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COMPENSATION STRUCTURE AND SYSTEMIC RISK

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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COMPENSATION STRUCTURE AND SYSTEMIC RISK

Thursday, June 11, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Waters, Maloney, Watt, Sherman, Moore of Kansas, Capuano, Hinojosa, Clay, McCarthy of New York, Scott, Green, Cleaver, Ellison, Klein, Wilson, Perlmutter, Carson, Speier, Adler, Driehaus, Kosmas, Grayson, Peters; Bachus, Castle, Royce, Biggert, Hensarling, Garrett, Barrett, Neugebauer, McHenry, Campbell, Bachmann, Marchant, McCarthy of California, Posey, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order.

I am told that the Ranking Republican is on his way, so we will begin. We are going to have 30 minutes of opening statements, by agreement between the two sides, and I will begin.

First, I want to make a very important distinction that doesn't always get made. We are not here today talking about the pay restrictions that apply to recipients of TARP money. There is a separate set of considerations there. We are talking about entities which received capital infusions from the Federal Government.

This hearing today is looking forward as to whether or not there should be bills enacted that deal with compensation without regard to whether or not people have taken TARP money going forward.

I believe that it is now clear, and I am reinforcing that by a number of authorities—Paul Volcker for example, Chairman Bernanke, people in the British Financial Services Authority—that the problem with compensation is that it has encouraged excessive risk-taking. That is, once we leave the area of the recipients of TARP money, it is not any part of my concern as to the dollar amounts that were given, from the governmental standpoint. We are not talking here about amounts. We are talking about the structure of compensation.

And I believe that the structure of compensation has been flawed. Namely, we have had a system of compensation for top decisionmakers in which they are very well rewarded if they take a risk that pays off but suffer no penalty if they take a risk that costs the company money.

Now, risk is a very important part of this business, and we are not trying to discourage people from taking risk. That is not the

government's job. But it should not be a system in which risk is artificially encouraged, in which excessive risk-taking takes place.

Now, I said, and I should correct myself before someone else does, that we weren't talking about dollar amounts. We are in one sense; I do think there is a problem with the overall compensation, but it is not one the government should try to solve in any specific way.

What we do instead here is, to borrow from our English neighbors and competitors, because people say you can have a competitive disadvantage, the system known as say-on-pay in which shareholders are empowered to vote. A number of my friends are great supporters of shareholder democracy until we try to implement it and say that the shareholders, the owners of the company, should vote. No, shareholders should not be running a company day-to-day; that is why you have a board of directors. But I think the evidence is overwhelming, as is the logic.

The relationship between boards of directors and CEOs is of necessity a fairly intimate, ongoing one. They have selected each other. They work together. It simply doesn't work to say that on 1 or 2 days a year, this group who works so closely together will now assume the arm's length positions of labor and management and bargain with each other as if there was that independence. Therefore, this is an exception to the normal rule, it seems to me, where shareholders ought to have a role. Boards of directors and CEOs are not going to be able to do that, I think, entirely by themselves. say-on-pay empowers the shareholders, and that is where any questions about amount would come in.

But what we should do now is deal with the structure, which should diminish the extent to which people get these incentives. I must say, I am somewhat puzzled when some of the most influential, highly-paid people in this country who represent very important institutions come to me and say they need these bonuses to align their interest with those of the company. Why a CEO of a major bank or investment firm does not already consider his or her interest aligned with the company is a strange one. They are apparently implicitly pleading to some contractor flaw that says, unlike the rest of us, they need to be specially incentivized to treat their employee's interest fairly. Most of us in this society are able to go home without that.

That is up to them and their shareholders, but it should not be done in a way that incentivizes too much risk. And I think it is irrefutable that it has happened in the past.

I do differ with the Administration in that hope springs eternal. And that position seems to be that, if we strengthen the compensation committees, we will do better. I agree with what they are trying to achieve there. I agree with their statement of goals. I have less confidence than they do that we will be able to find compensation committees among these boards that will have that independence. So I would go somewhat further.

But we do agree on the goals, and we do agree with the Administration on say-on-pay. And I would simply say this is the first in a set of hearings that will lead this committee, I hope, to begin marking-up in a month a set of financial regulations that I hope we will have to the Floor of the House before we adjourn for the

summer that will put in place rules that derive from the lessons we have learned in the most recent crisis. And as I said, we are here not because of concerns over the amount of compensation in general, but fundamentally because we think the incentive structure has contributed to excessive risk-taking.

The gentleman from Alabama is recognized for 5 minutes.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, I thank you for holding today's hearing on executive compensation, which is the first of a series on regulatory reform in the future of our financial system.

There is no question that there have been some questionable decisions made by some of our major corporations regarding executive pay. However, I strongly believe that it is neither the Executive Branch nor Congress' role to mandate compensation policies, or the role of this Congress or the Executive Branch to determine who sits on a corporate board of directors or to interfere with corporate governance in any way.

What we need instead is a strategy to get us out of what we have witnessed in the past 6 months, and that is government command and control of businesses. We need to get the government out of businesses, and what we need is no further intrusion in what should be private economic decisions made by corporations or directors and their shareholders.

Mr. Chairman, the series of regulatory reform hearings scheduled will, I believe, be among the most important the committee will be holding this year, and perhaps the most important hearings that we will hold in the 111th Congress. In these hearings, we will determine how we rebuild our financial system and whether we lay the foundation for economic growth and prosperity or whether we repeat the same mistakes that led us to the brink of ruin and those we have made since September.

Later this afternoon, the Republican leadership of the Financial Services Committee will unveil a proposal to reform our financial regulatory system. The Republican regulatory reform proposal calls for a return to market discipline and an end to bailouts, government intrusions into business, and the government picking winners and losers. The government plan addresses the major flaws in our current system exposed by the financial crisis.

And I look forward to working with my colleagues on both sides of the aisle on this and other proposals for reforming our regulatory system.

Over the past year, we witnessed unprecedented government interventions into the financial system and into corporate governance. Hundreds of billions of dollars have been spent recapitalizing individual financial institutions, some of which were probably insolvent and should have gone into bankruptcy proceedings instead of being propped up with taxpayer dollars.

The Federal Reserve's balance sheet has more than doubled from roughly $870 billion before the crisis to over $2 trillion now, according to remarks made by Federal Reserve Chairman Ben Bernanke. In the short run, government interventions may have stabilized the market, but I fear that these repeated multibillion dollar taxpayer bailouts are weakening our financial system and now threaten our economic future.

Combined with the current Administration's borrow-and-spend fiscal policy, many have come to believe, including myself, that the vast expansion of the Fed's balance sheets is in itself becoming a systemic risk to our national economy far greater than the failure of any private financial institution. It also I think fundamentally affects our ability to borrow money and the price at which we borrow that money.

To restore our economy, we should reject the philosophy that has transformed us into a bailout nation. However, there are some who want to go further in trying this failed government policy of rescuing too-big-to-fail institutions by crafting a resolution authority or systemic risk regulator which would give the government and government bureaucrats the power to use taxpayer money to prop up certain financial institutions.

We may think that we own AIG, the government, but in fact, I think AIG and these companies end up owning us.

Mr. Chairman, the appropriate response to this very real problem of handling market failures is, we should resolve insolvent nonbank institutions, no matter how large or systemically important, through the bankruptcy system. Bankruptcy is a transparent and impartial process with well-settled rules and precedents. It is far preferable to a vaguely defined resolution authority that encourages moral hazard and further entrenches megabanks and other large institutions as wards of the State.

In conclusion, it is important for the regulators to monitor the interactions of various sections of the financial system and to identify risks that could endanger the stability and soundness of the system. But it is unwise for Congress to place the stewardship of our economy in the hands of a super regulator thought to possess superhero powers to spot bubbles in excessive risk-taking before markets crash, given that we have no way of telling whose forecast will be right and whose will be wrong.

In conclusion, I would remind my colleagues of a comment made by the Fed Chairman on March 28, 2007: "At this juncture, the impact on the broader economy and financial markets of the problem in subprime markets seems likely to be contained."

My colleagues know I have the highest respect for Chairman Bernanke, but in this case, he obviously could not have been more wrong. This committee must have the courage to reject cause for a new regulatory regime that depends on the infallibility of the government regulators who have so far shown themselves unable to anticipate crises, let alone prevent them. We must encourage a return to market discipline.

Thank you.

The CHAIRMAN. The gentleman used an extra minute and 10 seconds. I would be glad to add that to both sides if that is acceptable.

Mr. BACHUS. Thank you.

The CHAIRMAN. So another minute and 10 seconds on that.

Mr. BACHUS. I appreciate the chairman.

The CHAIRMAN. The gentleman from Georgia for 2 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

I think this is a very, very timely and important hearing as we grapple with the issue of how the compensation structure affects systemic risk.

I think that I can understand pay for performance, but for the life of me, I cannot understand pay without performance. I think that gets to the heart of the matter here—pay without performance. So much of the compensation structure, I think, is inequitably distributed through salaries and then their bonuses. I think it is the bonus structure that we have to look at very carefully.

Now, we are responding to an issue that we did not create here in Washington or in Congress. This issue was created by overexuberant, overeager executives who were compensated for lack of performance.

The bonus structure is set up so that there is a reward system, hopefully a reward system for superior performance, but there is no downside to that. There is no reaction for failure.

If we look back at the history of our performance, we will find that many of these executives were rewarded for driving companies into the ground. As we and as the American people observe this and are looking at this, multimillion dollar bonuses on taxpayers' money while the American people are just hanging on by their fingernails in an economy where the salary and wage disparity has continued to widen and widen and widen; so if we look at the history and retrace the unraveling of our economy, there is a very significant role that this out-of-control compensation packaging of executives have led to a degree of the cause of the problem.

And Mr. Chairman, I appreciate this opportunity to explore this issue further.

The CHAIRMAN. The gentleman from Delaware is recognized for 2 minutes.

Mr. CASTLE. Thank you, Mr. Chairman.

I believe we need to be very cautious in the path that we are going down. The form of capitalism we have had in this country for decades, generations, even centuries at this point, has worked well. The States have created our corporate laws. The shareholders elect directors, and the directors set pay.

Obviously, there have been abuses in this area, and I think we all agree on that. And I tend to agree that the compensation structure could have some effect on systemic risk. But does that mean that the Federal Government should step in with legislation and try to correct this? Given that stockholders themselves can be individuals who are not necessarily a person owning 10 shares or 100 shares but corporations and others who own tens of thousands of shares, mutual funds or whatever, who may not have the true interest of the future of the corporation in mind, other than the immediate profit possibilities, and so as a result that potentially can be dangerous.

I think we need to emphasize to stockholders that they have a right to change directors. We need to emphasize to our States that they need to have good laws with respect to the ability to be able to change directors.

And I think we need to be very careful in Washington. We have gone through a bailout situation. I don't think anybody looks at Washington and thinks, gee, these people really know how to run things, either at the Executive Branch or at the Legislative Branch.

And one reason that people are not being penalized because of losses is that we have been willing to step forward with bailouts.

I think we need to be very careful about that. I don't think the government intervention is an acceptable end as far as this is concerned.

So I would encourage all of us to listen carefully, because I think there are some good points to be made, to think deeply about what we are doing and make sure that we do not upset something which has the history of working pretty well in this country. Maybe we can tweak it, but we need to be cautious about how far we go.

I yield back, Mr. Chairman.

The CHAIRMAN. Mr. Sherman for 2 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman.

I agree with the ranking member that if we have a risk regulator, this should not morph into an agency that could put taxpayer money at risk or engage in bailouts. It should not be permanent TARP.

As to TARP, it provides for appropriate standards of executive compensation. I regret the fact that the Administration seems that it will apply this only to those entities that have received three scoops of ice cream. I would think that, if you read the law, it should apply to any company that receives even one infusion of TARP funds.

The people of this country were outraged at executive compensation. That was not only understandable; it was valuable. And it will lead promptly to the return of some $68 billion to the Treasury by various banks that they would not have done if it was not for this outrage and the governmental reaction to it.

As to the proposals we are considering today, as to say-on-pay, I believe we ought to look at that being binding, not just advisory, and we ought to set as many of the standards here in this room rather than just transfer authority to the SEC. We are talking about shareholder democracy. Democracy starts by legislating by the elected representatives of people, not just granting power to an unelected board.

There are those who say that corporate boards will exercise the authority, and if they don't, well, there can be shareholder elections. The process of picking shareholder boards would make Hugo Chavez blush. After all, corporate funds can be used in unlimited quantities to back one side and to fight the other.

As to the pernicious incentives, I think we are all against them. It will be extremely difficult to design a system where an executive's compensation reflects whether that executive actually helped the company in the long term rather than simply made it look good in the short term. This will be easier for those who have company-wide decisionmaking since we could give them restricted stock in the entire company. But those who led to the success or failure of a single unit, it will be far more difficult.

I yield back.

The CHAIRMAN. The gentlewoman from Illinois for 2 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman.

I am disappointed that some Federal officials are moving in the direction of government-determined pay, not just for senior executives of United States companies, but for their secretaries, the analyst, and the janitor. I think that is a slippery slope or worse.

Don't get me wrong; financial criminals must be brought to justice, but most importantly, risky behavior in the financial services industry must be addressed. And I think we can do that with smarter, more effective financial services regulations that rein in reckless behavior, risky leveraging and concentrations of capital.

In addition, our financial services institutions need to retain the best and the brightest. We need not induce fear in our future financial service leaders or workers but provide them with improved guidelines that foster competition for the benefit of U.S. consumers, businesses, investors, and our economy.

And with that, I yield back.

The CHAIRMAN. The gentleman from Kansas is recognized for 1 minute.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

I want to commend you for your leadership on executive pay issues and for holding today's hearing so we can review how compensation affects risk-taking for better or for worse as we consider financial regulatory reform. One of the most important lessons I think we can learn from the financial meltdown is that excessive risk-taking and overleveraged activity with little or no oversight will lead to instability. As this committee considers financial reg reform we need to guard against destabilizing activity and identify the proper role of risk in a thoughtful way by improving compensation, risk management, and corporate governance practices.

I look forward to hearing our witnesses' testimony on these important issues.

And again, thanks, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling, for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Executive compensation limits to address systemic risk are the wrong remedy for what is probably a nonexistent problem. Any compensation legislation considered by Congress ought to be driven by two key principles:

Number one, executives of failed companies who come to taxpayers with tin cup in hand must be subject to compensation limits, period; let there be no doubt.

Number two, except for the first principle, Congress has no business setting artificial and mandatory limits on anyone's pursuit of their American dream. If someone aspires to be the next Bill Gates, Oprah Winfrey, Warren Buffett, or Charles Schwab, we should tell them, the sky is the limit, go for it, not, we are the U.S. Congress, you will not be allowed to go beyond the 10th floor, and, oh, by the way, take the stairs.

Now, I will be the first to admit that many compensation arrangements strike me as risky, illogical, unreasonable, if not downright offensive. But the solution to any concerns regarding executive compensation practices is for, number one, the shareholders to vote for a change in management or to take their investment dollars elsewhere; and for Congress to reexamine the Tax Code, which probably helps drive a lot of these arrangements in the first place; and even more importantly, to quit bailing out companies who fail in part due to flawed compensation systems.

Finally, I hope, I hope that in America the term "systemic risk" is not now being used the way the term "internal securities" was once used in the farmer Soviet Bloc, a justification for almost any and all government intervention.

For those who truly want to reduce systemic risk, I suggest a first look to Fannie Mae and Freddie Mac.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from Indiana is recognized for 3 minutes.

Mr. CARSON. Thank you, Mr. Chairman, for your tremendous leadership on the issue of executive compensation and for holding this hearing.

This issue promises to be one of the most important of the upcoming regulatory reform legislation. Recently, there have been a number of interesting characterizations of efforts to reform executive compensation structures on Wall Street.

In the wake of the worst economic crisis since the Great Depression, many financial industry leaders have insisted that CEO compensation is self-correcting. They urge inaction on reform, insisting that shareholder and media scrutiny has already moderated pay for leaders of poorly performing companies. They claim, if we enact stronger reforms, our financial talent will be driven overseas and our economic recovery will be delayed.

What is missing from that argument is both clarity and reason. For the 175 executives whose companies helped fuel the current economic crisis that ultimately required hundreds of billions of dollars in taxpayer assistance, I believe a capable compensation overseer should have the discretion to determine whether or not these companies' compensation packages are reasonable.

In any other industry, when someone takes excessive risks that lead to monumental failures, there are repercussions. Wall Street seems to expect a separate set of rules.

For my constituents, this double standard is nothing new. They know that, 30 years ago, the CEOs took home 30 to 40 times what average workers made, and now that number has exploded to 344 times an average worker's pay. They know that while the average CEO pay dropped by $1 million last year, many average workers were laid off. They know that the average bonus payments to Wall Street executives represent more than they hope to earn over a lifetime. And they know that, once again, Main Street is paying for the actions of Wall Street.

My hope is that industry leaders understand that calls for executive pay reform are not a retaliation for our current economic reality but rather an attempt to usher in a new era of real corporate responsibility. I hope that executives realize that performance incentives that are tied to the long-term success and soundness of an institution are essential if we hope to monitor systemic risk and restore confidence in our markets.

With that in mind, I look forward to working with the Administration, the chairman, and my colleagues on this committee.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman from New Jersey is recognized for 2 minutes.

Mr. GARRETT. Thank you, Mr. Chairman.

I appreciate the gentleman who just spoke, his comments, and I appreciate the witnesses here today and the chairman for holding this hearing.

Today, we are exploring compensation structure and systemic risk. But to me, as I look at it, the Federal Government really is the one that poses the single biggest systemic risk, and it is really not even close.

