Regulation JJ, Incentive-Based Compensation Arrangements (Docket No. R-1410).

On July 17, 2013, representatives of the following organizations met with Governor Sarah Bloom Raskin and discussed the proposed rule on incentive-based compensation arrangements: Americans for Financial Reform, Public Citizen, AFL-CIO, the Institute for Policy Studies, and Demos. They submitted two items for the record – testimony on February 15, 2012 before the Senate Subcommittee on Financial Institutions and Consumer Protection of the Committee on Banking, Housing, and Urban Affairs by Professor Robert J. Jackson Jr. of Columbia Law School and by Professor Lucien A. Bebchuk of Harvard Law School. The representatives stated that a final, meaningful, incentive compensation rule should be adopted expeditiously. They stated that the incentive compensation rule should cover a broad range of employees, broader than those covered in the proposed rule, that it should not allow covered institutions' boards of directors to approve the institutions' own incentive compensation policies, and that it should require meaningful, quantitative disclosure of covered institutions' incentive compensation arrangements. They also stated that the deferral provision should be strengthened and that bonuses should be "escrowed" for several years. In addition, limits should be placed on the "cashing out" of incentive compensation in any year, and there should be limitations on the use of equity and hedging transactions in incentive compensation arrangements at covered institutions.

Testimony of Professor Lucian A. Bebchuk

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Before the
Subcommittee on Financial Institutions and Consumer Protection
of the
Committee on Banking, Housing and Urban Affairs Committee
United States Senate

Hearing on Compensation Practices at the Largest Financial Institutions

February 15, 2012

*The views expressed herein are solely my own and should not be attributed to Harvard Law School or any other institution with which I am affiliated. My affiliation is noted for identification purposes only.

Chairman Brown, Ranking Member Corker, and distinguished members of the Subcommittee, I would like to thank you very much for inviting me to testify today. Adequate design of compensation practices at large financial institutions is important for financial stability, and I am honored to have been invited to testify on this subject.

Below I discuss the role that compensation practices played in the financial crisis and how they should generally be designed going forward. I describe two distinct sources of risk-taking incentives: first, executives' excessive focus on short-term results; and, second, their excessive focus on results for shareholders, which corresponds to a lack of incentives for executives to consider outcomes for other contributors of capital. I discuss how pay arrangements should be designed to address each of these problems. The issues I discuss are ones on which I have done a significant amount of academic writing, and my testimony draws on my writing.[1]

My focus throughout is on how senior executives of financial firms should be compensated. Regulators now rightly devote attention to the compensation of all employees of financial institutions who take or influence risk and not just senior executives. However, the pay arrangements of senior executives deserve special attention because such executives have substantial influence both on key risk choices of their firm and on the setting of compensation arrangements for other employees in their firm.

Problem I: Short-Term Focus

Standard pay arrangements have incentivized and rewarded short-term results. Jesse Fried and I warned about this problem and its consequences in our book *Pay without*

[1] My testimony draws on Lucian Bebchuk, Alma Cohen and Holger Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008," *Yale Journal on Regulation* 27 (2010): 257-282, available at http://ssrn.com/abstract=1513522; Lucian Bebchuk and Jesse Fried, "Paying for Long-Term Performance," *University of Pennsylvania Law Review* 58 (2010): 1915–1960, available at http://ssrn.com/abstract=1535355; Lucian Bebchuk and Holger Spamann, "Regulating Bankers' Pay," *Georgetown Law Journal* 98 (2) (2010): 247–287, available at http://ssrn.com/abstract=1410072; and Lucian Bebchuk, "How to Fix Bankers' Pay," *Daedalus* 139 (2010): 52-60, available at http://ssrn.com/abstract=1673250.

Performance: The Unfulfilled Promise of Executive Compensation, published seven years ago.[2] Under the standard design of pay arrangements, executives have been able to cash out large amounts of compensation based on short-term results. This feature of pay arrangements has provided executives with incentives to seek short-term gains even when doing so creates excessive risk of a later implosion.

In our study "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman Brothers 2000–2008,"[3] Alma Cohen, Holger Spamann, and I illustrate the problem through a case study of compensation at Bear Stearns and Lehman Brothers. We document that, notwithstanding the 2008 meltdown of the firms, the bottom lines for the period 2000-2008 were positive and substantial for the firms' top five executives. These top executives regularly unloaded shares and options, and thus were able to cash out a lot of their equity before the stock price of their firm plummeted.

The top executives' payoffs were further increased by large bonus compensation during 2000-2007; while the earnings providing the basis for these bonuses evaporated in 2008, the firms' pay arrangements did not contain any "claw-back" provisions that would have enabled recouping the bonuses that had already been paid. Altogether, while the long-term shareholders in these firms were largely decimated, the executives' performance-based compensation kept them in decidedly positive territory. Indeed, combining the figures from equity sales and bonuses, we find that, during 2000 to 2008, the top five executives at Bear Stearns and Lehman pocketed about $1.4 billion and $1 billion, respectively, or roughly $250 million per executive.

The divergence between how the top executives and their companies' shareholders fared raises a serious concern that the aggressive risk-taking at Bear Stearns and Lehman (and other financial firms with similar pay arrangements) could have been the product of flawed incentives. The concern is not that the top executives expected their aggressive risk-taking to lead to certain failure for their firms, but that the executives' pay arrangements – in particular, their ability to claim large amounts of compensation based on short-term results – induced them to accept excessive levels of risk.

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[2] Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, Mass.: Harvard University Press, 2004).

[3] Bebchuk, Cohen, and Spamann, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008," *supra* note 1.

