation.¹² Goldman Sachs has already said that it will pay all of its executives’ discretionary compensation in “Shares at Risk” that cannot

⁴ Congressional Oversight Panel, *February Oversight Report: Executive Compensation in the Troubled Asset Relief Program* 18 (2011).

⁵ See Lucian Bebchuk, Alma Cohen & Spamann, Holger, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257, 282 (2010).

⁶ See *id.*, at 274.

⁷ See Financial Crisis Inquiry Commission, *THE FINANCIAL CRISIS INQUIRY REPORT* 63 (2011).

⁸ Testimony of Joseph E. Stiglitz, University Professor, Columbia University, before the Senate Banking Committee Subcommittee on Financial Institutions and Consumer Protection, “Debt Financing In The Domestic Financial Sector” 2, Aug. 3, 2011.

⁹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 956 (2010).

¹⁰ See *Incentive-Based Compensation Arrangements*, 76 Fed. Reg. 21170, 21180 (Apr. 14, 2011).

¹¹ See *id.*, at 21180.

¹² See Testimony of Professor Robert J. Jackson, Jr., Columbia Law School, before the Subcommittee on Financial Institutions and Consumer Protection, Senate Committee on Banking, Housing, and Urban Affairs, “Pay for Performance: Incentive Compensation at Large Financial Institutions” 7, Feb. 15, 2012.

be sold for five years.¹³ Despite these practices, it is clear that not enough is being done to tie long-term measurements of profits and losses. According to JPMorgan's recent SEC filings, there are "questions about the integrity of the trader marks" and that the traders "may have been seeking to avoid showing the full amount of the losses being incurred in the portfolio."¹⁴ This is a clear attempt by traders to use window dressing in order to maximize short-term profits at the expense of long-term growth.

Federal regulators should adopt rules that are more forward-looking than current industry practices by increasing the percentage of deferred compensation. Stock compensation arrangements for all employees, particularly those that engage in significant economic activities, should be subject to long-term holding periods and pro rata payments should be prohibited. Because of the sheer size of bank executive compensation, allowing bonuses to be paid out in pro rata shares over the mandated three-year retention period will not have a substantial impact on risk taking behavior. This will both align the economic incentives of employees with the firm overall, and will create what Professor Robert Jackson called a "base of patient capital" to be used either to finance economic activity or to help the institution weather economic difficulties. Implementing such a long-term holding period would be a step toward recreating the incentive structure that existed when Wall Street firms were organized as private partnerships.¹⁵

Second, although executive officers undoubtedly play important roles at financial firms, Federal Reserve General Counsel Scott Alvarez has also recognized that "[c]ompensation practices can incent even non-executive employees, either individually or as a group, to undertake imprudent risks that can significantly and adversely affect the risk profile of the firm."¹⁶ The first such example is London-based JPMorgan Chase Chief Investment Office trader Bruno Michel Iksil, also known as "The London Whale," who caused at least \$5.8 billion in losses on large, complex, illiquid derivatives trades.¹⁷ In 2008, trader Boaz Weinstein lost \$1.8 billion running an internal fund for Deutsche Bank.¹⁸ And recent reports concerning manipulation of the London Interbank Overnight Rate (LIBOR) show that derivatives traders at the British bank Barclays sought to influence LIBOR submissions, in order to benefit their profit & loss numbers, and presumably the bonuses based upon such figures.¹⁹ It is clear that various levels of traders at

¹³ See Lucian A. Bebchuk & Jesse M. Fried, *How to Tie Equity Compensation to Long-Term Results*, 22 J. OF APPLIED CORP. FINANCE 99, 101 (2010).

¹⁴ JPMorgan Chase & Co. Form 10-Q, June 30, 2012 at 9.