Part of the reason the government poses such a large systemic risk is because of the often misguided Federal Government policies we have seen. Yet government officials with their long-term track record of success continue to come forward with proposals that, to one degree or another, dictate to private firms just about how they should properly compensate executives and measure performance.

Look, there is certainly room for improvement at particular individual companies in putting together compensation practices. And to the extent this discussion today, just like the gentleman from the other side just made his comments just now, helps to inform boards as they take a closer look at their compensation policies, that could all be a positive development.

But you know, I have a problem. I believe the American people are growing weary of recent government overreach into the private sector. With the government now owning GM, and with the way the rule of law was disregarded in the Chrysler bankruptcy case, dangerous actions are taking place which will create uneven playing fields and increasingly inject political decisions with so many unintended consequences into our economy.

So individual boards from companies have a responsibility for establishing compensation packages that not only take into account the long-term best interest of the company and its shareholders, but also allow them to attract the best available talent. This is a fundamental underpinning of our free market economy, and it should not be put in the hands of government bureaucrats.

With that, I yield back.

The CHAIRMAN. The gentleman from Florida for 2 minutes, Mr. Klein. Is he here?

We will hold off then. And let me go to the gentleman from Texas, Mr. Neugebauer, for 2 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

One of the things that has happened over the last few months is we have formed new entities called TSEs, that is taxpayer-supported entities. And that is where the American people were impressed to be shareholders in companies that, in many cases, they wouldn't have invested on their own. But, unfortunately, that marriage was made.

And I would guarantee that if you think the marriage isn't working very well, wait until you see the divorce as we try to unravel these. But yet this looks like we are moving in the direction of increasing the consequences of this marriage.

One of the things that I think is ironic is we are focusing on compensation rather than performance. And one of the things that is most embarrassing, I think, about all of this is that we have people who have never run anything trying to tell companies how to run their own business. We have people that the only risk they may

have ever taken is to buy a lottery ticket trying to tell companies how they should move forward with their business plans.

I think it is a poor direction for us to move. If we really want to help the shareholders and help the American people, first, we need to get them out of these businesses. Second, we need a regulatory structure that ends these bailouts; ends the government picking winners and losers; and more importantly begins to put a market discipline into these companies. Letting them fail, knowing that there are consequences.

If you think shareholders will have an uprising, wait until they think that they are about to lose their investment. Today, we send a signal, hey, you may not lose your investment, or more importantly and more sadly is, we say to the American people, guess what, you didn't buy shares in that company; well, we are going to buy them for you because we are the government, and we think we know what is the best investment of the American taxpayers' money.

And by the way, we don't have any of this money. This is all money that we are borrowing. We are borrowing from China and Japan and from people that we are selling—we are having to buy energy from on a daily basis.

The American taxpayers are sick and tired of being shareholders. Let's get them out of that. Let's get an exit strategy. And more importantly, let's don't let the Federal Government encroach in the business any more than it already has.

The CHAIRMAN. The gentleman from California for 2 minutes.

Ms. WATERS. Thank you, Mr. Chairman.

I would like to begin by thanking you for facilitating this hearing this morning.

Executive compensation has been a complicated and reoccurring issue in our discussions on financial reform. As you yourself have mentioned, compensation that promotes excessive risk is a systemic concern. To that end, what occurs in financial centers, such as Manhattan and Charlotte, affects everyone across the country, including residents from my district in California.

Some of the compensation packages that were lavished on top executives are mind-boggling. Former executives, such as Merrill Lynch's John Thain or Countrywide's Angelo Mozilo, were collecting salaries and bonuses into the multimillions while running their companies into the ground.

To the extent these CEOs and others were incentivized to produce short-term profits, they were equally as incentivized to flood the market with predatory loan products, such as subprime mortgages; weaken their shareholders long-term prospects for financial gain; and increase systemic risk. As a result of this increased systemic risk, the American taxpayer has been asked to bail out financial institutions through liquidity tools, such as the Capital Purchase Program and the Term Asset-Backed Securities Loan Facility, or TALF. That gift is not a gift but rather a loan from the public and, as such, requires certain protections. One of these protections is a special master or pay czar who will place transparency into the system so the public and shareholders are properly informed.

To the extent bonus compensation poses a systemic risk, it, too, merits some limits.

I thank our witnesses today for helping us to frame a discussion on which bonus compensation limits may be appropriate to rein in systemic risk. That said, I do not believe non-TARP recipients should have their salaries capped by the President or the Congress.

Thank you, Mr. Chairman. I yield back the balance of my time.

The CHAIRMAN. We will do 1 minute now for Mr. Moore, then Mr. Campbell, then Mr. Peters, and we will be finished.

Mr. Moore for 1 minute. I apologize. All right. Then we will go to Mr. Campbell for 1 minute.

Mr. CAMPBELL. Thank you, Mr. Chairman.

You know, there is no argument that there have been instances, a number of them, in which people in companies have been paid a great deal for not very much performance. The question is, what do we do about it?

As someone who has designed incentive compensation plans for hundreds of employees in my own business over a 25-year career, I will tell you that it is not easy; that sometimes you pay people too much for too little performance and sometimes you pay people too little for too much performance, for a lot of performance. And the idea that somehow that some Washington bureaucracy, distant Washington bureaucrat, can do this better than people in a business and in the company is simply ludicrous.

Also I believe the idea of having a direct shareholder vote opens up the idea of direct democracy within corporations which leads to the question of, well, should we also have them approve union contracts, approve major expenditures, etc., all of which arguably have done more to bring companies down over the years than excessive compensation.

Instead, in my view, the SEC is moving in the right direction by giving shareholders greater rights to make nominations for and changes in the board of directors when they get too cozy with management. I yield back.

The CHAIRMAN. Finally, the gentleman from Michigan, Mr. Peters, for 1 minute.

Mr. PETERS. Thank you, Chairman Frank, for holding this hearing and for your leadership on this issue.

It is estimated that as many as 100 million Americans own stock either in individual accounts or through a mutual fund, and those investors have lost trillions in the current stock market decline. There is no doubt that one of the causes of the current financial crisis was executive compensation schemes in place in many of the largest financial institutions, from the top executives to the traders on the floor, people who are receiving a compensation package that emphasized short-term gains rather than rewarding long-term growth and shareholder wealth.

I am happy that the Obama Administration has announced that they are taking steps to address this issue by calling on Congress to pass legislation that requires companies to hold an advisory shareholder vote on compensation and mandating their corporate boards use independent compensation advisors.

Tomorrow, I will be introducing legislation that will do that and more. It will also include a number of other provisions that I be-

lieve will reform corporate governance practices by empowering shareholders to have a greater oversight over the management of the companies that they own.

I look forward to hearing the testimony today.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the members.

And we will begin with the witnesses.

Let me say we have an important subject. We have, as always, too many members on this committee, and I am going to hold everybody strictly to the 5-minute rule. No one will be recognized as a member after the 5 minutes. We will allow witnesses to give a short answer to finish up. And if you ask a complicated question with 30 seconds left, it will be your fault if you don't get a serious answer.

We will begin with Mr. Sperling.

STATEMENT OF GENE SPERLING, COUNSELOR TO THE SECRETARY OF THE TREASURY, U.S. DEPARTMENT OF THE TREASURY

Mr. SPERLING. Thank you, Chairman Frank, and Ranking Member Bachus. It is very good to be here. I appreciate that you are holding this hearing. I think there is little question that one contributing factor to the excessive risk that was central to the crisis was the prevalence of compensation practices at financial institutions that encourage short-term gains to be realized with little regard to the potential economic damage such behavior could cause, not only to those firms but to the financial system and the economy as a whole down the road.

Compensation structures that permitted key executives in other financial institutions to avoid the potential long-term downsides of their actions discouraged a focus on determining long-term risk and underlying economic value while reducing the number of financial market participants who have an incentive to be the important canary in the coal mine.

I want to make clear, as Secretary Geithner said yesterday, our goal is to help ensure there is a much closer alignment between compensation, sound risk management, and long-term value creation for firms and the economy as a whole. Our goal is not to have the government micromanage private-sector compensation.

As Secretary Geithner said yesterday, we are not capping pay. We are not setting forth precise prescriptions for how companies should set compensation, which can be counterproductive. And we come to this with a clear-eyed sense of both the seriousness and the humility one must bring, both the importance of the issue but also the care and rigor one must take to ensure that well-intentioned actions do not lead to unintended consequences.

I will mention just a few of the principles that Secretary Geithner laid out yesterday, a couple of examples, and then I look forward to the discussion.

One, compensation should accurately measure and reward performance. And I think this is an important issue. It is a lot easier to get everybody to agree that performance—pay should be performance-related. But it is a lot more complex to find out what is that right mix of metrics that ensures that it is true performance.

Simply using stocks, as they say, can confuse brains for a bull market and, on the other hand, not properly rewarding an executive who may be doing enormously well in a difficult economic time. I think one of the things we should study carefully is what is the careful mix of metrics that truly rewards performance in fact and not just in name.

Secondly, compensation should be structured in line with time horizons, the right time horizons. A friend of mine said to me recently, it is like there is an entire industry which is—you know entire sets of financial actors which are able to realize private gains in a single year for risks they are creating over a 30-year period, which could be externalized to either their firm or, as we have seen, the economy as a whole. We need to have structures that help internalize those risks to make sure that we are having—that those—that it is not easy for financial actors to simply put off the potential harm they could be leaving to their firm, their shareholders, and the economy as a whole.

Third, compensation practices should be aligned with sound risk management. Now, this authority and dependence of risk managers within firms, ensuring they are independent, compensated well, is most important when you are going through a period of excessive optimism, where asset depreciation can temporarily make the reckless look wise and the prudent look overly risk adverse.

Former Federal Reserve Chairman William McChesney Martin once said, the job of the Federal Reserve is to take away the punch bowl just when the party starts getting interesting. Likewise, risk managers must have the independent stature and pay to take the car keys away when they believe a temporary good time may be creating even a small risk of a major financial accident down the road.

Fourth, we should examine whether the prevalence of golden parachutes and supplemental retirement packages truly align the interest of executives with shareholders. Lucien Bebchuk, who will be speaking to you, has written that firms use retirement benefits to provide executives with substantial amounts of stealth compensation, compensation not transparent to shareholders that is largely decoupled from performance.

And concerning golden parachutes, there is more evidence that they are prevalent, not tied to performance or even mergers and acquisitions. And I fear that they leave the understandable impression that there is a double standard in our economy when top executives are rewarded for failure at the same time working families are forced to sacrifice.

Finally, we believe that it is very important to have greater transparency and independence. The say-on-pay legislation that Chairman Frank has long sponsored, and of which President Obama as Senator Obama was a co-sponsor in the Senate, would be a very significant move forward in terms of transparency and accountability. The evidence in the UK shows that it has had a positive impact.

And in terms of the independence of compensation committees, I will just say briefly, we start with the same premise as Chairman Frank that independence in name does not mean independence in fact. But we do believe that if you gave the comp committee the

funding and authority to be the sole hires of the compensation consultants and the counsel and that you had the SEC go forward to ensure a reduction or elimination of conflicts of interest for compensation consultants, it is our hope that we would at least make progress and move the ball forward. Thank you very much.

[The prepared statement of Mr. Sperling can be found on page 183 of the appendix.]

The CHAIRMAN. Thank you.

Mr. Alvarez.

STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. ALVAREZ. Thank you, Chairman Frank, Ranking Member Bachus, and other members of the committee for the opportunity to offer the Federal Reserve's perspective on compensation in the financial services industry. Compensation practices at financial firms and other business organizations can have a significant effect on the safety and soundness of banking organizations and on financial stability.

Compensation arrangements, which include salary, bonuses, retention payments and other forms of compensation, at any type of organization serve several important and worthy objectives. For example, they are important for attracting skilled staff, promoting better firm and employee performance, promoting employee retention, providing retirement security to employees, and allowing the firm's cost base to move along with its revenues.

It is clear, however, that compensation arrangements can also provide executives and employees with incentives to take excessive risks that are not consistent with the long-term health of the organization. This misalignment of incentives can occur at all levels of a firm and is not limited to senior executives.

In addition, incentives built on producing sizable amounts of short-term revenue or profit can encourage employees to take substantial short or long-term risks beyond the ability of the firm to manage just so the employees can increase their own compensation.

Risk management controls and frameworks have proved incapable alone of acting as a break on excessive risk-taking where compensation programs have created overly strong incentives to take risk.

These and other weaknesses in the ways that firms have thought about and implemented compensation programs have become apparent during this period of economic stress. As a result, many financial firms are now reexamining their compensation structures to better align the interests of managers and other employees with the long-term health of the firm. The Federal Reserve is also actively working to incorporate the lessons learned from recent experience into our supervisory activities.

The Federal Reserve played a key role in the development of the principles for sound compensation practices issued by the multinational Financial Stability Board in April 2009. In addition, we are in the process of developing our own enhanced guidance on compensation practices at U.S. banking organizations. The broad goal is to make incentives provided by compensation systems at

these institutions that we supervise consistent with prudent risk-taking and safety and soundness.

In developing this guidance, we are drawing on expertise within the Federal Reserve, as well as on research from the broader academic community and other compensation and industry experts. Our investigations suggest that there are certain key principles that should guide efforts to better align compensation practices with the safety and soundness of financial institutions.

First, to be effective, compensation practices must be properly aligned throughout a financial firm. This includes careful review and construction of compensation programs at the level of middle management, traders and other individuals who can alter the risk profile of the firm. Firms' boards of directors and supervisors must broaden the scope of their review of compensation practices beyond the traditional focus on senior executives.

Second, compensation practices must take into account the risks of the activities and transactions conducted by the firm and not simply be based on targets for short-term profits, revenues or volume. Substantial financial awards for meeting or exceeding volume revenue or other performance targets without due regard to the risk of the activities can create incentives to take unsound risk. Moreover, incentives that reward good performance but that do not adjust compensation downwards when risks are increased or performance targets are missed are not effective in limiting risk.

Third, more can and should be done to improve risk management and corporate governance as it relates to compensation practices. This will involve more active engagement by boards of directors and risk management functions in the design and implementation of compensation arrangements firm-wide. Improvements in compensation practices are likely to be harder to make and take longer than anyone would like. One size will not fit all firms.

However, well-crafted supervisory principles can play an important role in moving practices in the right direction. I appreciate the committee's interest in this important topic, and I am happy to answer any questions you may have.

[The prepared statement of Mr. Alvarez can be found on page 78 of the appendix.]

The CHAIRMAN. And finally, on behalf of the SEC, Mr. Breheny.

STATEMENT OF BRIAN V. BREHENY, DEPUTY DIRECTOR, DIVISION OF CORPORATION FINANCE, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. BREHENY. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee. I am pleased to be with you here today to testify on behalf of the Securities and Exchange Commission so that I may share with you our thoughts on the topic of executive compensation.

As an initial matter, I think it is important to note that as the landscape of compensation practices continues to change, the Commission is committed to keeping the disclosure rules we administer up-to-date so that investors have the information they need to make informed investment and voting decisions.

As we all know, in recent years, the issue of executive compensation has garnered significant public attention. As revelations about

executive compensation come to light, claims have been made that bonuses and severance packages at some companies have been exorbitant. Indeed, executive compensation has been a lightning rod amplified by the recent financial crisis for concerns about the accountability and responsiveness of some boards of directors to the interest of their shareholders.

We believe that, in order for public markets to function properly, it is crucial that shareholders, the owners of the company, be able to make informed decisions about their investments and that shareholders can hold the members of the board of directors accountable for their decisions. Notwithstanding the Commission's current rules, we recognize that there is an ongoing vigorous debate between those who believe that there should be more substantive constraints on pay and those who believe the Federal Government should never or rarely set pay parameters. It is important to note, however, that this debate is significantly more meaningful as a result of our disclosure rules.

However, the challenge the Commission has always faced in promulgating and administering its executive compensation disclosure rules is that compensation practices are not static. As a consequence, the Commission has revised its disclosure rules as necessary to keep pace with new developments in compensation practices. Most recently, in 2006, the Commission adopted a comprehensive package of amendments to its rules that was intended to significantly improve the existing regime of executive and director compensation disclosure.

While the adoption of the 2006 rule revision significantly expanded the extent and strengthened the caliber of compensation disclosure, the Commission is once again considering further possible enhancements. It has been suggested that some companies' executive compensation has become disconnected from long-term company performance because of the interests of management, in the form of incentive compensation arrangements, and the interests of shareholders are not sufficiently aligned.

Critics have complained that, in some cases, the incentive structure created by executive compensation may have driven management to make decisions that significantly and inappropriately increase company risk without commensurate risk to management's compensation should the decision prove costly to the company. Indeed, one of the many contributing factors cited as a basis for the current market turmoil is the misalignment at a number of large financial institutions of management's financial interests with those of shareholders.

Compensation policies and incentive arrangements represent just one of the issues that the Commission plans to take up next month when it considers a broad package of proxy disclosure enhancements. Many of these enhancements are designed to provide shareholders with additional information about their company's key policies, procedures, and practices. For example, the Commission plans to consider whether greater disclosure is needed about how a company and the company's board in particular manages risk, including within the context of existing compensation plans and setting compensation levels.

The Commission also plans to consider whether greater disclosure is needed about a company's overall compensation approach, in particular as it relates to the company's risk management and risk-taking beyond decisions with respect only to the highest-paid executive officers.

The Commission further plans to consider proposing new disclosure requirements regarding compensation consultant conflicts of interest.

In addition to these executive compensation disclosure enhancements, the Commission plans to consider proposals related to the directors themselves. For example, it plans to consider whether to enhance disclosure of director-nominee experience, qualifications, and skills so that shareholders can make more informed voting decisions.