Such incentives were not unique to these two firms: a subsequent study by Sanjai Bhagat and Brian Bolton finds a similar pattern – pre-crisis cashing out of large amounts of compensation by the CEO that exceeded losses suffered by the CEO from stock price declines during the crisis – for other large financial firms that had to be bailed out during the financial crisis.[4] There is also empirical evidence indicating that risk-taking was associated with the extent to which the CEO's compensation was sensitive to the volatility of the company's stock returns,[5] as well as with the sensitivity of the CEO's compensation to short-term earnings per share.[6]

Solving Problem I: Paying for Long-Term Performance

To address the problem of short-term focus, financial firms should reform compensation structures to ensure tighter alignment between executive payoffs and long-term results. Senior executives should not be able to collect and retain large amounts of bonus compensation when the performance on which the bonuses are based is subsequently sharply reversed. Similarly, equity incentives should be subject to substantial limitations aimed at preventing executives from placing excessive weight on their firm's short-term stock price. Had such compensation structures been in place at Bear Stearns and Lehman, their top executives would not have been able to derive such large amounts of performance-based compensation for managing these firms in the years leading up to their collapse.

Equity-based compensation is the primary component of modern pay packages. In a recent article, Jesse Fried and I, building on the approach we put forward in *Pay without*

[4] Sanjai Bhagat and Brian Bolton, "Bank Executive Compensation and Capital Requirements Reform," Working paper (2011), available at http://ssrn.com/abstract=1781318.

[5] See Marc Chesney, Jacob Stromberg, and Alexander Wagner, "Risk-Taking Incentives and Losses in the Financial Crisis," Swiss Finance Institute Research Paper No. 10-18 (2010), available at http://ssrn.com/abstract=1595343; Robert DeYoung, Emma Peng, and Meng Yan, "Executive Compensation and Business Policy Choices at U.S. Commercial Banks," *Journal of Financial and Quantitative Analysis*, forthcoming, available at http://ssrn.com/abstract=1544490; Amar Gande and Swaminathan Kalpathy, "CEO Compensation at Financial Firms," SMU Working Paper (2011), available at http://ssrn.com/abstract=1865870; and Felix Suntheim, "Managerial Compensation in the Financial Service Industry," Working paper (2011), available at http://ssrn.com/abstract=1592163.

[6] Sugato Bhattacharyya and Amiyatosh Purnanandam, "Risk-Taking by Banks: What Did We Know and When Did We Know It?," Working paper (2011), available at http://ssrn.com/abstract=1619472.

Performance, proposed a detailed blueprint for preventing equity-based compensation from producing an excessive focus on short-term results.[7]

First, the time that options and restricted shares can be cashed should be separated from the time in which they vest. As soon as an executive has completed an additional year at the firm, the options or shares promised as compensation for that year's work should vest; it should belong to the executive even if he or she immediately leaves the firm. The executive, however, should not be free to cash out these vested equity incentives; rather, he or she should be permitted to do so only after a substantial passage of time.

Second, unwinding should be subject to a combination of grant-based and aggregate restrictions. Grant-based limitations would require executives to hold equity incentives awarded as part of a given grant for a fixed number of years after vesting. For example, an executive receiving an equity award could be prevented from unwinding any awarded equity incentives for two years after vesting, with each subsequent year freeing another 20 percent of the awarded incentives to be unloaded.

These grant-based limitations, however, are not sufficient to ensure adequate long-term focus. With only grant-based restrictions in place, longtime executives might amass large amounts of equity incentives that they could immediately unload, which could induce them to pay excessive attention to short-term prices. Therefore, grant-based limitations should be supplemented with aggregate limitations restricting the fraction of an executive's otherwise unloadable equity incentives that could be sold in any given year. To illustrate, executives could be precluded from unloading, in any given year, more than 10 percent of their total portfolio of otherwise unloadable incentives. By construction, such limitations would ensure that executives would not place substantial weight on short-term stock prices.

Firms should not make limitations on unwinding a function of events under the control of executives. Some reformers have urged using, and some firms have been using, "hold-till-retirement" requirements that allow executives to cash out shares and options only upon retirement from the firm. Such requirements, however, provide executives with a counterproductive incentive to leave the firm in order to cash out their portfolio of options and shares and diversify their risks. Perversely, the incentive to leave will be strongest for executives who have served successfully for a long time and whose accumulated options and shares are

[7] Bebchuk and Fried, "Paying for Long-Term Performance," *supra* note 1.

especially valuable. Similar distortions arise under any arrangement tying the freedom to cash out to an event that is at least partly under an executive's control.

Third, firms should generally adopt robust limitations on executives' use of hedging and derivative transactions, a practice that can weaken the connection between executive payoffs and long-term results. An executive who buys a "put" option to sell his or her shares at the current price is "insured" against declines in the stock price below current levels, which undermines incentives and the effectiveness of limitations on unwinding. Therefore, whether or not they are motivated by the use of inside information, executives should be precluded from engaging in any hedging or derivative transactions that would reduce or limit the extent to which declines in the company's stock price would lower executive payoffs. In 2009, following the anti-hedging approach that Jesse Fried and I advocated in our book, the Special Master for TARP Executive Compensation Kenneth Feinberg (whom I served as an adviser) required companies subject to his jurisdiction to adopt such an anti-hedging requirement.[8] This approach should be followed by financial firms in general. Whatever equity-plan design is chosen by a given bank's board, executives should not be allowed to unilaterally use hedging and derivative transactions that undo the incentive consequences of this design.

In addition to equity compensation, bonus plans should also be designed to encourage long-term focus. Bonuses should commonly be based not on one-year results but on results over a longer period. Furthermore, bonuses should not be cashed right away; instead, the funds should be placed in a company account for several years and adjusted downward if the company subsequently learns that the bonus is no longer justified. The need for such a downward adjustment is not limited to firms in which financial results are restated. Even if results for a given year were booked consistent with accounting conventions, executives should not be rewarded for profits that are quickly reversed. Rewarding executives for short-term results distorts their incentives and should be avoided by well-designed compensation arrangements.

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[8] See testimony of Kenneth R. Feinberg, the Special Master for TARP Executive Compensation, before the House Financial Services Committee, February 25, 2010, http://www.treasury.gov/press-center/press-releases/Pages/tg565.aspx. Feinberg reports that one of the principles used in evaluating pay at subject firms was that "employees should be prohibited from engaging in any hedging, derivative or other transactions that undermine the long-term performance incentives created by a company's compensation structures."