¹⁵ Because private partnerships put partners' investments directly on the line, management had a natural incentive to be risk-averse. Unfortunately, current practices appear to offer inadequate incentives for proper risk management. For example, the head of Barclays Capital told the U.K.'s House of Commons Treasury Committee that he was unsure about what portion of his incentive compensation was based upon the firm maintaining "good controls." See Evidence from Jerry Del Missier and the Financial Services Authority, Treasury Committee, House of Commons, July 16, 2012 available at: <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/uc481-iv/uc48101.htm>.

¹⁶ Testimony of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System before the Committee on Financial Services, U.S. House of Representatives, Feb. 25, 2010 at 1.

¹⁷ See Jessica Silverberg-Greenberg, *JPMorgan Says Trading Loss Tops \$5.8 Billion; Profit for Quarter Falls 9%*, N.Y. TIMES DEALBOOK, July 13, 2012 available at: <http://dealbook.nytimes.com/2012/07/13/jpmorgan-reports-second-quarter-profit-of-5-billion-down-9/>.

¹⁸ See, e.g., Azam Ahmed, *The Hunch, the Pounce and the Kill*, N.Y. TIMES, May 27, 2012 at BU1.

¹⁹ See, e.g., Financial Services Association, Final Notice 122702 (June 27, 2012) at 12 ("Trader C stated 'We have an unbelievably large set on Monday (the IMM). We need a really low 3m[onth LIBOR rate] fix, it could

large firms have the means and the incentives to take excess risk in pursuit of profits that will result in greater compensation. Adjustments to the incentives created by compensation arrangements at large financial institutions should be extended to include *any* employees who could put the firm at substantial risk.

Third, the rules would require each board of directors to identify employees who “individually have the ability to expose the institution to possible losses that are substantial in relation to the institution’s size, capital, or overall risk tolerance,” and to approve compensation packages for such employees.²⁰ It is highly unlikely that the board of directors would actually reject executive compensation packages.²¹ Further, while the rule provides the example of traders authorized with “large position limits relative to the institution’s overall risk tolerance and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution[,]” this interpretation sets a low bar and likely provides institutions with too much discretion.²² For example, Mr. Iksil’s trades have lost \$5.8 billion to date. The Comptroller of the Currency has said that this loss “does not present a solvency issue,” that JPMorgan’s capital levels are “sufficient to absorb this loss,” and that “the events at JPMC do not threaten the broader financial system.”²³ It seems hard to believe that these compensation rules would not apply to a single trader who is capable of losing \$5.8 billion, but the Comptroller’s comments suggest that they would not. To accomplish the desired effect of this rule, federal regulators should enumerate more specific and more stringent standards that would make an employee’s compensation subject to review, not by their board of directors, but by a non-conflicted party, such as the appropriate federal regulator.²⁴

Fourth, when making a determination on whether incentive-based compensation is excessive or could lead to material financial loss, regulators must have access to granular data behind a firm’s decisions on bonuses. Under the existing rule, financial institutions must provide a clear, narrative description of their incentive-based compensation packages, as well as an overview of the policies and procedures governing compensation decisions.²⁵ However, given the fact that regulators – to a certain extent – have access to general information on the compensation structures at each firm already, such a rule is unlikely to yield improved information. Rather than “generalized essays about pay-per-performance” as Professor Jackson describes the current rule, regulators should require financial institutions to provide specific quantitative data that describes the level and nature of the compensation each worker receives. Requiring quantitative data allows regulators to establish metrics and set benchmarks, giving them the ability to analyze

potentially cost a fortune. Would really appreciate any help”); *see also id.*, at 22 (“Trader D stated in an instant message to an external trader ‘look at the games in EURIBOR today [...] I am sure a few names made a killing’.”).

²⁰ *See Incentive-Based Compensation Arrangements*, 76 Fed. Reg. at 21181.

²¹ For example, Citigroup shareholders recently rejected, through non-binding “say on pay” votes, executive pay packages that had been approved by Citi’s board. *See* Suzanne Kapner, Joann S. Lublin & Robin Sidel, *Citigroup Investors Reject Pay Plan*, WALL ST. J., Apr. 18, 2012, at A1.