The Commission further plans to consider proposed disclosures to shareholders about why a board has chosen its particular leadership structure, such as whether that structure includes an independent Chair or perhaps combines both the CEO and the Chair in one position, again so that shareholders can better evaluate the board when making a voting decision.

Notwithstanding the Commission's executive compensation disclosure requirements, however, it has been argued that, absent a more effective way for shareholders to exercise their fundamental right to nominate and elect directors to the company's boards of directors, board accountability to shareholders cannot be maximized. Accordingly, on May 20th, the Commission voted to approve for notice and comment proposals that would give shareholders a more effective way to exercise their State law rights to nominate directors.

Under the proposal, shareholders who otherwise have the right to nominate directors at a shareholder meeting would, subject to certain conditions, be able to have a limited number of nominees included in the company proxy materials that are sent to all voters. To further facilitate shareholder involvement in the direct nomination process, the Commission also proposed amending its shareholder proposal rule to require companies to include proposals related to the nomination process in their proxy materials, provided that certain other requirements of the rule are met.

If adopted, we believe these new rules would afford shareholders a stronger voice in determining who oversees management in the companies that they own.

Thank you again for inviting me to appear before you today. On behalf of the Agency, we look forward to working with Congress and with this committee going forward on these issues. I would be happy to answer any questions you may have.

[The prepared statement of Mr. Breheny can be found on page 148 of the appendix.]

The CHAIRMAN. Thank you.

Before I get to questions, I do want to comment on some of what we have heard earlier from my member colleagues. I think what we have heard today is the final repudiation of the Bush Administration by many of my Republican colleagues, because we have heard a fairly vigorous and thorough denunciation of the various

actions of that Administration; no more bailouts, no more taking over companies.

Well, AIG, I remember, in September of 2008, being told by Secretary Paulson and Chairman Bernanke, two Bush appointees, that they had decided with no congressional input or even advice to advance $82 billion to AIG.

Two days later, we were asked by the same two Bush appointees to initiate the TARP program of $700 billion.

Subsequently, we worked with the Bush Administration, and after we were unable to pass a bill because the House passed it and the Senate didn't, involving the auto companies, the Bush Administration initiated it.

So we are talking now about a Bush Administration initiation of funding for AIG, a Bush Administration request to Congress to create the TARP, and the Bush Administration intervention without congressional final action in the auto companies.

How that became a Democratic agenda puzzles me. Perhaps I will be enlightened later on.

I do know that I have colleagues who believe that the world was created only 4,000 years ago. I had not previously known there were some who thought it was created on January 20, 2009.

So I do want to say, we are engaged in this, and we are engaged and have been engaged for months in dealing with the consequences of decisions made by the Bush Administration, some of which I agreed with, although I thought they weren't carried out well.

I would note on the TARP money that, thanks in part to an increase in the conditions that have been imposed on TARP recipients both by the Congress and the Obama Administration, more than one-third of the money advanced to banks has already been repaid to the Treasury. Now, we have to decide what we do with that.

But those who consider the whole $700 billion gone have to cope with the fact that of approximately $200 billion advanced in less than a year, more than $70 billion has come back, some of which exceeded the loans because there was some interest.

Now, these are complicated questions to be worked out. And I would not ordinarily have brought this up, but listening to what I heard before, it did seem to me the history was relevant. Yes, we have had a problem with bailouts.

The second point I would make is that a say-on-pay comes from England. It is not some intervention. It is not a bailout. The compensation matters we talk about, and I try to be very clear, it is one thing to have fairly intrusive compensation restrictions when people are getting money directly; it is another when we are talking about risk assessment.

And so I will now ask my question of these three gentlemen. One of the arguments we have heard is that if we restrict compensation, it will contribute to capital fight, that people will flee America. It has been my experience that, in the first place, American corporate executives were rewarded far better in dollar terms and other ways than others. Sometimes I think the Japanese executives and American executives are paid the same amounts, except in our case it

is dollars, and in their case it is yen, and so the yen-dollar difference means that ours are getting a lot more.

But I would ask all three of you, is there a danger if we were to adopt say-on-pay or some of the other rules that you are proposing, that we would have the capital flight that some of the best and brightest who have run the financial system with such elan would now decide that they were not sufficiently appreciated and would move to other countries?

Let me begin with Mr. Sperling.

Mr. SPERLING. Chairman Frank, I suppose if one were to put a hard and arbitrary cap on the top talent at a firm, that could lead to flight and the kind of deterioration that you mentioned.

But as far as I know, I can say with certainty that there is nobody in the Obama Administration who is proposing such things. What we are proposing in the legislation we did put forward yesterday is greater transparency and accountability to the owners of the company. We find, and I think practice has shown, that sunshine and transparency does have a powerful deterrent effect on improper or ill-advised behavior. And I think, even more important, it starts an important dialogue.

The CHAIRMAN. I want to talk strictly about the competitive piece.

Mr. SPERLING. I do not believe that anything we are proposing today or that you have proposed would have a deterrent impact.

The CHAIRMAN. Let me ask Mr. Alvarez.

Mr. ALVAREZ. Mr. Chairman, I think one good piece of information here is that the world is looking at this problem as well. So the British have already begun to consider it. The Swiss have proposed some principle similar to what we have discussed today.

As I mentioned, the board has worked on an international panel with a financial stability board. So this is a global issue with a global set of solutions that the globe is coming to consensus on.

The CHAIRMAN. Thank you.

Mr. Bachus?

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, your earlier remarks, I will just say that whether we tag this on Bush, sort of pin the tail on the donkey, or whether we pin it on the elephant, it is now all of our problems. And it is now; it is not then. And I just ask that we all work together to get us out of this, these bailouts and these government-funded programs, and that we extricate ourselves from that and the deficit spending that we have witnessed.

So we will work together on that I hope.

Let me say this. Gene, you and I have worked on several things. I have a deep respect for you. I very much agree with you that one of the contributing factors to the excess risk-taking that was central to the crisis was compensation that was linked to short-term gains without any consideration of the long-term risk. As you say, across the subprime mortgage business, brokers were compensated in ways that placed a high premium on volume without regard to whether the borrowers had the ability to make those payments. That is pretty clear. I associate myself with all of those remarks.

I also associate myself with the remarks you have made that top executives offered those golden parachutes weren't aligned with

shareholder interest. You said it creates the impression, and a lot of my constituents have this impression, that there is a double standard in which top executives are rewarded for failure at the same time that working families are forced to sacrifice. We have seen instances and a lot of cases where executives received these tremendous salaries as they went out the door on failing corporations, and at the same time, most of the workers were being given pink slips or their retirement benefits or health care was being cut back.

Having said that, I take those as givens. You say that the goal of the Administration now is to move compensation committees from being independent in name to being independent, in fact, and not only would committee members be truly independent, but they would be given authority to appoint and retain compensation consultants and legal counsel, along with the funding necessary to do so. This legislation would instruct the SEC, and I think we have had testimony from the SEC, to create standards for ensuring the independence of compensation consultants, providing shareholders with the confidence that the compensation committee is receiving objective, expert advice.

Would all of you gentlemen admit that is a major mandate by the government in the corporate governance?

Mr. SPERLING. Thank you, Congressman. I feel that this is just simply trying to ensure that the independence of comp committees is as it is advertised, which is independent. The reality is, and I say this as a person who has participated in a board of directors, if the CEO controls the compensation consultant, you can have an independent compensation committee, but the power and the information that is being gathered is being gathered by somebody who almost inherently has a conflict of interest in this situation.

I think one of the things that you try to do is not to intervene or micromanage, but I think when you can have transparency and reduce conflicts of interest, then you are laying foundations for capital markets to work more efficiently.

Mr. BACHUS. But you are putting independent people within the corporate governance and you are mandating that they be independent and be compensated. That is a type of corporate governance. I guess what I am saying is that 95 percent of the corporations never made a mistake or never performed in a risky manner, so you are basically taking and you are saying to all of those corporations we are going to change the rules.

Mr. SPERLING. Well, as we have seen, it doesn't take that many types of excessive risk-taking to do a lot of damage that goes not only to the shareholders but to the economy as a whole.

We believe if we advertise to shareholders and the public that compensation committees are independent, and yet we know that if the company itself hires the compensation consultant, if that compensation consultant can also be taking other fees and being paid by the company, then you have a bit of false advertising. I think what we are doing here, far from being intrusive, is simply ensuring that the independence of compensation committees, as advertised, is independent, in fact.

The CHAIRMAN. The gentleman's time has expired.

The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to thank our panel for being here today to help us wrestle with one of the most serious problems in the financial services community dealing with compensation and bonuses, etc.

There are some things that we have learned about actions that were taken that are very disturbing. I don't know that we have gotten any information to help us understand what went on in some of these actions. For example, I want to know what you have discovered, starting with Mr. Sperling, about the authorization for $5 billion for bonuses to be given to Merrill Lynch employees at the time the merger took place between Bank of America and Merrill Lynch. I have read accounts in the paper and heard information that Bank of America knew and signed this agreement that these bonuses could take place.

Later I am told that the CEO said that he was made to sign an agreement understanding that these bonuses were going to be given. Normally these bonuses were given at the beginning of the year. They rushed them so that they would be given toward the end of the year and prior to the signing of the agreement. What do you know about this?

Mr. SPERLING. Congresswoman, there obviously has been very contentious discussion which has gone out to the public between former Secretary Paulson and the chairman of Bank of America over what transpired during that transaction which as you know was months before I entered the Obama Administration.

Ms. WATERS. Yes.

Mr. SPERLING. I would have to go back, and would be happy to do so, and get what our Administration's best understanding is of that dispute. But it is an ongoing dispute with I believe our own Justice Department engaged in it, so I don't have intimate knowledge of where that is right now. But I would be happy to get back to you.

Ms. WATERS. Well, as we try and create public policy around some of these issues, what would any of you suggest that we should include in legislation that would prevent this kind of action?

Mr. SPERLING. Well, one thing I would mention is, with the legislation that you all have already passed, let's remember that in the situation of TARP, which I know we are going well beyond, but obviously the legislation you have passed would have limited those types of bonuses to one-third of overall salary. So in the case of someone receiving TARP, a recipient, had Merrill been a TARP recipient at that point, it would not have been permitted under the law.

But more generally, again, our view is very much to try to have greater transparency on the practices, greater independence; and we feel very much that these type of practices, when brought to light, that the transparency is often decisive. And so when people say, for example, say-on-pay is nonbinding, I don't think that is the way it works, in fact. I think it is very, very troubling for a company to face a negative vote in those areas, and few want to take that type of public risk.

Ms. WATERS. Any other comments on this issue?

Mr. ALVAREZ. Madam Congresswoman, one issue I would add to what Gene has said, it is important when an organization has not

performed well that bonuses be adjusted for that. One of the principles that we think is very important and that the Federal Reserve will incorporate in its guidance going forward is that the compensation should be risk sensitive. It should reward good performance. But when performance doesn't meet goals or when there are losses, then the compensation has to be adjusted in the other direction.

Ms. WATERS. That is the Barney Frank law. He is the first one who emerged with the risk assessment relative to the management of risk basically. He maintained from the beginning that those persons responsible for creating the risk would have to accept the responsibility for the failures. And so I think we are on that path for sure. But I just want to make sure that I understand when mergers are occurring, buy-outs are taking place, what the purchasers are being forced to do by anybody. I want to understand that better, and I will continue to pursue that.

Mr. SPERLING. I think, as the chairman would say, in the say-on-pay legislation proposal, there is often a separate vote on the golden parachutes in exactly that merger transaction.

The CHAIRMAN. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Sperling, in your testimony, you said that you all were going to be asking the President's Working Group to provide an annual review of compensation practices so the government can monitor whether they are creating excess risk. How will that work? How will you determine whether compensation is actually creating excess risks?

Mr. SPERLING. I think the reason Secretary Geithner felt it was good to put this on the agenda, and it is the same reason that you hear Mr. Alvarez talking about it from the Federal Reserve's perspective, we have all learned painfully that compensation is closely related to the safety and soundness obligation, not only the Federal Reserve, but all of us have.

I think we also are aware that one always has to be worried about fighting yesterday's war. New practices, new trends can emerge, and I think to ask the major supervisors in the U.S. Government to take a yearly look or annual review of what those trends are could be again one more check against the type of excessive risk-taking that we have seen, which too often can get a pass in exactly a bubble atmosphere where again everybody looks smart because assets are all going up year after year. These are exactly the times when you need to have more risk management in place at companies, and perhaps at the Federal level as well.

One of the things that Secretary Geithner did was to invite many of the major organizations, nonprofits and business groups, to be part of that process so we are reviewing not just what may be going wrong but also best practices. I think one of the positive things that are coming out of the discussion, and we heard in the expert meeting that we did, which was a very wide group that went from Nell Minow, who you have speaking today, to the Business Roundtable, was that there was enormous optimism that there could be an emerging sense of best practice if this discussion is rigorous enough and if there is enough of a spotlight shined on it.

Mr. NEUGEBAUER. One of the things you said in your testimony, you said you think one of the major causes of the financial crisis we are in today was based on compensation. The problem I have with going down this compensation road is where in the chain was the compensation inappropriate for the risk being taken? Was it the young originator of the loan, or was it at the person at the financial institution that was packaging the loan? Or was it the securities company that was securitizing it? Or was it the investment company that was buying those loans? Where in the process was the person being overcompensated and the risk and compensation out of proportion?

Mr. SPERLING. I think it is less how much, but it is more—what you don't want, whether it is the person originating the subprime mortgage or the executive, is you don't want to encourage compensation practices where one gets to internalize the gains short term and externalize to others the potential risk and harm down the road. So, for example, if a subprime mortgage originator, if part of their compensation might be based on how the mortgages were being paid, that would be a way that you would ask that person to think not just about how much volume that I can push this year, but whether or not you give have them an incentive or their unit an incentive to consider how it is going to perform. Some firms are now doing bonuses banks. What they are saying basically is that if everybody knew their bonus was going to be held for a few years before they got all of it, then if people said we are doing some excessively risky things here, there would be a lot greater incentive for people to be self-checks in their own businesses because they would see their compensation reduced.

Across the system, too many people could internalize private gains by the volume of what they were doing regardless of its quality or the risk it was externalizing to the firm, the shareholders, or as we have painfully learned, the economy at large.

Mr. NEUGEBAUER. I have a quick question for the three panelists: If you gave me $1,000, and in 2 years, I had made that into $1 million, would it be fair for me to get a $10,000 fee for doing that; yes or no?

Mr. SPERLING. It depends.

Mr. NEUGEBAUER. Mr. Alvarez?

Mr. ALVAREZ. I couldn't say.

Mr. BREHENY. I couldn't say.

Mr. NEUGEBAUER. So you all are going to set compensation for companies, yet you do not know what adequate compensation for return is, and this is the problem.

The CHAIRMAN. The House is in recess, so we are not going to have to disrupt this.

The gentlewoman from New York.

Mrs. MALONEY. Thank you, Mr. Chairman. I thank all of the panelists. I would like to note for my colleagues that I have worked closely with Kenneth Feinberg during the 9/11 recovery for New York City. He took on an incredibly difficult task determining what the compensation would be for families who had lost their loved ones. It was a very difficult task, and he won applause from everyone. He did a magnificent job with a murky and confusing problem. So I compliment the Treasury Department on your selection, and

I wish him great success and that he will be as successful as he was with the 9/11 Compensation Fund.

My question to Treasury is, how did you determine the seven companies that are going to have their compensation determined or guidelined by Mr. Feinberg? Some people have said if there was 40 percent ownership by the taxpayer, was that the standard? What was the standard that determined who the seven companies were?

Mr. SPERLING. In the regulation itself, it actually mentions the specific names of the programs that they are under. But I think your question actually goes more towards what is the logic and rationale.

I think that our feeling is that some of the things we have done, some of the facilities that were set up are set up to be generally accessible to companies, financial institutions at large. And they are often set up because we think that there is a positive public purpose in them participating. We think if community banks wanted to not have more capital, if they wanted to do less loans, we believe it is in the interest of recovery to have stronger capitalization of banks and a stronger lending profile. So those are generally accessible programs.

Where a company comes to the U.S. Government and U.S. taxpayer and requires exceptional assistance that is not being offered to their peers because they face an enormous threat to their fundamental financial stability that we find to have such an impact on the economy as whole that we have to intervene, that is an exceptional case and that requires of us at the Treasury Department to have a stronger fiduciary duty to the United States taxpayer. And so even though the legislation and Congress has spoken, there is the law of the land in the Recovery Act; we felt that the law as stated does not have a limit on salary. We felt that in the case of companies who received such exceptional taxpayer assistance that we had to have a stronger fiduciary duty and we spent a lot of time trying to think what was the best way to do that.

In the end, we felt that if we could find somebody of the judgment and stature of Ken Feinberg who could look across these companies and look at a set of principles on risk and performance, but also on whether it is going to lead taxpayers to get return on their dollar, that extra level of protection for the taxpayer was necessary and important there in the way it would not be if simply a community bank in your district chose to participate in the capital purchase program partly because their government thinks it is a good thing for them to have stronger capital and be in a stronger position to lend.

Mrs. MALONEY. Well, I think everyone understands that if you take taxpayer money, you are subject to a higher form of oversight and accountability. But the question basically that I am hearing from my constituents is, what was the standard? It would be helpful if it was more clear. Is it 40, 50, 60, 80 percent of taxpayer dollars? If it is a standard that the public could understand; and connected to that question, what would trigger the eighth company to come into the fold? I certainly don't think it would be totally the discretion of one individual. It should be some form of public standard that people can understand and hopefully support.