Problem II: Excessive Focus on Shareholder Interests

Thus far, I have focused on the insulation of executives from long-term losses to shareholders – the problem that has received the most attention following the recent crisis. However, as Holger Spamann and have highlighted in our research,[9] there is another type of distortion that should be recognized: payoffs to financial executives have been shielded from the consequences that losses could impose on parties other than shareholders. This source of distortion is distinct from the "short-termism" problem discussed above and would remain even if executives' payoffs were fully aligned with those of long-term shareholders.

Equity-based awards, coupled with the capital structure of banks, tie executives' compensation to a highly levered bet on the value of banks' assets. While bank executives expect to share in any gains that might flow to common shareholders, they do not expect to bear (in the event losses exceed the common shareholders' capital) any part of losses borne by preferred shareholders, bondholders, depositors, or the government as a guarantor of deposits. This state of affairs leads executives to pay insufficient attention to the possibility of large losses sustained beyond the shareholders' equity; it thus incentivizes excessive risk-taking.

Insulation of executives from losses to parties other than shareholders can be expected to produce at least two types of risk-taking distortions. First, it encourages executives to make investments and take on obligations that can contribute to "tail" scenarios, in which the bank suffers losses exceeding the shareholders' capital. Second, it creates reluctance to raise capital and fosters excessive willingness to run the bank with a capital level that provides inadequate cushion for bondholders and depositors.

The above analysis is consistent with empirical evidence indicating that risk-taking was positively correlated with CEOs' equity-based compensation;[10] that risk-taking was negatively

[9] Bebchuk and Spamann, "Regulating Bankers' Pay," *supra* note 1.

[10] Sudhakar Balachandran, Bruce Kogut, and Hitesh Harnal, "The Probability of Default, Excessive Risk, and Executive Compensation: A Study of Financial Services Firms from 1995 to 2008," Columbia Business School Research Paper (2010), available at http://ssrn.com/abstract=1914542.

correlated with inside debt holdings by bank CEOs;[11] and that banks whose CEOs had larger equity holdings performed worse during the crisis.[12]

Solving Problem II: Linking Executive Pay to the Payoffs of Non-Shareholder Stakeholders

How should pay arrangements be designed to address the above problem? To the extent that executive pay is tied to the value of specified securities, such pay could be tied to a broader basket of securities, not merely common shares. Thus, rather than tying executive pay to a specified percentage of the value of the common shares of the bank holding company, compensation could be tied to a specified percentage of the aggregate value of the common shares, the preferred shares, and all the outstanding bonds issued by either the bank holding company or the bank. Because such a compensation structure would expose executives to a broader fraction of the negative consequences of risks taken, it would encourage greater prudence in evaluating risky choices.

One could broaden further the set of positions to which executive payoffs are tied by using the value of credit default swaps. Because the value of credit default swaps is associated with increases in the risk posed by the bank's operations, adjusting executives' long-term payoffs by an amount dependent on changes in the value of credit default swaps would provide executives an incentive to take into account the effects of their risk choices on non-shareholder stakeholders.

Similarly, in firms in which executives receive bonus compensation tied to specified accounting measures, bonuses could be linked instead to broader metrics. For example, the bonus compensation of some bank executives has been dependent on accounting measures that are of interest primarily to common shareholders, such as return on equity or earning per common share. Such plans could be redesigned to be based on more expansive measures, such as earnings before any payments made to bondholders. Alternatively or in addition, bonuses could be paid

[11] Frederick Tung and Xue Wang, "Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis," Boston Univ. School of Law Working Paper No. 11-49 (2011), available at http://ssrn.com/abstract=1570161.

[12] Rüdiger Fahlenbrach and René Stulz, "Bank CEO Incentives and the Credit Crisis," *Journal of Financial Economics* 99 (2011): 11-26, available at http://ssrn.com/abstract=1439859.

not in cash but rather in the form of a subordinated debt obligation of the bank payable in several years.

Ensuring that executives perfectly internalize the expected losses their choices would impose on contributors of capital other than shareholders is far from straightforward. But doing so imperfectly would likely be better than not doing so at all. Requiring financial executives to expand their focus beyond consequences for shareholders would significantly improve their risk-taking incentives.

The Role of Regulations

Outside the financial sector, the government should not intervene in the substantive terms of pay arrangements. In the case of banks, however, financial regulators should monitor and impose meaningful regulations on financial firms' compensation structures. Such pay regulation is justified by the same moral hazard reasons that underlie the long-standing system of prudential regulation of banks.

When a bank takes risks, shareholders can expect to capture the full upside, but part of the downside may be borne by the government as guarantor of deposits. Because bank failure imposes costs on the government and the economy that shareholders do not internalize, shareholders' interests may be served by greater risk-taking than is in the interest of the government and the economy. This moral hazard problem provides a basis for the extensive body of regulations that restrict the choices of financial firms with respect to investments, lending, and capital reserves.

Aligning the interests of executives with those of shareholders, which some governance reforms seek to do, could eliminate risk-taking that is excessive even from the shareholders' perspective. But it cannot be expected to get rid of incentives for risk-taking that are excessive from a social standpoint but not from the shareholders' perspective.

Shareholders' interest in greater risk-taking implies that they stand to benefit when bank executives take excessive risks. Given the complexities of modern finance and the limited information and resources of regulators, the traditional regulation of banks' actions and activities is necessarily imperfect. Regulators are often one step behind banks' executives. Thus, executives with incentives to focus on shareholder interests can use their informational advantages and whatever discretion traditional regulations leave them to take excessive risks.

Because shareholders' interests favor incentives for risk-taking that are socially excessive, substantive regulation of the terms of pay arrangements – that is, limiting the use of structures that reward risky behavior – can advance the goals of banking regulation. Regulators should focus on the *structure* of compensation – not the amount – with the aim of discouraging excessive risk-taking. By doing so, regulators would induce bank executives to work for, not against, the goals of banking regulation.

The regulation of bankers' pay could well supplement and reinforce the traditional direct regulation of banks' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation need not be as stringent as would otherwise be necessary. Conversely, as long as banks' executive pay arrangements are unconstrained, regulators should be stricter in their monitoring and direct regulation of banks' activities. At a minimum, when assessing the risks posed by any given bank, regulators should take into account the incentives generated by the bank's pay arrangements. When the design of compensation encourages risk-taking, regulators should monitor the bank more closely and should consider raising its capital requirements.