²² *See Incentive-Based Compensation Arrangements*, 76 Fed. Reg. at 21207.

²³ Testimony Of Thomas J. Curry, Comptroller of the Currency Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 6, 2012 at 26-27.

²⁴ Alternatively, board member compensation could be subject to clawback for failing to properly execute pay package review responsibilities. This would provide a powerful incentive for board members to focus their attention on compensation package reviews.

²⁵ *See Incentive-Based Compensation Arrangements*, 76 Fed. Reg. at 21206.

both the connection between value created and pay and the aggregate effect of bankers' pay structures on institutions and the financial system. Such information would also aid in the enforcement of the compensation provisions of the Volcker Rule prohibition against proprietary trading.²⁶

Fifth, the proposal requests comment on whether compensation hedging practices should be prohibited.²⁷ Hedging compensation packages using derivatives and other financial instruments blocks many of the negative implications of an executive unloading their company stock.²⁸ Preventing executives from circumventing incentive-based compensation arrangements through hedging will become particularly important as financial institutions move toward more equity-based pay arrangements with longer retention periods.²⁹ Indeed, some financial institutions have already recognized that hedging practices distort employee incentives and have banned the practice for their employees.³⁰ There is no reason for federal regulators to adopt rules that are more lenient than industry best practices. As a result, compensation hedging must be prohibited.

Sixth, in implementing the risk management and corporate governance aspects of the proposed rule, regulators should pay close attention to institutions' clawback policies. The Dodd-Frank Act contains clawback provisions in case of materially false financial statements or for executives of an institution placed in orderly liquidation.³¹ These provisions are necessary, but not sufficient—they apply in specific situations and contain limitations.³² The recent examples of wrongdoing in the financial sector encompass a wide range of behavior, from rate manipulation to falsifying trading positions, which can result in different kinds of short- and long-term losses. Robust clawback provisions should be used as a response to individuals seeking to game compensation policies.

Finally, after evaluating the proposed rules regarding incentive-based compensation, these proposals must be adopted expeditiously, so that we can reform the excessive and dangerous financial incentives that helped bring our nation to the brink of financial collapse in recent years. The Dodd-Frank Act – and in particular, Section 956 – provides regulators with tools to rein in reckless, irresponsible, and excessive compensation packages. But it has been nearly 16 months since your draft rules were first proposed, and nearly 16 months since the Dodd-Frank Act

²⁶ See *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 76 Fed. Reg. 68846, 68872 (Nov. 7, 2011) (“[T]he compensation arrangements of persons performing market making-related activities at the banking entity must be designed not to encourage or reward proprietary risk-taking.”); see also *id.*, at 68876 (“[T]he compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking.”).

²⁷ See *Incentive-Based Compensation Arrangements*, 76 Fed. Reg. at 21183.

²⁸ See Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 COLUM. L. REV. 951, 958-60 (2012) (noting that executive stock unloading sends negative signals about the company to markets and other company employees, and may have negative reputational implications for the executive).

²⁹ See Bechuck & Fried, *supra*, at 105.

³⁰ See Testimony of Professor Robert J. Jackson, Jr., *supra*, at 8 n.11. Anti-hedging policies were also required by the Special Master for TARP Executive Compensation. See Bechuck & Fried, *supra*, at 105.

³¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 at §§ 210(s), 954.

³² See, e.g., Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. OF CORP. L. 721, 747-50 (2011) (noting limitations of the SEC clawback provision and suggesting some improvements).

requires these rules to have been prescribed.³³ Your agencies must use these tools now to bring more meaningful reform to Wall Street's incentive-based compensation practices.

Thank you again for your attention to this important matter. I look forward to your response and, more importantly, your action in finalizing these rules.

Sincerely,



Sherrod Brown
United States Senator

³³ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 at §956.