So my second question is: What would trigger, say, an eighth company to be under the same type of supervision as the seven companies named in the legislation? I will go back to the legislation, but I am still a little unclear as to what was the standard and I think it would be helpful if the standard was clearer to the public and to Members of Congress as to how these particular companies were selected. I would think that the easiest form is what is the degree of public funding that has gone into them.

The CHAIRMAN. The gentlewoman's time has expired. Is there a brief answer?

Mr. SPERLING. The reason that I feel that exceptional assistance is the right standard as opposed to ownership: let's say that we decided that we did not want to lever up GM and put them in the situation of having extremely high debt, which was the problem they had, so we gave our assistance through equities. But had we done so through very exceptional lending on attractive terms, that would not have given us a certain ownership perspective, but you would have looked and thought they are receiving exceptional taxpayer assistance that their peers are not. By being in that situation, that brings on a higher fiduciary duty. I think that general principle is the right principle.

The CHAIRMAN. I would advise members we have to be conscious of the time and questions with no time left are hard to get answered.

The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman.

I have an abiding concern what the Federal Government is doing in this area versus what the States are doing and in general what the Federal Government has been doing in terms of bailout situations and whether it is really working or not.

My first question to you is, have any of you or your different agencies studied who the shareholders are? I say that knowing that in many corporations, wealthy private individuals, private firms, mutual funds and others become the stockholders of record and sometimes very often the voting stockholders. I am afraid their interest may be absolutely no different than some of the so-called greedy executives who are looking for immediate compensation? In other words, they are trying to get in and out in a relatively brief period of time. Are we really serving the public by making these changes? I realize as you go through each corporation it would be different, but is there a general sense who the shareholders are in American corporations today that has been well analyzed?

Mr. SPERLING. I will let my colleague from the SEC answer; but I would say that we have to be very careful in a one-size-fits-all metric for rewarding behavior. And I think some of the experts you are going to hear in the next panel are very persuasive in making that case that simply using stock, while often successful, is not foolproof. I think it is something that we should all, us included, be studying very carefully and listening to the type of people that you have coming up on the next panel.

Mr. BREHENY. I appreciate the question and having an opportunity to answer it. I don't know that I have a fulsome answer, but I will work with you to get that.

The issue you bring up is one that we absolutely have considered in rulemaking matters that I have been involved in, interest of shareholders, long term, short term, percentage ownership, small companies versus large cap companies, are many of the issues that we think about when adopting rules. It is certainly something that we seek comment on when we issue rules, and we have been thinking about economic interest and voting interest in going forward.

I am aware of those issues, and we think about those issues. I don't know that I have a full answer, if I can give a response, can I tell you the makeup of the American shareholders, but those particular interests are definitely raised with the Commission, and it is something that we think long and hard about before we adopt rules.

Mr. CASTLE. I think it is important and we need to keep an eye on it. My next question is sort of general and it goes back to what I said at the beginning.

What should we in the Federal Government be doing versus what the States are doing? Most corporations in this country are at the State level. States are beginning to make some changes, not dissimilar from what you are saying. As I have indicated, I think there are some concerns about some of the compensation factors, but I am not sure that the Federal Government should be stepping in and doing this. My concern is if we do this, are we going to be expected to take the next step, whatever it may be, or are we better off discerning exactly what the problem is and then allowing the States to make whatever the decisions are that would be corrective in this case versus doing it at the Federal Government level?

Mr. BREHENY. I am not sure that the Commission itself has weighed in on that particular issue. But I think if you go back and look at the provisions adopted in Sarbanes-Oxley, the provisions, the rules that the Commission has adopted, we have gone to great lengths to maintain that balance between the interest of the SEC, the authority that Congress has given to the SEC to protect investors, versus the very important State law rights that all shareholders have.

I think you will see that in many of the rulemakings that the Commission has gone through, there is a balance. It is a policy question you need to answer, which is why you are asking me the question. I don't know that I can tell you. I think it is an important balance. I think State-Federal rights are recognized throughout the rules that the Commission has and the authority that the Congress has given to the Commission.

Mr. CASTLE. I understand what you are saying, but I think we need to be very careful about how encroaching we are being with respect to dictating in terms of corporate structures and corporate methodologies involving the Federal Government. I think it can be putting the foot in the door for what can happen in the future. I think we need to be very cautious.

Mr. Sperling, I was going to ask you about the structures and the timelines you talked about at the beginning, but I will submit that question in writing because the red light is now on.

The CHAIRMAN. I thank the gentleman for his sensitivity to the time. I now recognize the gentleman from North Carolina for 5 minutes.

Mr. WATT. Thank you, Mr. Chairman. I apologize to the witnesses for not being here for their testimony, but I have been reviewing it.

I want to take the semantic way in which Mr. Sperling addressed these issues differently and ask a broader question.

The first three principles that you outlined in your testimony, Mr. Sperling—compensation plans should properly measure and reward performance; compensation should be structured in line with the time horizon of risk; and compensation practices should be aligned with sound risk management—are all kind of general principles. But then in the fourth and fifth principles, and you may not be aware of this, in the fourth and fifth principles, you shifted to a different phraseology. You say we should reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders. And number five, we should promote transparency and accountability in setting compensation. My underlying question is: Who is the "we," first of all? And the extent to which authority already exists, either at the SEC or the Fed, to do some of this under existing statutes, or whether there are specific things that this committee and Congress must do to change the law to address these issues?

Mr. SPERLING. Thank you.

Perhaps in the fourth, I did not use our words well, because I think they are actually different.

I think on the issue of golden parachutes and supplemental retirement packages, we were not coming with a particular legislative or even regulatory proposal. We really were in a sense trying to shine a spotlight on a practice that we think—

Mr. WATT. The "we" in that case being the Treasury Department?

Mr. SPERLING. The Treasury Department. We are trying to suggest that based on our review, this is a practice that, that there are practices on the supplemental retirement accounts, excessive retirement accounts for executives and golden parachutes, that shareholders and management should reexamine. There may be times that they are appropriate, but there seems to be increasing evidence that they have been more prevalent.

Mr. WATT. And my second question?

Mr. SPERLING. I perhaps chose my words poorly if that implied that we, the Treasury Department, had a specific proposal.

On the fifth point, there we were coming to the table with a specific proposal and it was a proposal to essentially give the SEC the authority they need to do two things that we, that the Treasury Department and the SEC both feel are in the interest of a sounder—

Mr. WATT. And those two things, quickly, are what?

Mr. SPERLING. Are the say-on-pay legislation, which again, we are giving the SEC authority to do, and giving the SEC clear legal authority to strengthen the independence of compensation committees in the way that after Enron Congress gave the SEC the authority to strengthen audit committees.

Mr. WATT. I thought the SEC already had this authority, Mr. Breheny, and maybe it is not just exercising it. Do you need more authority or is it just that the SEC that we have had has not exercised the authority that they already had?

Mr. BREHENY. No, I don't believe we have the authority to require companies to have a say-on-pay proposal or to strengthen the compensation committee consultants. The Chairman of the SEC is on board supporting both the say-on-pay legislation—

Mr. WATT. Well, if the SEC doesn't have it, do the regulators have it? Or are we talking about all public companies that don't have regulators? What about with banks, regulated banks, would the regulators already have the authority to say, you have to have a more aggressive compensation committee on your board? Would they have the authority already to say you have to give your shareholders a right to have say-on-pay?

Mr. ALVAREZ. No, on say-on-pay. We would not have the authority to require those kinds of disclosures. That is not safety and soundness related.

On strengthening compensation committees, we may be able to do some actions there, but I am not sure we would be able to get as far as the Treasury Department would like.

Mr. WATT. Thank you, Mr. Chairman.

The CHAIRMAN. I think historically, safety and soundness has more often been used to invoke nondisclosure than disclosure.

The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Mr. Sperling, I listened carefully to your testimony, and in listening to it, I must admit I find myself in agreement with most, if not all, of the principles that you lay out. Compensation plans should properly measure and reward performance, structured and aligned with time horizons of risk, should be aligned with sound risk management, and the rest.

For most of my life I have signed the back of a paycheck, but there was a time I actually signed the front of a paycheck. There was a time I served on the compensation committee of a New York Stock Exchange company, and not unlike the gentleman from California in his opening statement, I thought I worked very hard to try to ensure that these principles were put into place.

I remember an unhappy CEO when I was part of a comp committee informing him he would not be getting the pay package compensation structure that he had desired.

I guess my question for you is, since I have found this challenging, and I was in the private sector for 12 years, and I have been a Member of Congress for 6½ years, when I came to Congress, I didn't have any kind of epiphany that now I know what the perfect compensation structure is. Going back to what the gentleman from California said, why can you do better?

Mr. SPERLING. I don't think there is anything that we are proposing that suggests we could. I think we are perhaps suggesting on the compensation committees, when you were in that position, if you had the authority to hire your own compensation consultant, if there was not an ability for the compensation consultant to have a conflict of interest because they were being paid by the CEO and some other measure, that would strengthen your hand.

You seem to have been able to, in your situation, strike that type of independence, and I compliment you on that. But I can say that many people find on a compensation committee that if the company itself is hiring both the counsel and the consultant, it is very difficult. In fact, there is a study that shows that CEO pay does end up being higher when you use a compensation consultant that has conflicts of interest.

Mr. HENSARLING. I appreciate your approach in that regard. It will be an open question in my mind whether or not there are ways to strengthening the hand or the powers commensurate with the responsibilities of comp committees of public companies. I have an open mind about that. I can tell you from my experience on this committee, though, that there have been many witnesses from private enterprise sitting at that table who have received strong suggestions from this committee that this is a way that you might want to do something because if you don't do something, we will do it for you. So I am somewhat fearful that once we go down this road, we may go way beyond merely strengthening the hand of compensation committees.

Also, Mr. Sperling, on page 4 of your testimony, you state that, "when workers who are losing their jobs see the top executives of the firms walking away with huge severance packages, it creates the understandable impression that there is a double standard." I agree with that impression. Let me ask you since the executive compensation first has arisen in terms of TARP, I want to ask you a TARP-related question. The Administration put forth a reorganization plan for GM. Under that plan, GM bond holders, many of whom are middle-income Americans, including blue collar workers and tradesmen who invested money in GM bonds for their 401(k)s for their retirement, the GM bond holders under the Administration plan get 10 percent of the company for $27 billion in claims, warrants for an additional 15 percent, the United Auto Workers get 17½ percent of the company for less in claims, $20 billion, and $10 billion in cash, $6.5 billion in preferred stock, $2.5 billion IOU, and warrants for an additional 2½ percent of the company. Would that not create an impression of a double standard?

Mr. SPERLING. I really don't believe so. I really believe that the bond holders represented themselves very well. I think they were better off than had they allowed for a completely uncontrolled bankruptcy. And in terms of the VEBA, it is going to require a very painful sacrifice from retirees, retirees who did nothing wrong and were not part of contributing to this financial crisis. I believe there was very careful, shared sacrifice in that arrangement.

Ms. WATERS. [presiding] Thank you.

Mr. Sherman?

Mr. SHERMAN. Thank you, Madam Chairwoman.

I am not sure that the bond holders were hurt. Rather, a huge infusion of taxpayer money helped all the old stakeholders. I think we were more generous with the workers than we were with the bondholders. But if anybody is not being treated well in this, it is the taxpayers.

I want to recognize Kathleen Connell who is here in the audience, who for 8 years was controller of the State of California.

I notice that quite a number have railed against government-controlled pay. I should point out that these are companies that have taken and are holding our TARP money.

I want to join the chairman in welcoming Republicans when they reject virtually every Bush Administration economic policy of the last 7 months of his Administration, but I think it is now time for Democrats to reject with the same intensity virtually all of those policies.

We are told that only a few TARP recipients have received extraordinary help, and only those few should face real limits on executive compensation. I would say that TARP is an extraordinary departure from free enterprise and only those who got one infusion of, say, $25 billion of capital, should be viewed as getting extraordinary help.

I have one question for the record, because I would like all three of you to answer it, and it is way too complicated to do so orally. I want you to imagine how we would design an executive compensation system for the derivatives unit of AIG, or some other derivatives unit inside a big company. If you just said, we will give them restricted stock and restrict it for a few years, they might take extraordinary risk so the unit looked extraordinarily profitable, get an extraordinary amount of AIG restricted stock, they would have believed that AIG would have been a solid company no matter what their unit did. I don't think anybody in that unit or in this country realized that unit could bring down that enormous company.

Likewise, keep in mind, at least for this example, assume that this unit might show profits for accounting purposes for 5 or 10 years in a row before it imploded, and now try to figure out what kind of executive compensation system would reward the people in that unit for taking the right kinds of risks but would actually penalize them for taking the wrong kinds of risk.

Now for a question for our representatives from the SEC. There were elections in Venezuela to control the government of Venezuela. Our State Department criticized Hugo Chavez for using the resources of the government to affect the outcome of the elections for representatives to control the government. So what can you do to propose to Congress or to your own board for regulatory changes, rules that would prevent corporate management from using the resources of the company to unduly influence the outcome of the election without giving similar resources to the other side?

What would you do to certain challengers who were supposed to get resources, and what has the SEC done to make sure that the challengers have equal space in the proxy statement which is the one document you do control?

Mr. BREHENY. Thank you, Congressman. That exact issue was the point that the Commission took up on May 20th. And as you may know, this is the third attempt that the Commission has made to give shareholders, who have a State law right to nominate directors, the ability to have those nominees included within the company's proxy material.

So the issue about disclosure and the ability to provide disclosure about their nominees is all included, and that rule proposal is up on the Commission's Web site as of last night.

Mr. SHERMAN. I would hope that you would propose legislation that would go far beyond the proxy statement. Trust me, it is a very boring document. What is needed is equal amounts of, and in some cases millions of dollars to call shareholders and try to get their proxies, and that process needs to be equal. My time has expired.

Ms. WATERS. Thank you.

Mr. Garrett.

Mr. GARRETT. Before I go to my questions, let's go back to the opening of the hearing where the chairman was talking about history and how history is relevant. Indeed, it is. More the pity that revisionist history is not relevant. Yes, there were some Republicans on this side of the aisle just now repudiated what the past Administration did with a lot of the bailouts. Unfortunately, the chairman and others were not repudiating it when it was going through the House. And you will remember, as some said, the chairman carried the water for the past Administration to make sure that legislation was not only engaged in and made sure that the TARP legislation actually passed. And we must also remember that history tells us that this new Administration has basically adopted hook, line, and sinker the past Administrations of the bailout philosophy.

So, yes, there are a number on this side of the aisle who repudiated in the past, and on the other side of the aisle maybe there is one that I see who joined with us in that fight against the TARP bailouts and all of the string of bailouts that followed. So let's remember what history was.

I also see we have the counselor to the Treasury Secretary here with us. Remember also that Mr. Geithner at that time was with the New York Fed, and at that time the New York Fed was considered the architect of the AIG bailout and this Administration adopted Mr. Geithner as their Treasury Secretary. So I think there is the pity that this Administration is continuing on in the mold and continues on with the bailout and that is what a number of us thought was wrong then and continue to fight against now with our legislation and what we will roll out later on.

With history now clarified, Mr. Alvarez, I see in your testimony you say that employees throughout a firm who expose a firm to significant risk, and improperly designed compensation programs might incite a wide range of employee behavior. You also say we should adjust compensation so that employees bear some of the risks associated with their activities. An employee is less likely to take an imprudent risk if incentive payments are reduced or eliminated for activity that imposes higher than expected losses. I agree. How does that occur in the Fed right now with the activities that the employees take that have a risk not only on themselves but the entire economy? Or can they do anything that they want without any risk?

Mr. ALVAREZ. There is no one at the Fed who can do anything that they want without taking risk.

Mr. GARRETT. As far as their compensation?

Mr. ALVAREZ. No, as far as their actions as well. So there is performance. At the Federal Reserve, there is a tie between performance and pay. We are all rated on our performance, and we all

have adjustments to our pay based on our performance. We are not paid with bonuses like the way the industry is that we are talking about today.

Mr. GARRETT. For all of the panel, looking at the proposal that is coming from this Administration that the chairman is talking about, some would suggest that the proposal would have higher cost for businesses to operate. Most would agree with that. Some would argue that larger corporations could probably bear that cost. Others would argue that may be the case, but smaller firms would have difficulty dealing with those pretty significant additional expenses. Does anyone have a comment on how smaller firms would have to deal with these costs to the operation?

Mr. ALVAREZ. I would say that smaller firms actually do a better job of aligning risk and rewards than the larger firms do in part because typically in a smaller firm the CEO, the CFO if there is one, knows the employees, knows the risks that are coming onto the balance sheet, knows what the employees are doing, and so is able to adjust the compensation practices.

Mr. GARRETT. If we set up any additional requirements as far as outside requirements, doesn't this add to the cost of them doing business? Will they be able to absorb that?

Mr. ALVAREZ. I will defer to the others on theirs, but the kind of approach that the Federal Reserve is considering is outlining principle.

Mr. GARRETT. Thank you, Mr. Alvarez, I appreciate that. And I ask Mr. Sperling on the Administration's proposal?

Mr. SPERLING. The two proposals that Secretary Geithner put forward, the say-on-pay and the independent comp committees, I don't believe would have a significant cost. It would obviously apply to public companies. It doesn't mandate that there is—it does not put a mandate. It says if you are a comp committee, if an independent comp committee is going to hire a consultant or counsel, that committee needs to have the authority and funding to do their job without conflicts of interest.

I feel the things that we have put forward right now would be affecting public companies, but I share your view that one always has to do an analysis of what the differential impact would be.

Ms. WATERS. Thank you.