Before concluding, it is worthwhile to respond to objections that have been raised against a meaningful governmental role in this area. First, regulation of pay structures may be opposed on grounds that it is the shareholders' money and the government does not have a legitimate interest in telling bank shareholders how to spend their money. The government, however, does have a legitimate interest in the compensation structures of private financial firms. Given the government's interest in the safety and soundness of the banking system, intervention here is no less legitimate than the government's established involvement in limiting banks' investment and lending decisions.

Second, opponents of meaningful regulation have argued that one size does not fit all and that regulators are at an informational disadvantage vis-à-vis decision-makers within each firm. But the knowledge required of regulators to effectively limit compensation structures that incentivize risk-taking would be no more demanding than that which is requisite to regulators' direct intervention in investment, lending, and capital decisions. Furthermore, setting pay arrangements should not be left to the unconstrained choices of informed players inside banks;

while such players might be best informed, they do not have incentives to take into account the interests of bondholders, depositors, and the government.

Proposed Regulations

The case for meaningful regulation of pay structures in large financial firms is strong. Although regulators issued proposed rules for incentive-based compensation arrangements in April 2011, they have not thus far adopted final rules. Furthermore, and importantly, the proposed regulations should be tightened to ensure that firms take the steps discussed above as necessary to eliminate excessive risk-taking incentives.

The proposed regulations should be revised to include robust and meaningful rules requiring large financial firms to subject all equity compensation of senior executives not only to vesting schedules but also to grant-based limitations on unwinding for a substantial period after equity incentives are vested, as well as to aggregate limitations on unwinding. The proposed regulations should also be revised to require large financial firms to prohibit their senior executives from engaging in any hedging or derivative transactions that would reduce or limit the extent to which declines in the company's stock price would lower executive payoffs. Adopting the rules discussed in this paragraph would serve both financial stability and the long-term interests of shareholders.

In addition, the proposed regulations should be revised to include rules that would induce firms to make the variable compensation of senior executives significantly depend on long-term payoffs to the bank's non-shareholder stakeholders and not only on the payoffs of shareholders. In designing such rules, regulators should recognize that securing risk-taking incentives that are optimal from shareholders' perspective would be insufficient to eliminate risk-taking incentives that are excessive from a social perspective.

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To reduce the likelihood of future financial crises, it is important to pay close attention to the incentives provided to financial firms' senior executives. The structure of pay should induce executives to focus on long-term rather than short-term results, as well as to take into account the consequences of their decisions for all those contributing to the bank's capital (rather than only for shareholders). Because of the importance of providing such incentives for financial stability, ensuring that financial firms design pay arrangements to provide such incentives should be regarded as a regulatory priority.

Senate Committee on Banking, Housing, and Urban Affairs

Subcommittee on Financial Institutions and Consumer Protection

Hearing on *Pay for Performance: Incentive Compensation at Large Financial Institutions*

Testimony of Professor Robert J. Jackson, Jr.
Columbia Law School

Dirksen Senate Office Building
February 15, 2012

Thank you, Chairman Brown and Ranking Member Corker, for the opportunity to testify before you about incentive compensation at America's largest financial institutions. Hard experience has taught us that bankers' pay can be a source of concern for all Americans, so I welcome your invitation and look forward to participating in this hearing. As a researcher at Columbia Law School who writes on, among other matters, bankers' incentives, I am pleased to have the opportunity to testify on this important issue.[1]

The financial crisis of 2008 brought the potential dangers associated with bankers' incentives into sharp relief. In 2010, Congress responded with the Dodd-Frank Wall Street Reform and Consumer Protection Act, which included several important new rules that now govern executive pay at large public companies. For example, one provision proposed by the Administration and included in Dodd-Frank now requires large public companies to give shareholders a vote on executive pay. Boards of directors initially resisted federally mandated "say-on-pay" votes, arguing that they might compromise the board's longstanding freedom to use its business judgment in setting executive pay. While it is too soon to know how say-on-pay will affect executive compensation in the long run, preliminary study of results from the first year of votes suggests that say-on-pay has facilitated important dialogue between directors and shareholders on pay while leaving the ultimate decision to the sound judgment of the board.[2]

Say-on-pay has been the subject of considerable political debate and media scrutiny. But Dodd-Frank's broadest compensated-related provision has received much less attention. That

[1] My institutional affiliation is given for identification purposes only. Further, from 2009 to 2010 I served at the Department of the Treasury as an advisor to senior officials on executive compensation and in the Office of the Special Master for TARP Executive Compensation. The views set forth here are solely my own and should not be attributed to the Treasury. This testimony expands upon comments I submitted to federal regulators in May 2011, *see* Robert J. Jackson, Jr., Ltr. to the Board of Governors of the Federal Reserve System, *available at* http://www.law.columbia.edu/null/download?&exclusive=filemgr.download&file_id=6035.

[2] *See, e.g.*, COUNCIL OF INSTITUTIONAL INVESTORS, SAY ON PAY: IDENTIFYING INVESTOR CONCERNS (Sept. 2011), at 20 (concluding, following empirical study of the shareholder votes cast during the 2011 proxy season, that "[i]nvestors by and large agree that they do not want to dictate executive pay arrangements").

provision, Section 956, gives nine federal agencies, including the Federal Reserve, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission, extraordinarily expansive authority to ensure that bonus practices at our largest banks never again endanger financial stability. Section 956 gives the agencies two key powers in regulating banker bonuses. First, the agencies must "prohibit *any*" bonus arrangement that gives bankers excessive pay or could lead to material financial loss. Second, the agencies must require banks to disclose "the structures of *all*" bonus arrangements to regulators so that those who oversee our financial institutions can identify incentive structures that could lead bankers to take excessive risks.[3] In Section 956, Congress and the Administration gave federal regulators the expansive powers they will need to ensure that bonus practices do not threaten the safety and soundness of America's financial system. The agencies jointly issued proposed rules under Section 956 last April, and these rules are scheduled to be finalized later this year.[4]

Unfortunately, the agencies' proposals fall far short of the rigorous oversight of banker pay that Congress authorized in Section 956. In this testimony, I will provide three reasons why Congress should not expect these rules to change bonus practices at America's largest banks, and describe three principles for reform that would help ensure that incentive structures give bankers reason to pursue long-term value rather than the illusory, short-term profits that led to the crisis.

First, the rules focus their attention on the few top executives who lead America's banks. But bank executives' incentives have for many years been the subject of extensive disclosure rules and media scrutiny. That is not to say that top executives' incentives are unimportant. But

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956(a-b), 124 Stat. 1376, 1905 (2010) (emphases added).

[4] Office of the Comptroller of the Currency et al., Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (April 14, 2011). Although the agencies initially expressed hope that the rules would be finalized in the first six months of 2012, they recently signaled that final rules will not be issued until the second half of this year, *see* SEC, Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Upcoming Activity, *available at* http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#07-12-12.

for two reasons the rules governing bankers' incentives should apply beyond this limited group. First, one of the clearest lessons of the crisis was that bankers outside the executive suite can cause a great deal of systemic damage. None of the employees at American International Group's Financial Products division, the unit that contributed to the system's collapse in September 2008, was an executive. If that division were still operating today, the agencies' most stringent rules under Section 956 would not apply to bonuses paid to its employees. Second, because executives' incentives have long been scrutinized by investors and the public, rules governing their bonuses may be redundant to existing practices. Indeed, as I explain below, the agencies' most rigorous rule under Section 956 is redundant to pay practices that were in place at many large banks years before the crisis. Accordingly, I argue that ***rules governing bankers' bonuses should not be limited to the group of executives, and regulation of executives' incentives should go beyond longstanding industry pay practices.***

Second, the rules provide little hope that regulators will actually oversee or address the incentives of employees, like those who worked at AIG Financial Products, who make decisions with critical consequences for the safety and soundness of our financial system. The rules require only that banks identify these employees using a vague standard—and then have the bank's own board of directors approve the employees' pay. For two reasons, we should not expect these rules to address bonus structures that encourage bankers to take excessive risk. First, because there is no clear standard for identifying these employees, there is little hope that the rule will apply to all of the risktakers whose decisions might threaten systemic stability. In 2008 alone, just six of our largest banks collectively had more than 1.3 million employees, more than 4,500 of whom received bonuses of more than $1 million each. A vague standard applied by the banks themselves is hardly likely to lead to the identification of the few employees in that large group whose incentives warrant special attention. Second, even if banks do identify the appropriate group of employees, the rule is unlikely to eliminate bonuses for those employees that encourage them to pursue short-term profits at the expense of systemic stability. Because directors, as a matter of law, owe their allegiance to shareholders rather than to financial stability, there is no reason to think that requiring the board to approve bonuses will eliminate incentives for excessive risktaking. Thus, regulators should ***provide clear rules for identifying significant risktakers at large banks and require bonus structures for these risktakers to be reviewed by regulators rather than the boards of directors of the banks themselves.***

Third, while there can and should be debate about how regulation should influence bonus practices, there is no question that regulators need detailed information about those practices to do their work under Section 956. Congress and the Administration understood as much; that is why the broadest language in Section 956 is reserved for the requirement that banks disclose detailed information about incentives to regulators. But the agencies' proposal requires only that banks provide qualitative, general descriptions of their policies on pay. These reports will be redundant to disclosure long required by securities rules. And, more importantly, because they will consist of qualitative reports rather than clear, quantitative data, they have very little chance of giving regulators the information they need to identify bonus practices that could lead bankers to take the kinds of excessive risks that contributed to the financial crisis. Instead, I argue, the agencies should ***require banks to provide meaningful quantitative disclosure of bankers' incentives*** rather than the duplicative qualitative reporting that the agencies have proposed.

Despite the sweeping authority Congress granted federal regulators in Section 956, the agencies' proposal likely leaves bonuses completely unregulated for many significant risktakers at our largest banks. Below I explain why—and what might be done about it.

I. Regulation of Executives' Incentives

Consistent with Section 956's command that regulators prohibit incentive-pay arrangements that encourage bankers to take inappropriate risks, the agencies' proposal requires that, at large financial institutions, at least 50% of each executive's incentive pay be deferred for at least three years. Many have debated whether a 50% deferral requirement is likely to give bankers optimal risk-taking incentives. I agree with the agencies that deferrals can be useful in structuring incentives—because, as the agencies have explained, deferral "allows a period of time for risks not previously discerned" "to ultimately materialize," and for bankers' pay to be adjusted for those risks. But for two reasons, the agencies' decision to apply this rule only to executives means that the deferral requirement will have little effect on bankers' incentives.

First, one of the few clear lessons from the financial crisis is that employees outside the group of executives frequently make decisions that affect systemic stability. None of the employees at American International Group's Financial Products division was an executive; nor was the Citigroup banker who earned more than $100 million in annual bonuses trading energy futures in the years leading up to the crisis.[5] Congress and the Administration understood well that, even though they are not executives, these employees' incentives demand scrutiny. That is why both Congress's rules and the Treasury Department's oversight for bonuses at recipients of financial assistance under the Troubled Asset Relief Program apply beyond the group of executives,[6] and that is why the language of Section 956 itself specifies that it applies not only

[5] *See* American International Group, Inc., Form 10-K (filed Feb. 2, 2008), at 15 (listing AIG's executives, including its general counsel and chief human resources officer—but excluding employees at Financial Products). *Compare* Michael Siconolfi & Ann Davis, *Citi in $100 Million Pay Clash*, WALL ST. J. (July 25, 2009), at A1 (describing the trader, who was an employee of Citigroup's energy-trading unit, Phibro) *with* Citigroup, Inc., Form 10-K (filed Feb. 22, 2008), at 129, 201 (listing Citigroup's executives, including its general counsel and vice chairmen but excluding this trader—even though Phibro earned $843 million in trading revenues in 2007 alone).