Mr. Moore.

Mr. MOORE OF KANSAS. Thank you, Madam Chairwoman. Before we learned about the $165 million AIG bonuses in March, we also learning from New York's comptroller in January that Wall Street executives were paid $18.4 billion in bonuses last year. I was troubled by this news, especially during a national emergency when the Federal Government is providing billions of dollars of taxpayer funds to stabilize the financial sector. Under normal circumstances I don't believe, and I think most of the American people don't believe, that we, Congress, should be involved in any way in setting executive compensation or compensations for board of directors of shareholders. We shouldn't be setting those salaries. But we are not in normal circumstances, and that is why I filed H.R. 857, the Limit Executive Compensation Abuse Act, which for TARP recipients only would have limited the annual executive compensation to

the same level of compensation that the President of the United States gets paid, $400,000.

Mr. Sperling, do you believe compensation practices can pose a systemic risk or jeopardize a firm's safety and soundness? How should Congress guard against risks to the financial system without stifling reasonable compensation practices?

Mr. SPERLING. I think we have learned the hard way that they can contribute, and I think it has been part of the discussion that we have had today.

And I do want to say that we often do mention or use the examples of the extreme cases or where people were truly bad actors. But a lot of the danger comes from building systems where even good people are not given the right focus. We talked before on the whole practice from the origination of subprime mortgages to their packaging to their sales. You almost have a chain of financial transactions where you were paid by fees by the volume of what you did, and then you either externalized it to the firm or kind of moved it on to the next person. Of course, what happens is when you are in kind of a bubble, an asset bubble situation, the people who are being cautionary start looking like they are overly risk adverse. And the people who are being reckless starting looking wise and right and making good money.

That is exactly why a company has to believe in risk management, and it has to be something that they do throughout the system, and they have to empower that person that even when the going is getting good, why was it. In firms throughout the financial industry, there was so little effectiveness of risk management when there were no shortage of people writing that there was a potential housing bubble. Perhaps people didn't realize the degree, the depth of what we would go through, but there was a problem.

So I do think that companies have to believe in strong risk management, and they have to empower their risk managers. They have to have the stature and independence to stand up even in good times and say yes, this practice has worked the last few years; but when we look at the underlying value of what is happening, we think that we are creating risks in the outyears for our company, our shareholders, and the economy as a whole.

Mr. MOORE OF KANSAS. Thank you, Mr. Sperling.

Mr. Alvarez, do you have any comments.

Mr. ALVAREZ. The only thing I would add is that the industry recognizes that there was systemic risk, and risk to the health of the firms through the compensation practices of the past.

If you recall 15 or 20 years ago, there was quite an effort to just get pay tied to performance as a beginning spot. And so the methods that were used to tie pay to performance have shown in this crisis to have flaws to it. I think everyone is recognizing that, and so it is an opportunity. We have an opportunity now to make some strides to improve the health of the system and firms individually.

Mr. MOORE OF KANSAS. I thank you. My time is up.

The CHAIRMAN. The gentleman from Florida.

Mr. POSEY. Thank you, Mr. Chairman. I am still trying to figure out what would make some of the compensation boards or committees recommend the incredibly high compensation that they did when it was clear that the ship was on the rocks and it was going

down. How did the compensation laws that we have now, if they do, how do they affect gifts between, say, a CEO of a company and members of the compensation board?

Mr. BREHENY. Thank you, Congressman. The SEC's rules have quite a bit of requirement with regards to disclosure about conflicts between members of the compensation committee and other executives of the company. In fact, it is a New York Stock Exchange, a listing company requirement, that today, compensation committee members have to be independent. And those rules are quite extensive. I think what you are hearing from my colleagues on the recommendations that were made yesterday was to increase the independence of the members of the compensation committee beyond what they currently are today to restrict all sort of connections between compensation committee members and the board. I think we are looking at heightened compensation.

But there is an independent requirement today and there is quite a bit of disclosure already required under the SEC's rules.

Mr. POSEY. Have you ever found that to be violated in the history of the SEC or the law?

Mr. BREHENY. Unfortunately, I don't have that information to give you a thoughtful answer. I would be happy to look into that. Certainly the Commission takes its authority to enforce the rules with regards to violations of disclosure rules or other rules very serious, but I would be happy to get back to you with information about that.

Mr. POSEY. Mr. Alvarez and Mr. Sperling, why do you think they would pay out such incredibly high bonuses when they see the ship is on the rocks?

Mr. ALVAREZ. I think one reason is what we call a collective action problem: No one wanted to be the first to rationalize bonuses for fear that they would lose their best talent. That is actually one of the reasons why we as supervisors can be helpful here by increasing the priority of the board of directors and the management to pay attention to the incentives in compensation, helping to outline best practices and good principles.

We can push the whole industry to act together. In that way, there is a little bit of safety. Then there is less concern that an institution that does make the proper adjustments, does, for example, take away bonuses when performance is poor, won't be left as the only one doing it, and that will improve the practices of everyone.

Mr. POSEY. Do you think it would make any sense just to impute some culpability to stockholders in their losses if you act poorly like this? That opening the exposure to liability could be just as effective?

Mr. ALVAREZ. Shareholders already do share. When there are excessive bonuses paid to executives, that is costs that are borne by shareholders.

Mr. POSEY. When was the last time you are aware that was utilized?

Mr. ALVAREZ. It is reflected in decreasing in the price.

Mr. POSEY. I understand in theory. But most stockholders that I know, and they are small investors, not big investors, they think that these humongous bonuses are just a necessary evil and there is nothing they can do about them, it is just as bad one place as

another. Everybody is misbehaving. They are not going to find anything better to their bottom line if everybody is misbehaving to the same extent and nobody has done anything about it; and, quite frankly, I don't believe that you are going to be able to regulate people into doing the right thing. I think that just holding them more accountable individually and personally liable and accountable would just make a little more sense. Mr. Sperling?

Mr. SPERLING. I actually think the proposals we are talking about would be effective. I agree with Mr. Alvarez that there is a bit of—and you see this in the whole way that the compensation consultants work. There is less of is this fundamentally sound, fundamentally good for the shareholder, and more how does it compare to the practices of your peers. And so you do get a bit of a collective action problem where people simply say our five competitors do this, and that becomes the beginning and end of the discussion.

I think that empowering compensation committees, but also the say-on-pay, bringing this to light, does have a powerful deterrent impact. The U.K., and even the study from the Harvard Business School, which was a little more skeptical, said its positive effect was in deterring high payouts to those who clearly performed poorly.

The CHAIRMAN. We have a vote, so we will take a break after Ms. McCarthy.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. I appreciate that.

Many years ago, my husband worked on Wall Street. He started on Wall Street when he was 17, and he worked his way up and he worked for a very large financial service company.

He was in compliance, and he had the whole northeast corridor to go to all the little offices to make sure that they were complying with the FEC rules, but also for the company rules. And he always found it amazing because he never announced when he was going to be there that he would go into an office and allow them, obviously to follow all the rules and regulations, no problems. But there were certain offices that did not follow those rules and regulations and he would write them up and then make another surprise visit back to see if they cleaned everything up. They did not. And that is when they got in trouble with the company. And these were usually large—well, large offices that produced a lot of money for that particular location.

And I think when we talk about why we are here today, and even talking about what we are doing, I think people have forgotten that we are here because the companies did what they did and they are trying to get their reputation back now. The banks have to get their reputation back now, the financial services have to get their reputation back. People do not trust them yet. And it is our responsibility as the government to try to protect our constituents. They lost trillions of dollars. People are hurting and they are still hurting. We are happy to see that things are starting to go forward, I believe, because of what the government did that the markets are starting to stabilize, we still have a long way to go on housing. But it is because what we did do.

With that being said, and I have to say also for my colleague when she mentioned Kenneth Feinberg, he is great, I worked with him, unfortunately, with an awful lot of my constituents who lost somebody on 9/11, and I think it was a great choice. But I will go back to one of the articles—by the way, that was another thing in the article. Already—this Wall Street today. Already, many on Wall Street are beginning to voluntarily change their pay practices through—though it remains to be seen how long. That is another reason on why we are doing what we are doing today and hopefully for the future. But my question to you would be, could you expand on what is considered exceptional assistance? I actually don't understand that part.

Mr. SPERLING. The easiest way to describe it would be that in the previous Administration, they set up the Capital Purchase Program. And this was expanded to all banks. So even smaller banks can come in. And the idea was to try to give more banks the capital so that they were in a stronger position to lend, not because we were concerned about each of those banks, but because we felt collectively if there was stronger capitalization of the banking system there would be more lending and that would be good for the economy. An individual bank might say, do you know what, we are just going weather this storm by not lending, we are not going to make much money but we will get through it. But for us we know that if 5,000 banks all do that at the same time that means there is going to be less small business lending and there is going to be less growth and this recession will last longer.

So that is a generally accessible program. And the people who come to it don't necessarily come because they are weak, they come because we have a policy goal of wanting banks to have more capital. Compare that to perhaps Citigroup where they require government assistance for their fundamental financial stability. And because of their importance to the overall financial stability, the economy, because of our desire to not let something like Lehman Brothers again happen, we make an exceptional effort, we make an exceptional assistance that they get that is not available to their peers and it is not based on a general goal, it is based on an exceptional intervention to assist them essentially in their fundamental financial stability. That is a very different situation. And while I could give you—and I think that principle is one people understand.

I think people understand that there is something different about AIG and Citigroup and GM than their community bank that takes more capital in the capital purchase program. And I want to make clear, the law of the land that was passed in the Recovery Act applies to everyone, so the restrictions on bonuses. We added provisions on luxury expenditure, on say-on-pay, on having to write in a narrative way what your risk analysis is. But we were not as intrusive in those situations because many of those banks are the community banks in your district where you are giving taxpayer dollars to a company that would have gone into bankruptcy if they were not systemically significant we feel a higher obligation, and that really is, in many ways, the fundamental task.

Mrs. MCCARTHY OF NEW YORK. My husband actually believed nobody should get bonuses, just get a good paycheck.

The CHAIRMAN. We are going to return with this panel, and I am going to call on the Democratic side only those members who are here and did not yet get to ask questions. New members will get to question the second panel. So the five members here who didn't get to ask questions will be called on to finish this panel, and we will then get to the next panel. If one or two Republicans show up, we will do that. We should be gone for not more than 25 minutes. There are only two votes. Most of the time is gone on one of them. We will be back as soon as we can. I thank the panel for waiting.

[recess]

The CHAIRMAN. Mr. Scott of Georgia is recognized for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. I want to say two things at first, because I think that from our various conversations during the first part of the hearing, just to make clear, we are all capitalists here, we believe strongly in the capitalistic system. The reason this committee is moving and exploring this issue is because we care about the capitalistic system. And the capitalistic system is not manifested just with CEOs, it is not structured to take care of them first. The capitalistic system is geared with public interest, it is geared with shareholder interest. What we are concerned with here, particularly in the financial sector, is the health of our economy. At the heart of the health of our economy, the heart of it is basically our financial services industry.

And so what we have here in dealing with this issue of compensation and the role it plays in systemic risk is that there is some valve clogging going on. And we need to examine this so that this heart, the heart of our system, the financial system, does not endanger itself with a heart attack. Clogged arteries bring that, and we do have a clogged artery here. It is clear that excessive compensation has played some degree and some contributing factor to our financial situation.

I think what we are trying to do here is on two levels. One, we have to respond to companies like AIG and others that come and ask for the taxpayers' money to help them. We have to make sure we are good stewards of that taxpayer dollar, to make sure that compensation is in line. And it is clear to anybody with any ounce of caring about the capitalistic system that giving the $168 million in bonuses and compensation of taxpayers' money to a failing company asking for a bailout was excessive.

But what it did was it opened us up to a realization of perhaps this compensation issue, this heavily unbalanced structure between bonuses and salaries certainly had some risk involved. Excessive compensation packages were indeed a contributing factor because incentives for short-term gains overwhelm the checks and balances that were meant to mitigate against the risk of excessive leverage. So the question is how can we better align our compensation packages with sound management risk that properly measure reward performance. It is sort of like Scott Burroughs here with some of these CEOs where they have gone and cut deals regardless of performance.

So you are paying some of these CEOs as if there were 350 point hitters hitting 50 home runs when they are 220 hitters, no performance. So I think that what is wrong with having shareholders to be able to have a say in these packages. Now, we have an excel-

lent run company in my State of Georgia, Aflac, that has done this with great success. Shareholders want to see that their leaders, the people who are running the companies, they have the best talent, but they certainly want to make sure they perform.

So we have excellent examples here of shareholders who are taking part in that. But I just wanted to make sure that is clear. But my question, Mr. Chairman, before my time runs out, is just a comment from each of you is how can we better align our compensation packages with sound management so that they properly measure pay for performance. And what is wrong with having shareholders have a say, not the government, not us, but the people who own that company, they ought to have a say in what these people are being paid, particularly their hired guns with contracts.

The CHAIRMAN. We have time for one answer.

Mr. SPERLING. I truly think the say-on-pay is a situation of all upside, no downside. You are empowering shareholders with the ability to have stronger oversight. You are forcing the company to think more seriously about what they do, how it will be perceived and not just to go on automatic pilot doing practices that are not defensible simply because of their peer group is doing it. All I would say kind of quickly, knowing we have time issues, is that I think that you need some type of, some type of long-term compensation or something that at least makes you internalize some of the risks that you are creating so you do not get entire industries or entire sets of employees who are all being paid by volume based on fees and nobody in the process is looking at the underlying value or the long-term risk. And then I think the hard part for all of us is that we don't simply create a world where everybody is out saying, yes, pay for performance, and we haven't really looked carefully whether the performance we are now blessing is subject to manipulation itself. And I think that is going to mean more complex, more careful, mixes of metrics.

The CHAIRMAN. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Chairman, I thank you for your leadership. It has been said that managers want to do things right and the leaders want to do the right thing. I think we are doing the right thing. And I would like to have just a moment of soliloquy because I would like to speak for many persons who are not here to speak for themselves.

I want to speak for the autoworkers. I speak for them because today there seems to be some debate as to whether or not we should endeavor to make some adjustments with reference to executive compensation in terms of how it can promote excessive risk-taking. And the autoworkers have had their salaries maligned, they have been castigated for making too much money. And it is unfortunate that there are those who would want to limit the salaries of autoworkers, but would take a firm stand against making any endeavor to look into whether or not excessive risk by way of salary has driven some of this adverse, these adverse market conditions that we have. I have before me evidence of a bill, H.R. 7321, which proposed requiring the employees of Ford, GM, and Chrysler to receive the same compensation, or nearly the same as Nissan and Volkswagen. It just seems to me that those who would sponsor

this kind of legislation would find it in their hearts to see that we can look into the type of legislation that we are considering today.

I have evidence of H.R. 5 which passed the House in 2005 which would have placed a cap on the percentage of damages that lawyers can receive. It would have capped them at 15 percent of any fees over $600,000. A lot of money. Not nearly as much as what some others are making, however. And it just seems to me that if we can cap or try to cap and cap the fees of lawyers who represent consumers, we can also look at lawyers who represent corporations. Those who are not here today, I just believe they want this said, because there are people who are suffering who have had their salaries cut who work in the auto industry. And these are people who are not getting bonuses that they use to buy second and third homes or to buy additional cars.

What they lost was money for education, money to pay house notes, money to sustain themselves. And I find it quite frankly disenchanting to know that there are those who would want them to receive cuts and not want us to look at the compensation that these executives are receiving that can create excessive risk in the marketplace. So I thank you, Mr. Chairman, for giving me this moment to voice the concerns of those who are not here, the blue collar workers and the lawyers who represent the consumers who have gone to battle for them and made a difference in their lives and in the lives of people in this country by causing us to have products that are safe by virtue of knowing that there are these lawyers who will take on these challenges and make sure that the consumer is protected. Consumer protection is important. We had one of the best consumer protection systems in the world, and it did not cost the government one penny because we had lawyers who were willing to stand up for those who could not stand up and speak up for themselves.

And it is very unfortunate that we choose to regulate these lawyers, but we don't regulate—don't see the need to regulate lawyers who are creating excessive risk who work for corporations. I don't want to see anybody's salary cut. I don't want to see anybody's salary regulated. But the American people understand that something wrong has happened, and they want to see us do something about it. And that takes leadership. We can't just manage this problem, we have to show some leadership and make the necessary changes to eliminate this excessive risk-taking that created much of the systemic problems that we have had to contend with. I yield back. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Colorado, then the gentleman from Missouri.

Mr. PERLMUTTER. Thanks, Mr. Chairman. Just a couple of questions and comments. My friends on this side of the aisle have expressed a lot of what I am feeling. And even my friends on the other side of the aisle who could be the greatest laissez-faire capitalists in the world have to question when there is such a serious divide between management and ownership. And I will take Quest, which is a big company in Colorado. Quest, one of our CEOs, he has now gotten himself in trouble, got $148 million, all right. Now, this is comparing apples and oranges, but the governor of the State of Colorado gets $90,000. And most people make $50,000 to

$200,000 in Colorado. How is it that an executive gets $148 million. I mean how does that pay come about. Mr. Sperling, can you—I mean how does anybody approve that kind of salary for anybody.

Mr. SPERLING. Well, I am—I don't know your specific, the specific case. But I will say one thing, and again you have some excellent experts coming on, which is one of the things that, you know one of the things that disturbs me is whether or not retirement golden parachute type of payments are somewhat promoted because they are less transparent. People do not know the walk-away value of what a CEO may have until that moment.