[6] Congress placed limits on bonuses for employees of TARP recipients that applied, for most large banks, to the senior executive officers and 25 most highly paid employees of each firm, see American Recovery and Reinvestment Act, Pub. L. No, 111-5 § 7001, 123 Stat. 115 (2009). For seven significant recipients of TARP

to payments to any "executive" but also to any other "employee." That is also why international standards on banker pay require that mandatory-deferral rules apply to employees outside the executive suite.[7] But the agencies' deferral rules under Section 956 apply only to executives, excluding many employees whose decisions can have important systemic implications.

Second, because bank executives' pay has long been subject to disclosure and public scrutiny, the proposed deferral rule is redundant to longstanding pay practices at America's largest banks. Figure I below describes the percentage of executives' incentive pay that was deferred at six of America's largest banks in the years leading up to the financial crisis:

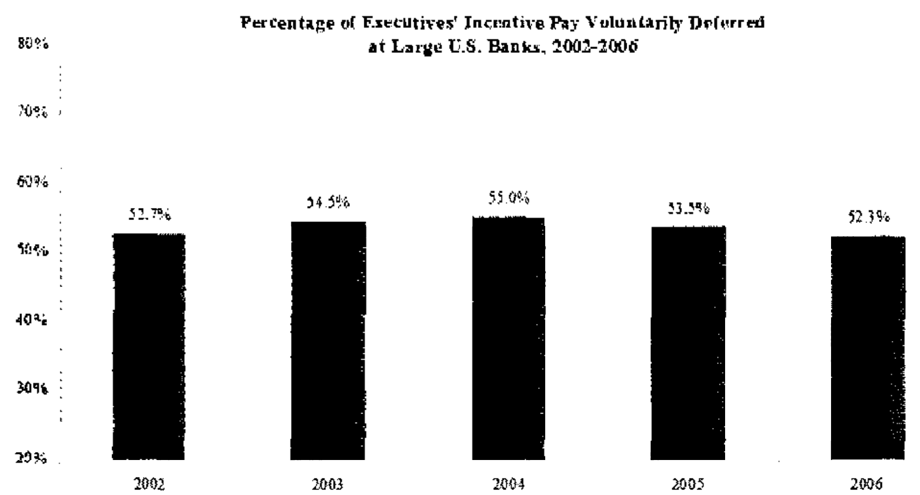

Figure I: Deferral Practices for Executive Incentives at Large Banks Before the Financial Crisis[8]

assistance, the Treasury Department went even further, requiring review by the Special Master for TARP Executive Compensation of compensation structures for both executives and the 100 most highly paid employees, Department of the Treasury, TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (2009).

[7] For example, standards on banker pay adopted by the Financial Stability Board state clearly that incentive pay should be deferred for "senior executives *as well as other employees whose actions have a material impact on the risk exposure of the firm.*" FINANCIAL STABILITY BOARD, PRINCIPLES FOR SOUND COMPENSATION PRACTICES: IMPLEMENTATION STANDARDS 3, Basel, Switzerland (Sept. 2009) (emphasis added). Similarly, deferral rules recently adopted by the European Parliament expressly apply "at least" to "senior management, risk takers, . . . and any employee whose [pay] takes them into the same [pay] bracket as senior managers and risk takers." EUROPEAN PARLIAMENT, Directive 2010/76/EU (Dec. 14, 2010) at ¶ 3.

[8] The data reflected in Figure I include incentive payments disclosed for the top five executives at Bank of America, Citigroup, Goldman Sachs, J.P. Morgan Chase, Morgan Stanley, and Wells Fargo, in each case drawn from the ExecuComp dataset. *See* COMPUSTAT EXECUTIVE COMPENSATION DATASET, WHARTON RESEARCH DATA SERVICES, *available at* http://wrds-web.wharton.upenn.edu/wrds/index.cfm (last accessed February 11, 2012). Figure I assumes that payments under long-term incentive programs and in the form of options or stock are

As Figure I shows, the largest U.S. banks deferred more than 50% of their executives' incentive pay for years prior to the financial crisis. Moreover, in the years immediately following the crisis, the banks voluntarily agreed to defer even larger proportions of executives' incentives even before Congress enacted Section 956.[9] Because the proposed rules are redundant to longstanding industry practices on executive pay, we should not expect that the agencies' proposed rules will meaningfully change bankers' incentives.[10]

The agencies' most stringent rules on incentives do not apply to bankers who take significant risk—and are redundant with respect to the few executives to whom they do apply. To the extent that Congress and the agencies seek to ensure that bonus structures do not give bankers incentives to pursue excessive risk, ***rules governing bankers' bonuses should not be limited to the group of executives, and regulation of executives' bonuses should go beyond longstanding industry practices on executive pay.***[11]

"deferred" for purposes of the agencies' proposal, because a standard term of those programs is that amounts paid vest over several years on a pro rata basis. *Compare* Morgan Stanley, Schedule 14A (filed February 24, 2006), at 22 (noting that stock awards granted to executives vested 50% on the third anniversary of the grant date and 50% on the fourth anniversary of the grant date) *with* Office of the Comptroller of the Currency et al., *supra* note 4, at 21,194 (explaining that the agencies' proposal under Section 956 requires deferrals "over a period of no less than three years, with the release of deferred amounts to occur no faster than on a pro rata basis").

[9] See, e.g., GOLDMAN SACHS GRP., GOLDMAN SACHS COMPENSATION PRACTICES 12 (March 2010) (noting that all of Goldman's executives, as well as other officials who are members of the firm's Management Committee, received 100% of their incentive pay in stock that was not transferable for five years pursuant to policies voluntarily adopted months before the passage of Dodd-Frank).

[10] In addition to the deferral requirement, the agencies' proposal also requires that, during the deferral period, incentives paid to executives be subject to a clawback, or "look-back" provision, that would require incentives to be "adjusted downward to reflect actual losses." Office of the Comptroller of the Currency et al., *supra* note 4, at 21,198. This requirement, too, is redundant to existing executive pay practices at large U.S. banks. *See, e.g.*, GOLDMAN SACHS GRP., *supra* note 9, at 12 (describing the adoption of such a clawback); Morgan Stanley, Schedule 14A (filed April 14, 2010), at 18 (same).

[11] Indeed, in many respects the agencies' proposal lags prevailing industry practices on executive pay. For example, the proposal would not prohibit executives from hedging—that is, from using derivatives and similar instruments to undermine the incentives created by stock compensation. Office of the Comptroller of the Currency et al., *supra* note 4, at 21,183 (requesting comment on whether hedging should be prohibited). Many large U.S. banks have prohibited executives from hedging for years, *see, e.g.*, Goldman Sachs Grp., Schedule 14A (filed March 7, 2008) at 21 ("Our [executives] are prohibited from hedging . . . their equity-based awards."), and academics long ago provided evidence that hedging is used to undermine the incentives provided by stock-based pay, see J. Carr Bettis et al., *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders*, 36 J. FIN. & QUANT. ANALYSIS 345, 346 (2001) (finding that executives "use [hedging transactions] to cover a significant proportion of their holdings of the firm's stock"). Hank Greenberg, the CEO of

II. Regulating the Incentives of Significant Risktakers

As I have noted, the agencies' proposed deferral requirement applies only to executives. With respect to all other employees, including significant risktakers, the proposal requires only that the board of directors of the bank identify employees who "individually have the ability" to cause losses "that are substantial in relation to the institution's size"; for these employees, the board must approve their incentive pay as "appropriately balanced." This approach is unlikely to allow regulators or banks to identify the employees whose incentives deserve special scrutiny. More importantly, even if those employees are identified, it is doubtful that the proposal will ensure that their incentives are consistent with systemic stability.

At a large financial institution, thousands of risktakers are spread throughout the firm. Although it is difficult to know how many of these employees take systemically important risk, pay levels may serve as a helpful means of identifying those who bear substantial organizational responsibility. Table I below describes the number of employees at six large U.S. banks—and the number of bankers who received bonuses of more than $1 million—in 2008:

Financial Institution	Total Number of Employees	Employees Receiving Incentive Pay of More than $1 Million
Bank of America	243,000	263
Citigroup	322,800	1,102
Goldman Sachs	30,067	1,407
J.P. Morgan Chase	224,961	1,826
Morgan Stanley	28,475	55
Wells Fargo	281,000	89
Totals	**1,130,303**	**4,742**

Table I. Bankers Receiving Incentive Pay of More Than $1 Million in 2008[12]

AIG, provided perhaps the most prominent example, hedging approximately $300 million worth of AIG stock in 2005 and avoiding $280 million in losses when the firm collapsed in 2008. *Id.* at 347. The Office of the Special Master for TARP Executive Compensation has prohibited hedging for all of the employees at all of the firms subject to its jurisdiction. Kenneth R. Feinberg, U.S. Dept. of the Treasury, Ltr. to Bob Benmoche (Oct. 22, 2009), at 3.

[12] *See* Andrew M. Cuomo, *No Rhyme or Reason: The "Heads I Win, Tails You Lose" Bank Bonus Culture*, *available at* http://www.oag.state.ny.us/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf.

At the height of the crisis these six firms alone had more than 1.1 million employees, more than 4,500 of whom received bonuses of more than $1 million in 2008—a year in which performance suffered considerably. Identifying the key risktakers among a group of this size and scope requires a careful assessment of the relationship between employees' activities and the firm's exposures against a clear set of rules. One might expect, for example, that the agencies would require that the group of significant risktakers include the employees who, according to the regulators' risk models, are responsible for the firm's most significant exposures. Instead, however, the agencies' proposal provides only a vague standard under which the banks themselves are responsible for identifying these critical employees. This approach is likely to lead either to an overinclusive group, with too little attention given to each risktaker's incentives, or an underinclusive analysis that excludes significant risktakers from regulators' reach.

More importantly, even if the group of significant risktakers is properly identified, incentives for these employees to take excessive risk will likely remain in place. That is because the agencies' proposal requires only that the board of directors of the bank itself approve the compensation of significant risktakers. The problem with this approach is that, as a matter of law, the board owes its duties strictly to the shareholders of the bank. And it is now well-accepted that shareholders in large banks prefer that the bank take excessive risk. That is because shareholders capture the full upside from such risktaking, while some of the downside of bank failures is borne by the government, both as an insurer of deposits and as a provider of bailout financing.[13] Thus, even if the board of directors identifies employees with incentives to take excessive risk, their legal obligations will not necessarily lead them to eliminate those incentives. Considerations regarding the socially appropriate level of risktaking are not within the purview,

[13] *See generally* Lucian A. Bebchuk & Holger Spamann, Regulating Bankers' Pay, 98 GEO. L.J. 247, 284-85 (2010).

or expertise, of banks' boards of directors. Those considerations are more appropriately addressed by bank regulators, which is why Section 956 requires those regulators to "prohibit *all*" bonus structures that could someday lead to material losses—even if those structures are in the short-term interests of shareholders.

The proposed rules under Section 956 would permit large banks to identify their most significant risktakers under a vague standard. Once these risktakers are identified, the proposal requires only that the bankers' bonuses be approved by the bank's own board of directors—whose duties are to shareholders, not systemic stability. This approach is unlikely to provide needed scrutiny for the incentives of all of the risktakers whose decisions have implications for the safety and soundness of our financial system—and, even if it does, that scrutiny will be applied by directors with no duty to pursue systemic stability rather than short-term profits. To the extent that Congress and banking regulators want to ensure that the incentive structures of significant risktakers are subject to meaningful oversight, ***clear, uniform rules for identifying significant risktakers are needed—and bonus structures for these risktakers should be reviewed by banking regulators rather than the banks' own boards of directors.***

III. Providing Meaningful Quantitative Disclosure of Bankers' Incentives

Section 956 requires "enhanced disclosure and reporting of compensation" at financial institutions, including disclosure on the "structures of *all* incentive-based compensation arrangements." This broad language empowers, and indeed directs, regulators to obtain detailed information from large banks about their employees' incentives. The agencies' proposal would require that each financial institution provide a "clear narrative description" of its incentive-pay arrangements; a "succinct description of [the bank's] policies and procedures" on incentive pay;

and "specific reasons why the [bank] believes the structure of its [incentive pay] does not encourage inappropriate risks." For two reasons, these disclosures are inadequate to carry out both the purpose of Section 956 and the agencies' policy mandate.