Mr. PERLMUTTER. Let me give you one that maybe you are familiar with, or maybe the other panelists. Because I appreciate giving some more teeth to the compensation committee, but I mean, there still is a divide between the owners of the company and the management, and maybe the owners rein it in. That is laissez-faire capitalism. Let's take Angelo Mozilo, Countrywide Financial, who has been involved in a lot of the troubles potentially that we have today. His salary was $102 million, $102 million. Are the owners of Countrywide actually having a say in what he is making? I mean, if I am the owner of the company, I am going to want that in my pocket as a dividend. Do you think your compensation committee approach really gives those owners the strength that they need to say no, that is too much?

Mr. SPERLING. Well, I think the case you just mentioned goes to the heart of the pay for performance. I think there has been nothing that so promotes the sense of double standard that I mentioned, and I believe you are mentioning, than the extraordinary cases of huge sums for CEOs who have failed. And the juxtaposition between workers losing their jobs, seeing pensions cut with the failed CEO, receiving enormous amount of sums as they leave having failed, I think is very destructive to the kind of public trust in our financial system. And so I think it really—I think it goes to almost the heart of everything we are talking about. How do you ensure that there actually is pay for performance. And I think part of that is actually shining a spotlight on whether people are just doing compensation based on what their peer group is, whether it is acceptable to have these kind of compensation packages that allow this when there has been no performance. And you know I am heartened a little bit to see that I saw that a couple of the companies who were just paying back their TARP without any push from the government, but I think because of this focus, put out statements saying they are just going to do pay for performance, they are going to give most of the compensation and stock to be held for a long time and they weren't having any golden parachutes. So I think this goes to the heart of almost everything we are talking about.

Mr. PERLMUTTER. All right. Just one more question. When we say pay for performance, is that going to be tied to like the stock market, because that is a problem in and of itself.

Mr. SPERLING. You are absolutely right. I mean, former Chief of Staff Erskine Bowles was the first person who told me that when he was at Wall Street, his boss used to always tell him never confuse brains for bull market.

Mr. PERLMUTTER. Exactly.

Mr. SPERLING. So, yes. I mean, the idea that performance is simply a stock price I think it works bad both ways. It rewards amazing awards for people that has nothing to do with their performance; just the overall economy is getting better. On the other hand, I don't have a problem with rewarding an executive who is doing an exceptional job in a terrible economic time. But you don't see that symmetry. The sense is that people get paid a lot when they fail; they get paid when they succeed. Chairman Frank was in the paper the other day, heads you win, tails at least you don't lose, on these packages. But I do think one of the key points is just tying to stock does have its risk. I know some of the experts we have talked to have said, you know, be careful, don't make that a one-size-fits-all, because if I accumulate all of my funds in stock, I have huge stock holding, and am allowed to take it as soon as I retire, well, that could create again for a corporate CEO a strategy to do, strategies about raising their stock price as they leave. So it is helpful but it is not one-size-fits-all.

Mr. PERLMUTTER. Thank you.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Mr. Chairman, I associate myself with the comments of Mr. Perlmutter, and I will forego any questioning and wait until the second panel, or I will yield to one of my colleagues on the other side.

The CHAIRMAN. Well, that concludes this panel. And we will call the next panel. Thank you all very much. As the next panel comes forward, they do so with my apology. We have a terrible problem with the size of this committee. I am going to experiment with new rules. This is a very important panel, and I appreciate and look forward to learning from them. We may have to do 2-day hearings so we have one major panel a day. We will be monitoring this. This is a panel that deserves some attention. You will get it. I apologize for the fact that some of us are going to have to be in absentia. Let's move quickly here people. Thank you. We will send out the word for our missing witness. And we will begin with a return witness who we have appreciated having before us, Nell Minow.

STATEMENT OF NELL MINOW, EDITOR AND FOUNDER, THE CORPORATE LIBRARY

Ms. MINOW. Thank you very much Mr. Chairman. This is, I think, my fifth or sixth time coming before the committee, but the first time you spelled my name wrong. So I would appreciate it if we could correct that in the record. There is one "N" in Minow.

The CHAIRMAN. Yes, we will do that. We just wanted to differentiate you from the big fish you will be discussing.

Ms. MINOW. Okay. I appreciate that. Thank you very much. Mr. Chairman and members of the committee, I am in the enviable, and, in my experience, unprecedented position of agreeing with both sides and with most of the comments that have been made here today. But I think it is a mistake to say that we object to the government getting involved in compensation. The government is already deeply involved in compensation, often inadvertently. And one of the things that I want to talk about today is removing some of the inadvertent obstacles that we have to having optimal pay. The markets and the government have both failed here.

The primary role of the government is to get out of the way of the market and remove obstacles to the kind of oversight that capitalism requires. Bad pay is a risk factor, and I was very pleased to hear the earlier panel talk about that, and that the Fed will now look at it. But where are the other people who are supposed to be looking at risk in the markets? The rating agencies, the securities analysts, the DNR liability insurers and the journalists. And it is also important to stop saying that the company pays the CEO this amount of money or that amount of money, it is actually the boards of directors, and we need to put the focus on there. And in theory, as we talked about with the last panel, it is the shareholders who elect the boards. But if you are going to give them say-on-pay and some of these other rights that you are talking about, proxy access, you have to make sure to remove the obstacles to their carrying it out.

And our report shows that shareholders fail tremendously most of the time, and that independence is as important on the shareholder side as it is on the board side. As I prepared my testimony, which I am not going to summarize because it is in the record, I felt a little bit like Dickens; I was talking about the ghost of compensation past, present, and future. And I want to really focus on what is going on now, because I did disagree with the statement made by Mr. Alvarez about the fact that they have gotten the message. In fact, what we see is that we have particular concerns about efforts to circumvent even the preliminary constraints already imposed. Executives will always be more motivated and agile than regulators and legislators. With regard to pay structures, I support indexed options, claw backs, banking of bonuses. With regard to boards of directors, it is very important that they have the vulnerability to remind them who they represent; that they can be removed if they don't represent shareholders. And with shareholders, I really want to focus on the collective choice problem, what is called by economists rational apathy and suggest possibly the appointment of independent voting fiduciaries. Finally, the billions lost in the financial market meltdown are dwarfed by the loss of reputation and the brand of American financial markets. I am a passionate capitalist myself, and I hope that this committee will work to restore the credibility of our system of capitalism by removing obstacles to the role of the market and establishing optimal compensation. Thank you very much and I look forward to your questions.

[The prepared statement of Ms. Minow can be found on page 161 of the appendix.]

The CHAIRMAN. Thank you. I apologize, but our Administration at the last minute has raised some issues with me about some other things they should have raised before, and I have finally told them to forget about it and show a little more consideration and I apologize that it spilled over on you. Another returning witness, Mr. Lucien Bebchuk.

STATEMENT OF LUCIEN A. BEBCHUK, WILLIAM J. FRIEDMAN AND ALICIA TOWNSEND FRIEDMAN PROFESSOR OF LAW, ECONOMICS, AND FINANCE, AND DIRECTOR, CORPORATE GOVERNANCE PROGRAM, HARVARD LAW SCHOOL

Mr. BEBCHUK. Mr. Chairman and distinguished members of the committee, one major factor that has induced excessive risk-taking is that firms reward executives for short-term gains. Although the financial sector has lost more than half of its stock market value during their last 5 years, executives are still able, during this period, to cash prior to the implosion large amounts of both equity compensation and bonus compensation. Jesse Fried and I warned about this short-term distortion in a book titled, "Pay Without Performance" that we published 5 years ago. And following the crisis, this problem has now become widely recognized. To tie compensation to long-term performance, executives shouldn't be allowed to cash out options and shares for several years after vesting. And similarly bonuses should not be cashed right away but should further be placed in an account for several years and adjusted downward if the company learns that the reasons for the bonus no longer hold up.

In addition to the short-term as a problem, bank executives had a second and important source of incentives to take excessive risks that thus far has received little attention. The payoffs of bank executives were tied to highly leveraged bets on the value of a bank's capital. Compensation arrangements tied the interest of executives to the value of common shares in the bank holder company or even to the value of options on such shares, and as a result, executives were not exposed to the potential negative consequences that very large losses could have for preferred shareholder bond holders and the government. This gave executives the incentive to give insufficient weight to the possibility of large losses and therefore gave them incentives to take excessive risks. To address this distortion, the payoffs of bank executives could be tied not to the long-term value of a bank's common shares, but to the long-term value of a broader basket of securities which should include at least the bank's preferred shares and bonus. Now, let me turn to what role the government should play. For nonfinancial firms, the government should avoid intervening in the substantive choices that firms make, but the government should see to it that shareholders have adequate rights.

And as I testified before this committee 2 years ago, the rights of shareholders in U.S. private companies are much weaker than in other common-law countries. We need to introduce say-on-pay votes to strengthen shareholder power to replace directors, and shareholders should also have the power to amend the corporate charter and to change the company's state of incorporation.

Finally, in the case of executive pay in banks, or more generally any financial firms that pose systemic risks, here the government should have a broader role. This is necessary for the very same moral hazard reasons that provide the basis for the traditional regulation of bank activities. The interest of common shareholders of banks are served by having investment, lending, and capital decisions that are riskier than is desirable for the government as the

government to have deposits. That is why traditional bank regulation monitors and regulates these decisions by banks.

By the same token, the interest of common shareholders in banks may be served by giving executives incentives to take risks that are somewhat excessive. Therefore, even if and when internal governance problems in banks are fixed, regulators should monitor and regulate executive pay in all banks regardless of whether they get public funding. The regulators should focus on the structure of pay arrangements, not the amount, and they should seek to limit the use of the type of incentives that have contributed to bringing about the current financial crisis. Thank you.

[The prepared statement of Professor Bebchuk can be found on page 92 of the appendix.]

The CHAIRMAN. Next, Mr. Lynn Turner, who is the former chief accountant of the Securities and Exchange Commission.

STATEMENT OF LYNN E. TURNER, FORMER CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. TURNER. Thank you, Chairman Frank, and thank you for the opportunity to be here today, and I applaud the leadership you exhibited in the past when the House did pass say-on-pay, and it is unfortunate that your colleagues in the Senate didn't share the same wisdom. And so as they say—

The CHAIRMAN. There is a lot of that going around.

Mr. TURNER. —we are back. And the views I express today, I might add, are based upon not only my time as a regulator but perhaps more importantly I have been an executive setting compensation in a large international semi-conductor company, as well as a small venture start-up and served on the board of a Fortune 500 company, as well as a small technology software company where entrepreneurship is very important, perhaps one of the few if not the only person at the table today with that type of experience and perspective.

There is no doubt in my mind that when it comes to influencing people's behavior in a company at the top level and at the low level there is nothing like pay that drives what people do. And when you give people pay that drives short-term performance, as we did on Wall Street where there was very low base and huge bonuses paid out on an annual basis, you are going to get the type of short-term thinking and short-term behavior all up and down the ladder that you turned around and got. You can't avoid it. If you want long-term thinking and long-term shareholder value, you have to change that compensation scheme significantly, and that is up to the compensation committees to do.

Unfortunately, today the compensation committees are all too comfy with the CEO. I have seen that on the boards that I have sat on. And they are very reluctant if not absolutely against really reining in the compensation. So we have to really put together a package that includes greater transparency, greater accountability, and some enforcement at the end of the day. So for the sake of time let me jump into some of the recommendations. I just would ask the chairman to include my whole written testimony in the record.

The CHAIRMAN. Yes. Without objection, all of the submissions will be included in their entirety.

Mr. TURNER. In the area of transparency, I think we have to start with the SEC enhancing its disclosure of compensation arrangements. In particular, today they don't require disclosure of the key performance metrics, the things that really drive how you get that package. So we don't get the details on how Quest got to $148 million. We don't get the factors, and we need to see those factors and require those factors be disclosed by the SEC. They made it voluntary a couple of years ago. About half of the companies give it, and half of the companies don't. We need it from all of the companies on an appropriate level of detail. That includes we need to get back and figure out what the value of the real equity grants are when they are given. We have lost that. We need to have disclosure about the compensation consultants and whether or not they are truly independent, are they being hired directly by the comp committee or are they doing a lot of other work for members of management.

I think we need to see transparency with how the investors are actually voting. We still have a lot of public pension funds, corporate plans, hedge funds that aren't disclosing how they are voting on this stuff, and we need transparency to it. At a public pension fund I sit on, that has about $30 billion of assets in our State, we recently went to disclosing our votes just so all of our members and people can see how we vote, and we think that sets some accountability.

If we don't do it right, we are going have to explain why we do it the way we do it. There needs to be something done with the way shareholders vote. We can put in say-on-pay, and I certainly support that, strongly support that. And by the way, I don't view that as government intervention in any way, shape or form. And to the question of whether or not that would drive people offshore, I absolutely don't believe it will drive people offshore. Many of the other countries around the world; Australia, the Netherlands, many of the European, UK countries, many of the countries where there is the largest market cap already have that.

So what are they going to do; leave here to go to another country with the same regime? I just think that is almost nonsensical. But we do need to get the shareholders and the mutual funds voting in the best interest of investors. As I say in my testimony, almost 90 percent of the time the mutual funds; the Fidelities, the Barclays, the Alliances of the world are voting with management. And there is no requirement that they vote for their investors whose money they are managing as opposed to voting their own interest.

And Fidelity, Barclays and these all manage a tremendous amount of money for these large companies with tremendous fees. That conflict is not disclosed. And it is shown time and time again they vote that way. So I certainly encourage say-on-pay, do something about the mutual fund voting, elimination of broker votes as the SEC has said they are going to do, I think we need to get to majority voting and the right for shareholders to also remove directors when they haven't got the job done. Thank you, Mr. Chairman.

[The prepared statement of Mr. Turner can be found on page 188 of the appendix.]

The CHAIRMAN. Thank you. Next, Professor Kevin Murphy from the University of Southern California.

STATEMENT OF KEVIN J. MURPHY, KENNETH L. TREFFTZS CHAIR IN FINANCE, UNIVERSITY OF SOUTHERN CALIFORNIA, MARSHALL SCHOOL OF BUSINESS

Mr. MURPHY. Thank you, Chairman Frank. We are here today in large part because we are all angry that Merrill Lynch and AIG gave huge bonuses to employees after receiving Federal bailout funds. Our anger, coupled with our suspicions say that the Wall Street bonus culture is a root cause of the ongoing financial crisis has led to an effective prohibition on cash bonuses for TARP recipients and is leading us today towards more sweeping regulation of compensation and financial services firms. I agree that there are problems with compensation structures in financial firms and in most other sectors, but it is my opinion that the constraints already currently on TARP recipients will likely destroy those organizations unless they can quickly repay the government and avoid the constraints.

Moreover, it is my opinion that regulating compensation and financial services more broadly will cripple one of our Nation's most important and historically most productive industries. The heavy reliance on bonuses has long been a defining feature of Wall Street compensation going back to the days when they were privately held partnerships. Such firms kept fixed costs under control by paying low based salaries and paying most of the compensation in the form of bonuses tied to profits. This basic structure remained intact when the investment banks went public, but the cash bonuses were replaced with a combination of cash restricted stock and options.

The primary way that such structures can encourage excessive risk-taking is through asymmetric rewards and penalties. That is high rewards for superior performance and essentially no penalties for failure. Financial firms provide significant penalties for failure in their cash bonus plans by keeping salaries below competitive market levels so that earning a zero bonus is actually a penalty. And bonuses do fall in bad years. Average bonuses for executives in the TARP recipient firms were 82 percent lower in 2008 than in 2007. Take away bonus opportunities and the banks will have to raise salaries or find other ways to pay or they will lose their top talent. In addition to cash bonuses, executives in financial firms receive much of the compensation in the form of restricted stock and options, and these instruments also provide penalties for failure.

The average intrinsic value of options held by executives in TARP recipient firms fell 94 percent from 2007 to 2008, and the value of their restricted stockholdings fell by 72 percent. And these statistics only include firms that continue to operate at the end of 2008, thus ignoring the losses incurred by executives at Bear Stearns, Lehman, Washington Mutual, Wachovia and the other casualties of the crisis. Given the existing penalties for failure there is nothing inherent in the current structure that leads to obvious incentives to take excessive risks. To the extent that the firms indeed such risks we need to look beyond the pay structure to explain it.

In particular, the role of bonuses is likely dwarfed by the roles of loose monetary policies, social policies on homeownership, and poorly implemented financial innovation such as exotic mortgages, securitization, and collateralized debt obligations.

Looking forward, I am especially concerned about offering too-big-to-fail guarantees that provide enormous incentives to take risks, but this isn't a compensation problem. Another way that compensation can lead to risk-taking is through inappropriate performance measures. For example, consider mortgage brokers pay for writing loans rather than writing loans that borrowers will actually pay back. We saw this happen at Washington Mutual, Countrywide, Wachovia, and scores of smaller lenders who weren't overly concerned about the default risk as long as home prices kept rising and as long as they could keep packaging and selling their loans to Wall Street. A solution to this performance measurement problem is to pay people to write good loans and penalize them for writing bad loans. The challenge is identifying a good loan without waiting up to 30 years to see whether the loan is repaid. The answer involves basing bonuses on subjective assessments of loan quality.

Unfortunately, most current and projected regulations go in the opposite direction and require that bonuses be based solely on objective measures of performance such as the quantity of loans. The regulatory demands effectively substitute the judgment of government for the business judgment of the directors, and this is a dangerous path to go down.

In conclusion it is not my opinion that current compensation practices are optimal. For example bonus plans could be improved by introducing and enforcing bonus banks and claw back provisions and making sure we reward long-term value creation rather than short-term results. And performance measurement could be improved by allowing more rather than less subjectivity and discretion.