First, most large banks are public companies subject to securities rules that have long required qualitative disclosure of exactly the kind required by the proposal.[14] In Section 956, Congress gave the agencies sweeping authority to obtain "*enhanced* disclosure and reporting" on bankers' incentives. Congress's purpose is hardly met by requiring banks to provide duplicative reports identical to those that banks already must provide under securities law.

Second, and more importantly, qualitative reports are unlikely to give regulators the information they need to supervise banker incentives. Importantly, the securities rules that require qualitative discussion of pay policies are accompanied by clear, quantitative tables describing the amount and structure of the compensation to be paid.[15] Unlike those rules, the agencies' proposal requires only generalized essays that will be difficult to compare either to each other or to prevailing best practices.[16] It is hard to see how regulators will be able to use these reports to identify bonus practices at large banks that could threaten financial stability.

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[14] *See, e.g.*, 17 C.F.R. § 229.402(b)(2)(i) (requiring a qualitative description of the company's "policies for allocating between long-term and currently paid out compensation"); *see also id.* § 229.402(e)(1)(i-iv) (requiring a "narrative description" of incentive pay). The proposal's language on this reporting requirement is nearly identical to the language that has governed securities-law disclosure requirements since 2006. Financial institutions and their counsel have generally concluded that the agencies' proposal allows them to use identical reports to comply with identical language in the agencies' proposal under Section 956 and longstanding securities rules. This might explain why comments from the Financial Services Roundtable and Chamber of Commerce, among others, although critical of some aspects of the agencies' proposal, offered only "applau[se]" in response to the "streamlined" nature of the reporting rules. Letter from Center on Executive Compensation et al. to Elizabeth M. Murphy, Sec'y, SEC (May 25, 2011), at 10.

[15] 17 C.F.R. § 229.402(c).

[16] Recently the Federal Reserve, upon the conclusion of its "horizontal review" of bonus practices at 25 large banks, indicated that its staff "intends to implement" disclosure requirements on banker pay recently promulgated by the Basel Committee. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, INCENTIVE COMPENSATION PRACTICES: A REPORT ON THE HORIZONTAL REVIEW OF PRACTICES AT LARGE BANKING ORGANIZATIONS (Oct. 2011), at 3, *at* http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf (citing BANK OF INTERNATIONAL SETTLEMENTS, PILLAR 3 DISCLOSURE REQUIREMENTS ON REMUNERATION ISSUED BY THE BASEL COMMITTEE, at http://www.bis.org/publ/bcbs197.pdf (July 2011)). The Basel standards appear to require disclosure of some quantitative information on bonus structures,

Indeed, qualitative descriptions, in the absence of quantitative data, may well give regulators misleading information about bankers' incentives. Suppose, for example, that a large bank qualitatively describes its pay practices as requiring that its employees' bonuses be paid in stock. Regulators might well conclude that these bankers have strong incentives to increase the value of the firm because the bankers will suffer personal losses if the bank's stock price falls. But this assumes that the bankers have not "unloaded" their shares—that is, sold a sufficient number of shares to eliminate the incentives created by the stock-based bonus. Empirical study has shown that unloading is common at the largest U.S. banks—both for executives and for other significant risktakers.[17] Without quantitative detail on unloading, qualitative disclosures will give regulators no way to distinguish between a banker whose pay is actually tied to the long-term future of her firm—and the banker who has unloaded, taking advantage of short-term increases in value before the systemic consequences of her risktaking can be known.[18]

In sum, the reporting provisions of the agencies' proposal will give regulators no new information on bonus compensation at America's largest banks. As proposed, the rules will leave regulators unable to identify which bankers have incentives to take excessive risk. These rules are inconsistent with the sweeping authority that Congress provided in Section 956 and the

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see BANK OF INTERNATIONAL SETTLEMENTS, *supra*, at 4. Those standards were promulgated in July 2011, however, and the agencies have not yet indicated that U.S. banks are required to provide that information to their regulators. Thus, it remains to be seen whether banks will be required to disclose meaningful quantitative information on their bonus practices under Section 956. Moreover, even the Basel standards would not provide regulators with all of the information they need to have a full picture of bankers' incentives. *See infra* note 18.

[17] *See, e.g.*, Lucian Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000—2008*, 27 YALE J. ON REG. 257 (2010) (documenting unloading prior to the collapse at Bear Stearns and Lehman Brothers); Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 COLUM. L. REV. ____ (forthcoming 2012) (documenting unloading by the partners of Goldman Sachs).

[18] More generally, the financial-economics literature on managerial incentives has shown that equity ownership in the firm provides a far stronger pay-performance link than standard incentive payments like cash 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 research has suggested that substantial equity stakes may lead bankers to pursue levels of risktaking that is socially excessive. *See, e.g.*, Bebchuk & Spamann, *supra* note 13, at 284. All agree, however, that bankers' equity ownership in their firms is a critical determinant of their incentives. Yet under the agencies' proposal and the Basel standards, federal regulators would have no quantitative data from America's largest banks about the equity ownership of their employees—even those who take systemically significant risk.

agencies' objective of ensuring that incentive-pay practices do not threaten the safety and soundness of these institutions. Rather than the duplicative qualitative reports required by the agencies' proposal, the rules under Section 956 should ***require large banks to provide the agencies with clear quantitative data on the structure of incentive compensation for all employees who take significant risk.***

* * * *

Bankers' incentives remain a significant concern for all Americans who rely upon the safety and soundness of our financial system. In Section 956, Congress and the Administration provided federal regulators with the sweeping authority they will need to ensure that bankers do not have incentives to pursue short-term gains that could compromise systemic stability. The agencies' proposed rules on banker incentives are, however, inadequate to the regulators' critical task. Further diligence from Congress, from the Administration and from the regulators themselves is needed to make certain that the agencies use this new authority to ensure that banker incentives are aligned with all Americans' interest in a safe and secure financial system.

Thank you once again for the opportunity to testify about this important issue. This statement concludes my formal testimony; I will of course be pleased to answer any questions you or your staff may have.