However, I believe that regulation will systematically and predictably make things worse rather than better. Indeed, Washington has a long history of attempts to regulate pay, including caps on golden parachutes in the 1980's, the million dollar pay cap in the 1990's, more recent restrictions on FERC compensation and the most recent constraints on TARP recipients. Each of these attempts has created unanticipated side effects that have generally led to higher levels of pay and less efficient pay deliveries. I strongly recommend that the committee consider carefully this history before inevitably repeating the mistakes of the past. Thank you.

[The prepared statement of Mr. Murphy can be found on page 169 of the appendix.]

The CHAIRMAN. Thank you. Professor Verret.

STATEMENT OF J.W. VERRET, ASSISTANT PROFESSOR, GEORGE MASON UNIVERSITY SCHOOL OF LAW

Mr. VERRET. Chairman Frank, Ranking Member Bachus, and distinguished members of the committee, it is a privilege to testify in this forum today. My name is J.W. Verret. I am an assistant professor at George Mason Law School, and also a senior scholar at the Mercatus Center's Financial Markets Working Group. I also

direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of State and Federal authority in corporate governance. Before I begin, I also want to say that it is a particular honor to testify on a panel with Professor Bebchuk. He was my mentor and without his guidance, I wouldn't be a law professor today, so that is a particular honor.

Today, I want to discuss executive compensation proposals currently under consideration. I will also highlight a Wall Street norm of issuing and feeling pressure to meet quarterly earnings guidance, which is the central cause of short-term tunnel vision for Wall Street executives. The role executive compensation plays in the current crisis is in fact unclear. There is little difference, and this is key, there is little difference between the executive compensation approaches of banks healthy enough to repay their TARP funds and those of banks likely to need additional injections of capital. If executive compensation were the culprit the differences between executive compensation and healthy banks and executive compensation at bad banks would be much more apparent.

What is apparent is that executive pay packages are of necessity complex. Compensation packages are designed to link pay to an executive's performance running the company without rewarding or punishing executives for factors outside of their control. Regulatory restrictions and say-on-pay requirements may limit a compensation committee's flexibility to achieve this important goal. There are no less than seven executive compensation initiatives either proposed or recently underway. Such a wide array of ideas from disparate corners offers to repeat the lack of coordination that contributed to the present crisis. The multitude of proposals also threatens to override two important SEC driven disclosure initiatives that offer some significant promise in this area.

Former SEC Chairman Cox completed an extensive overhaul of executive compensation disclosure in 2006. And Chairman Shapiro is promising further changes. Congress should study the effect of these disclosures rules before instituting prescriptive regulation. I would also add that they should think about studying disclosure rules and the SEC should consider disclosure rules for proxy advisor firms, which is notably missing from the chairman's current proposal. I would echo Professor Murphy's warning about the effect of unintended consequences, and we have seen them before. In 1993, lawmakers sought to limit the disparity in pay between executives and the average worker. The result was quite the opposite, in fact. Executive compensation increased exponentially, widening the gap between executives and the average worker. To offer an unintended consequence already apparent to the current reform effort pay restrictions had made it harder for American banks to retain talented executives.

Immediately following the announcement of compensation restrictions by the Obama Administration, Deutsche Bank poached 12 of Bank of America's highest performing executives. And UBS used compensation increases as high as 200 percent, this is a Swiss bank, to hire away financial advisors from top firms. The greatest risk to the safety and soundness of the Nation's banking system is not compensation but short-term thinking. Compensation is how companies may motivate executives to look short-term, but the real

question is why do companies pursue short-term goals in the first instance. The widely accepted convention of predicting quarterly earnings drives this short-term approach. Pension funds, mutual funds and company issuers all express dissatisfaction with the pressure to predict quarterly earnings.

But companies feel that voluntarily opting out will be taken as a negative signal. Pressure to make quarterly predictions about their earnings companies frequently feel pressure to cut corners to meet those predictions. I would recommend that the Treasury Department lift executive compensation restrictions for those companies and banks that adopt a bylaw to prohibit quarterly guidance. If this committee wants to limit systemic risk it should not dramatically overhaul executive compensation structures. Instead focus on the destructive pressures caused by the prediction of quarterly earnings and give the SEC's disclosure reforms time to work.

I thank you again for the opportunity to testify and I look forward to answering your questions.

[The prepared statement of Professor Verret can be found on page 209 of the appendix.]

The CHAIRMAN. I will just begin. Mr. Murphy, one historic inaccuracy, you said we are here because of Merrill Lynch, etc. In fact, the Democrats on this committee raised the say-on-pay issue in 2006, and in fact, the House passed say-on-pay in 2007 back when I thought TARP was what you used to cover the infield when it rained. So just historically, because it is not as you have suggested.

Ms. Minow, let me ask, your general sense is that you simply have to make it less difficult to replace board members, that is the central piece, and that other things aren't going to work out if you don't have a board that is more sensitive.

Ms. MINOW. Yes, I do think that is right. But you also have to have shareholders who are capable of exercising that authority.

The CHAIRMAN. That is what I mean. The key is not say-on-pay, but say on board.

Ms. MINOW. It is kind of a forest/tree thing. I think when we focus on compensation and we get down to the real fine details of whether options should be indexed or not or whether they should be tied to quarterly earnings or not, I think we are sort of missing the big picture here which is how it got out of whack here.

The CHAIRMAN. Nothing that we are proposing would get to that level of detail. say-on-pay would do that. So you think say-on-pay is a step forward. But in the absence of the kind of—well, let me ask, because we will get to corporate governance later on. The current SEC proposal they just talked about with access, does that meet your—

Ms. MINOW. I think that it is my opinion, I know the SEC doesn't agree with me on this, so you are going to need some legislative clarity on that point, but yes, I think proxy access would be very meaningful, but I also support majority vote.

The CHAIRMAN. Let me ask all of you compensation experts something that puzzles me. And that is we have the CEOs and other top decisionmakers telling us that part of the problem is that we have to align their interest with those of the company. Is there something about their character that is lacking that says that we

have to take extra steps to align their interest with those of the company.

In the normal course of economic life we kind of assume that your interests will be aligned with the people who are paying your salary for the job you are doing. What is it about the financial sector that says the most highly paid members who have taken on these jobs who have, in fact, fought hard to get these jobs, that somehow they will not align their interests with those of the company unless we design special incentives. Couldn't we expect them to have their interests aligned with the company even if there weren't these incentive bonuses. Let me start with Mr. Verret.

Mr. VERRET. Mr. Chairman, I think it is not about aligning the interest.

The CHAIRMAN. No, excuse me. My question is the world may not be, a lot of things aren't. The score of the Red Sox game is not about that. But my question is because one of the justifications we are getting for these forms of compensation is it is necessary to align the interest of these top decisionmakers with the interest of the company, and I don't understand why they need that special set of circumstances when most of us don't.

Mr. VERRET. Well, Mr. Chairman, I appreciate your Red Sox reference. I am a Red Sox fan as well. I think the issue is risk, the essence is risk. And I think the question is, do we want them to swing for the fences or do we want them to only swing for the easy hits and wait to get walked. And sometimes, I think we want CEOs to swing for the fences.

The CHAIRMAN. But if that is the right thing to do, why shouldn't they be able to—why shouldn't they do that because that is the right thing to do. By the way, I think to take the analogy, the answer is whether you swing for the fences or not would depend on the pitch, it would depend on the score, it would depend on the inning. If the bases are loaded and nobody is out in the last of the ninth, no, I don't want you to swing for the fences, there are probably more effective, less risky ways to advance your goals.

Mr. VERRET. Absolutely.

The CHAIRMAN. You are evading the question, which is however you decide what the interests are, what is it that makes us have to give them some special incentive to put the company's interest first?

Mr. VERRET. Well, because as you know, some players like to take the easy way out and some players can take a risk for the good of the team.

The CHAIRMAN. So you think that we have a—but we don't usually do that with our employment system and with compensation. Let me ask the others, does anybody know what it is about chief executives of financial companies that means that they have to get special bonuses to align their interests? Mr. Murphy?

Mr. MURPHY. And I will try to answer that question, but remember—

The CHAIRMAN. If you are not going to try to answer that question then—excuse me, Mr. Murphy, I asked you a question. If you don't want to answer it, you haven't been subpoenaed, you can pass. Does anybody else want to answer the question Mr. Murphy didn't want to answer?

Mr. MURPHY. Precisely the question is they say they want to align their incentives because of the human capital driven organization where they can go start their own firm with private equity and leave those firms.

The CHAIRMAN. Well, first of all, when we do uniform things, leaving the firm thing is greatly exaggerated, particularly since American companies pay much more than most other companies. I haven't seen all that reverse pay grade. But is that something then? Mr. Turner, would you want to try and answer that?

Mr. TURNER. Yes, Chairman Frank. We all wished everyone acted in the same way. But my experience, and I have worked with many executives, including executives in financial companies, and some do put the shareholders and the company first and other executives put their own interest first and that is just people being people, and because of that we have to put a system in and in this country put in corporate governance. We know what we have put in to date hasn't worked, the compensation committees haven't worked. So in light of that, it is very reasonable to put in—

The CHAIRMAN. No, I agree—

Mr. TURNER. But not everyone is the same way.

The CHAIRMAN. —except I think the lesson we have is that we have overdone this so-called alignment of interest, that we have overcompensated them to do what they should have been willing to do in the first place. And I think if you called their bluff, they probably would still keep doing it. The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman. Mr. Verret, I was interested and intrigued by your testimony until you admitted you were a Red Sox fan. And I have no hope for the chairman, but you should know the Philadelphia Phillies are the world champions. You ought to think about who you are cheering for out there.

Mr. VERRET. I understand, Representative Castle.

Mr. CASTLE. One of the things you state in your writing, but you also mentioned in your testimony, the part that I heard, is the whole quarterly earnings pressure. We talk about the compensation issues, and I want to talk about that in a minute. But the quarterly earnings business concerns me. I don't know if you have any ideas about how to change that. I mean, do we ask them not to publish anything or do it once a year or something to make it longer range? Because I am of a belief that is probably a greater driving force in the managing of a corporation that even the salaries are. And I am not sure how we should approach that. I am not sure we should approach it or the States should be approaching it. But the question I have is do you have any thoughts about any solutions to what a lot of us feel is a problem.

Mr. VERRET. Well, I appreciate your question, Representative Castle, and I think the unique thing about this issue is this something that everybody agrees on. The U.S. Chamber of Commerce, the pension funds, the mutual funds all say, we hate quarterly earnings guidance. And companies, when we ask them privately, they say, we don't like to do it either, but we feel pressure to do it. And we feel that if one of us were the first one to stop doing it, then everybody would say, oh, well, this is because obviously you have bad news about your quarterly earnings, that is why you are stopping.

Before this crisis hit, things were beginning to change. About 10 percent of companies stopped providing quarterly guidance. Intel stopped and I think that Unical stopped, I know Berkshire Hathaway stopped. In fact, Warren Buffett said it is both deceptive and dangerous for CEOs to predict growth rates for their companies. I think that very clearly gives us his view. So it is already going in that direction. And I think that perhaps the focus on executive compensation is kind of stealing attention away from that important issue. And in terms of specific policy prescriptions, I would say I think that to the extent we want to lift the restrictions in TARP on executive compensation, I think it could be tagged.

We could say if you are a TARP company but you adopt a bylaw, and a bylaw that is in accordance with and legal under your State corporate law obligations, a legal corporate bylaw, that says we will no longer provide quarterly earnings guidance, and boards can do that, then perhaps we could give it in some sort of a reward, a carrot rather than a stick under TARP because they have taken steps to limit systemic risk of their companies. I think that might be one way worth at least talking about.

Mr. CASTLE. Let me shift back to the subject of the hearing today which is the executive compensation question, and just ask you about the governance of all that. I am concerned that the Federal Government is getting more and more involved in the running of corporations. In fact, we own corporations now which we don't really want to do and hopefully work away from that. But that is where we are. We seem to be even going further in that direction with the various things that I am hearing. And the States, for years, have handled matters of corporate interest and corporation, etc.

And my concern is that all of a sudden, we are asking that the Federal Government come in and override what the States may or may not do. And I am not saying they shouldn't do anything. I think there are some executive compensation issues that should be addressed, but I would hope that the States would be the ones to address that. I would be interested in your parsing that issue in terms of what we as a Federal Government—Executive Branch, Legislative Branch—should do versus what should be done at the State levels, if anything, in the area of executive compensation.

Mr. VERRET. Sure. To the extent that this discussion has gone towards proxy access and say-on-pay as prudent aspects of the executive compensation discussion, I think State law does play a very important role. With respect to proxy access, the SEC's current proposal is very clear in that it says the Federal Government should say how proxy access should work, how State law nomination rights should work. And it specifically says if you want to exercise your State law rights you have to make sure that they don't conflict in any way with what the SEC says is the one single approach to proxy access that we think should work for all of the over 4,000 publicly traded companies in the United States. I think it is about 4,000 is my guess. So I think that is an issue worth thinking about. And with respect to say-on-pay I think this is basically sort of an attempt to make a change that companies, that a small subset of shareholder haven't been able to achieve through proposals. Just

last year, seven proposals for say-on-pay were introduced at companies in 2008, ten of them were successful.

The average vote was a 60 percent vote against say-on-pay by the shareholders. At financial companies it is even higher. 70 percent was the average vote against say-on-pay at financial companies. So shareholders have at least—shareholders at the majority of companies in a very strong majority way have expressed dissatisfaction with say-on-pay proposals.

Mr. CASTLE. I yield back the balance of my time.

Mr. CLEAVER. [presiding] I recognize the gentlelady from California, Ms. Waters.

Ms. WATERS. Thank you very much.

I think part of what I was interested in has been answered. I basically take the position that the government, perhaps, should not be involved in deciding the compensation for executives of these companies, but I do believe that, when you have your banks and financial institutions coming to the government and accepting TARP money, accepting investments by the government, that they have to accept some of the rules of government to go along with it. And part of that may be say-on-pay.

But I am really interested in the shareholders, and you just gave us some information that is surprising to me, that basically the majority, more than a majority of shareholders do not support say-on-pay. Is that what you just said?

Mr. VERRET. Well, I just said, last year, there were 70 proposals at companies to adopt say-on-pay at those companies. Now, of those 70, 10 of them were successful. And the average vote at those 70 different elections on whether we should do say-on-pay, the average vote was a 60 percent vote against.

Among the financial companies subset of this, and this is from a paper by Jeff Gordon at Columbia Law School, the average vote at financial companies was a 70 percent vote against say-on-pay.

Ms. WATERS. Well, I need to ask all of you, and you may have stated this already, whether or not you believe that the government has a right to say-on-pay and other demands on companies that receive taxpayer money in the form of loans.

Ms. MINOW. Yes.

Mr. TURNER. Congresswoman Waters, absolutely.

When you take money from a government, you understand it is a whole new rule of game. And if you don't want to play by the government rules, you don't need to take the government's money. It is as simple as that.

Back to the point on investors' votes on say-on-pay, there are a couple of other key facts that you need to consider in those votes. In some of those companies, the compensation, the investors might have in fact decided that compensation was satisfactory, and in that case, they tend not to vote for say-on-pay proposals.

I sit on two large institutional funds, one being the public pension fund for Colorado, the equivalent of your CalPERS and CalSTRS, as well as a mutual fund for AARP. If compensation is fine and we think within limits, one may not vote for say-on-pay, although typically we still do.

The second thing is that the large mutual fund institutions, Fidelity, Barclays, etc., vote with management close to 90 percent of

the time. The reason they do is because they get assets from management, from the corporate pension funds, to manage, and they get tremendous fees for that. And as a result of that, they aren't going to vote against management. They aren't going to vote for say-on-pay because the management team will take those funds away from them and place them with another asset manager, and so those votes become very problematic.

What we need is legislation that says, when the pension fund—or when the mutual funds vote on behalf of the investors in that fund, they have to make that vote based on the best interest of those investors, not their best interest as a mutual fund.

A prime example is a few years ago when there were phenomenal, almost $200 million in payouts to an executive leaving at Pfizer, and there was a question about their board and all. The Pfizer management team, two senior top people, who are quite frankly close personal friends, flew to California, met with Barclays and reminded Barclays that they were getting $14 million in fees to manage Pfizer assets, and the next day, they voted straight down the line for Pfizer. And I think that is a classic example of what goes on and what needs to be corrected.

Ms. WATERS. I appreciate that advice and that information. I am looking to play a role in some of this reform, and those are precisely the kinds of issues that I want to deal with, so you will hear more from me.

Thank you very much. I yield back.

Mr. CLEAVER. Thank you.

I will yield time now to the gentleman from North Carolina.

Mr. MCHENRY. Thank you, Mr. Chairman.

I have a question that one of my colleagues asked the previous panel that I thought was an interesting one. Mr. Neugebauer from Texas asked a question. He asked, if I presented you with $1,000, and in 2 weeks, you brought back $1 million on that investment, that in essence you made me—took $1,000 and turned it into $1 million for me, would it be appropriate for me to pay you $10,000? Would that be fair compensation for the return you have given me?

Mr. Bebchuk, if we can go quickly down the line and answer this question yes or no.

Mr. BEBCHUK. I wouldn't be able to answer it without knowing more about the circumstances. But none of the proposals that even anyone here supports, none of the proposals that the government has put forward, involves this kind of judgment.

They all involve at most either changing the governance rules and letting make people make decisions or involve judgment about structure. If you ask me about structure, I will have clear answers.

Mr. MCHENRY. Well, the structure is just as I said. If we could just do quickly; I only have 5 minutes.

Ms. Minow?

Ms. MINOW. I think you would be getting a very good deal for that amount of money.

Mr. MCHENRY. So it is fair compensation?

Ms. MINOW. Yes, or even a higher amount could be fair under your scenario.

Mr. MURPHY. It might not be fair to the agent who should be getting a higher percentage of the deal.

Mr. MCHENRY. Interesting.

Mr. TURNER. The question may be whether or not you should pay them more than $10,000 or not if they were able to get you a million.

The problem is that isn't the facts we are dealing with. The fact is, instead of paying a thousand, we paid hundreds of thousands or millions of dollars and instead of getting back the million dollars of profit, we ended up with billions of dollars in write-offs that in fact today are in excess of a $1.2 trillion and requiring government bailout of companies that failed.

The question isn't should they get a $10,000 bonus, the real question is should I get my thousand bucks back because they lost so much.

Mr. VERRET. Well, Representative McHenry, I have a lot of confidence in my investment skills, and I would be happy to put you in touch with my agent, but I think $10,000 would be way too low.

I would just offer that this hearing is about systemic risk and executive compensation. I would rest on my testimony that if that were really such a strong link, healthy TARP banks that are about to get out of TARP and bad TARP banks, we could look at them and we could see some differences in their executive comp.

I have read through the disclosures of every single one of them over the last 2 days, haven't done much else besides that, and there is not much difference between those two comp policies.

Mr. MCHENRY. Would it be fair to perhaps up the base compensation and have fewer incentives? Is that best aligned with shareholder interest, Mr. Verret?

Mr. VERRET. Well, in some cases, yes, and in some cases, no. I would defer to negotiations between the shareholders and the board on that issue.

Mr. MCHENRY. So how can the government proscribe corporate governance effectively?

Mr. VERRET. Well, I think that it is about a combination of corporate governance issued at the State level that is I think very effective in a lot of areas. Some corporate governance disclosures issued at the SEC, and that by the way has become the central mission of SEC. I think some of the things that the SEC has been trying to do, especially with respect to the current proxy access proposal as it is currently designed, exceeded its authority under the 1933 and the 1934 Acts.

And we have seen the SEC is about 0 for 3 in challenges before the D.C. Circuit. I think it is going to be 0 for 4 after this proxy access rule. So I think it is about disclosure, and I think it is about State corporate law and the protections afforded shareholders at that level.

Mr. MCHENRY. Is the shareholder proxy vote on executive compensation the way to go?

Mr. VERRET. I think say-on-pay can be particularly dangerous. And I also think comparisons to the U.K. are deceptive for a lot of reasons.

The structure of shareholders in the U.K. is very different, dominated by insurance companies and private pensions much more where the United States is more retail investors with a lower vot-

ing rate and also substantially more union pension ownership. So I would say it is not the right way to go.

Mr. MCHENRY. Now, in the previous panel, Mr. Sperling testified that the corporate community is setting best practices in regard to executive compensation. Do you think that is the way to go?

Mr. VERRET. I think best practices generally are great. I think we have seen some great best practices promulgated by Risk Metrics, great best practices promulgated by the Council of Institutional Investors, and some great best practices promulgated by the Chamber of Commerce and the Business Roundtable.

When the government does it, I wouldn't call it best practices any more. We have seen the government use its moral authority and the threat of regulation when best practices are effectively a demand.

Mr. MCHENRY. How effective do you think the 2006 executive compensation laws have been?

Mr. VERRET. The 2006 disclosures, I think it is too early to tell because we have only had about 2 years of history there. I think part of the issue is there is not enough working history to really work from. And I think part of what Chairman Shapiro's committee is doing on refining those disclosures I would also, frankly, support.

Mr. CLEAVER. The gentleman from Minnesota is recognized.

Mr. ELLISON. Professor Verret, you just made an interesting point about there not being enough history to make a decision. And I think that might even apply to your analysis with regard to banks that paid back their TARP funds and banks that did not having similar compensation systems. TARP hasn't been around that long, so how can you be so sure, based on the limited history that we have? And why is that metric one that we should rely on when we determine whether or not compensation systems have a causal effect on risk-taking?

Mr. VERRET. Congressman, that is exactly the point; I am not sure. I am not sure that executive compensation led to systemic risk issues. The reason why I am not sure is because of the evidence I have suggested.

Mr. ELLISON. When you are not sure, that means maybe it is, maybe it isn't. The point you are making, I come away with thinking, well, so what? You know, there is not enough of a body of information to use that metric to decide whether it is or it isn't. Can you tell me why I am wrong about that, Mr. Bebchuk?

Mr. BEBCHUK. I think you are actually right. There is no widely shared consensus that executive compensation incentives did contribute to the crisis. We can rely on the CEO of Goldman Sachs who, in an editorial in the Financial Times just 2 months ago, stated very strongly his view that those compensation arrangements were flawed, and we need to reform them.

Indeed, financial firms across-the-board now take the view that they were wrong. They might not like government intervention, but I think that at this point there is widely shared consensus that executive compensation arrangements need to be reformed, and the only room for disagreement is what role the government should have in bringing about the changes that everybody agrees are necessary.

Mr. ELLISON. Professor Bebchuk, or actually I want to open this up to anyone. One of the things that I keep hearing is, we have to let American corporations get all of the money they want under whatever compensation system that they want because if we don't, then these really smart, talented people are going to go elsewhere. What I am thinking, and I know that I am not doing exact justice to this exact point of view, but you have heard this line of argument. Ms. Minow, can you comment on this issue? If we reform the entire American system—

Ms. MINOW. Yes, I agree with you, Congressman.

I think that is a bogus argument. The first point is, where would they go? They would go into private equity, and the shareholders can invest in the private equity. So that is just fine.

Second, these guys didn't do that good of a job, so let them go. Let them go abroad and let them wreck their economy.

Mr. ELLISON. Do European firms compensate the way we do? And in line with that, I mean, is there another way to conceive of executive compensation, or is the way we have been doing it the only way to see it? And from what I understand, and I could well be wrong, European and Asian firms don't pay their executives this way.

Ms. MINOW. Unfortunately, one area where the United States is way ahead of everybody else is in the area of disclosure, and so we don't have good, comparable data. So there are a lot of off-of-the-disclosure-books kinds of payments that we don't know about.

Mr. MURPHY. We have increased disclosure across the world. I have just completed a study of 27 countries, and one of the things we find is that the rest of the world slowly is catching up to the United States.

The United States has higher compensation after you control for size and industry. But stock options, for example, which used to be nonexistent in all but a couple of countries 20 years ago, are now prevalent in almost all countries.

Mr. ELLISON. I would like you to send me that study. Would you?

Mr. MURPHY. Absolutely.

Mr. BEBCHUK. The argument that people will go and work elsewhere is also unwarranted because everybody here is focused on changing the structure. So there is really no reason whatsoever to provide compensation that produces perverse incentives and destroys value. At most, this argument would be, give them the same amount but use it to give the incentives to work for the company, not against it.

Mr. ELLISON. Are you familiar with a book called, "In Search of Excess" written in 1991?

Ms. MINOW. Graef Crystal wrote that, yes.

Mr. ELLISON. So this conversation about excessive executive pay, whether or not you will buy it or not, it is not a new argument, is it?

Ms. MINOW. No. The book that I would recommend to you even more than that because it is more up to date is Rakesh Khurana's book, "In Search of a Corporate Savior." And the thing I like about that book which influenced my thinking is that he says payments of executive compensation need to be looked at in terms of return on investment, like any other asset allocation.

Mr. ELLISON. I think I am out of time. I thank you very much.

Mr. CLEAVER. The gentlewoman from Minnesota is recognized.

Mrs. BACHMANN. Thank you, Mr. Chairman.

Mr. Bebchuk, publicly traded companies also pay high salaries to entertainers, to athletes, and to news anchors. And what I am wondering is, should these decisions also be subject to shareholder approval?

Mr. BEBCHUK. No, I think not. What we are concerned about, about top executives, is not so much the amount but the concern that we don't have arm's-length contracting, that we don't have the market at work. When you have the market at work, we can let privately reached decisions stay. But what we are trying to do with respect to top executives is to make sure that we have a well-functioning system rather than the one that we have had thus far.

Mrs. BACHMANN. Thank you.

Next would be Ms. Minow. You mentioned in your testimony that, although disclosure is important that people have to be able to act based on the information that is disclosed, isn't the right to sell stock the ultimate way that shareholders can act? What is your opinion on that?

Ms. MINOW. Not really. The one thing that you know about stock is you want to buy low and sell high. If the stock has been depressed by bad decisions on the part of management, it can be cost-effective for you, in fact, to send a message back to that management rather than to sell out.

Furthermore, many of the investors, including the large institutional investors, are so large and diverse that they are either indexed de facto or indexed de jure, they have nowhere else to go. And these pay plans are so pervasive, they have nowhere else to go, at least within the United States. So they don't have the opportunity for what is called the Wall Street walk.

Mrs. BACHMANN. Given the shareholders' ultimate ability just to be able to sell their shares, shouldn't we be concentrating our efforts on compensation disclosure in your opinion?

Ms. MINOW. Compensation disclosure is absolutely essential, and I hope we can improve it. As Professor Verret said, we made some improvements in 2006, but it doesn't really cover a lot of the kinds of issues that have been revealed by the financial meltdown.

Mrs. BACHMANN. And you had talked before about preventing bad compensation practices, that really little can be done before the structure of the board is fixed. I think that is an excellent point that you are making. And could you talk about what your proposal would be?

Ms. MINOW. Certainly. Right now, I know it is hard to understand if you are an elected official, but right now boards are elected. No one runs against them. Management counts the votes, and they can serve even if they only get one vote. I think it is very important that directors not be allowed to serve unless they get majority support from the shareholders. I think that way shareholders would be able to remove bad directors.

Mr. VERRET. I would add that contested elections that would be part of the Commission's current proxy action proposal would also be, I believe, plurality votes. So the same standard would apply. It wouldn't be majority voting for contested elections.

Mrs. BACHMANN. I would open the questioning up to any panel member. On my previous question regarding athletes and news anchors and entertainers, and also on transparency and on disclosure, if anyone else would like to comment.

Ms. MINOW. Lucien is 100 percent right. Those transactions are very closely negotiated at arm's length. It is the coziness of the transactions between the top executives and the board that leads to this problem.

Mrs. BACHMANN. Why is it that the board can't be changed?

Ms. MINOW. Because the CEO picks the board.

Mrs. BACHMANN. And so you have the circle, they are chasing each other?

Ms. MINOW. Yes.

Mr. BEBCHUK. I would add that disclosure is helpful only if investors can then make decisions that would have an impact on directors using the information that they are given. And right now, their hands are tied in a number of ways. In addition to the difficulty of replacing the board, there are staggered votes, which are a unique American institution, which in a large a fraction of publicly traded companies prevent the shareholders from replacing the full board in any given election. And there is also the inability of the shareholders to amend the corporate charter so the shareholders cannot change the rules of the game. If they could, some of the work that you guys are called on to do could be left to the market. But right now the market cannot put in place corporate governance reforms that are viewed as important.

Mrs. BACHMANN. Professor Verret?

Mr. VERRET. I would counter that about half of the S&P 1500 is declassified. It is difficult, but shareholders have made some progress in declassifying boards.

I would also just highlight a bit of a market failure, I think, in proxy advisory services. We saw the problems with market concentration in the credit rating agencies. It is much, much worse with proxy advisory services. Risk metrics rules the roost, and there is no required disclosure in these independence of competition committee rules. There is no required disclosure for proxy advisory firms, and I think there should be.

We are not likely to see it, of course, because the former chief administrative officer of Risk Metrics is now a special adviser to the chairman, so I think we are unlikely to see it at this point. But I think it is worth considering.

Mrs. BACHMANN. I yield back.

Mr. CLEAVER. I recognize the gentlewoman from California.

Ms. SPEIER. Thank you, Mr. Chairman.

I want to thank the panel. It has been a very lively discussion, and I think you underscore for all of us what a sticky wicket this issue area is.

I would first like to point out that Paul Volcker said it very succinctly very recently when he said that the financial demise that we have just witnessed is the result of executive compensation that has been linked to riskier and riskier activity. And I think a number of you have pointed that out in your testimony.

I think that we have no role as a Congress to effect executive compensation if we don't have an investment, so to speak. So when it comes to TARP recipients, you bet I think we have a role to play.

Now what we do have a role to play in other circumstances is empowering the shareholders. That is what our focus should be. And I think right now the game is fixed. Based on what you have just said, if you get one vote, you are reelected. Wouldn't we all like to have that kind of experience being elected to Congress?

It sounds fundamentally undemocratic that you don't have someone independently counting the ballots and that a majority is not required. So I think, and I keep coming back to Mr. Sullivan, who was then the CEO of AIG who had performance requirements for bonuses. He went to his board of directors and said, we want you to waive the requirement for performance in this situation even though we have just lost $6 billion and give the bonuses anyway. And guess what the board did?

Ms. MINOW. They said yes.

Ms. SPEIER. They said yes, and those bonuses were offered and Mr. Cassano received a million dollars a month after he was fired. It is extraordinary, and it is wrong, and the American public is on to it.

My question to all of you is, since you can always manipulate the system, as Mr. Sullivan did where he actually had performance requirements in place for purposes of giving bonuses, why not just require of all of the members of the board of directors a fiduciary duty to the shareholders?

Mr. BEBCHUK. They do have a fiduciary duty, but the problem is that enforcing fiduciary duties is difficult because there is the business judgment rule, and courts are not going to second guess the judgment of the directors. That is why the main remedy is to make directors accountable to the judgment of the shareholders.

And you mentioned AIG. We have never had in the history of the U.S. public markets a control contest for a company the size of AIG because the impediments to a proxy fight in a company that large are just practically insurmountable. And many of the arrangements that people are discussing are arrangements that tried to expose incompetent directors more to the discipline of an electoral challenge.

Mr. TURNER. I might note that there are almost never any actions brought against boards of directors. The SEC, to the best of my knowledge, never brought an action against any of the directors of Enron; never brought an action against any of the directors of WorldCom; and only brought one action against the directors of Tyco, and that was because the guy had taken a bribe.

So for the most part, given the way that State laws operate, which aren't very good and quite frankly, the staff of this committee has been urged to take up a proposal to allow shareholders to ask for reincorporation in a more shareholder-friendly State, which is an excellent proposal, by the way.

But for the most part, until you can hold directors accountable, and in this way it is the proposal just to be able to throw them out, you are never going to get any action because the law enforcement agencies literally will not touch them, have not touched them, even in the most egregious cases today.

Ms. MINOW. Many of the directors of the failed companies are continuing to serve on boards. It is flabbergasting to me, but they are still there.

Mr. VERRET. I would specifically counter the observations about State law. Delaware is the corporate State law that I have spent the most time studying. Delaware is very responsive to shareholders, particularly responsive. They instituted majority voting. They made majority voting easier. As a result, now we have majority voting in, I think, 60 to 70 percent of companies; this is the withhold vote, kick-the-bums-out sort of rule. People wanted proxy access. Delaware instituted proxy access, although the SEC wasn't able to do it. So that was very responsive to shareholders, I would say.

Ms. MINOW. When is the last time a director has been held liable by a Delaware court for any personal payment out of his own pocket absent personal corruption?

Mr. TURNER. After approving the Ovitz, and the court held Ovitz could get paid $160 million in the most egregious situation and said, it is a-okay. The courts in Delaware said it; it is not an investor-friendly State.

Mr. VERRET. The Ovitz litigation is one specific case. That was 6 or 7 years ago.

Ms. SPEIER. Thank you, my time has expired.

Mr. CLEAVER. The ranking member from Alabama is recognized.

Mr. BACHUS. Thank you.

How many of you were at the first panel and heard the testimony?

Mr. Sperling, I have a great respect for him. He talked about some of the executive compensation decisions that actually led companies, they actually increased risk, and I think when we hear that we think of AIG, and we think of maybe some of the subprime lenders where people, mortgage originators were paid by the volume of work without regard to whether the borrower could repay. Give me a percentage of companies that you think engaged in this sort of risky dangerous behavior?

I will start with Professor Bebchuk.

Mr. BEBCHUK. I think that the widely shared view that I alluded to before, that incentive structures were flawed, applies to companies in the financial sector across-the-board. Most of the companies in the financial sector, this is what made this financial crisis so difficult. Most of them made decisions that at least in retrospect seemed to have involved excessive risk-taking, and they all generally had those incentive structures that had the short-term flow that they now generally recognize.

Mr. BACHUS. Of just corporate America, how many corporations do you think engaged in dangerous, risky behavior that endangered the economy?

Mr. BEBCHUK. I think the problem of short-termism, the practice that is now widely recognized as being problematic, namely that executives can cash out shares and options immediately upon vesting and that bonuses are often short term, this practice is general across corporate America.

Now I would say the financial sector, the opportunities for risk-taking are not as large as they are in the financial sector, and,

therefore, the fact that we have had flawed incentives has manifested itself. But it is now generally accepted that also firms outside the financial sector should fix this very problem of tying compensation to the long term and not to short term.

Mr. MURPHY. I would like to be careful not to define excessive risk-taking as just those risks that generate losses as opposed to gains. Actually, through most of our history, our problem in corporations has been to encourage individuals, risk-averse individuals to actually take risks, and the individuals inside corporations tend to be more risk-averse than the shareholders. The entrepreneurial spirit is all about risk-taking.

Mr. BACHUS. I agree. Mr. Verret?

Mr. VERRET. Just to answer your question specifically, I think it is a small number of corporations in terms of number; very large in terms of the assets that they manage. I think this goes to a related issue of, do we let them get too big? And I would applaud the Federal Reserve's current initiative to think about changing capital requirements based on size. I think that is a useful thing to talk about.

And I would also offer, just highlighting from my testimony, I would offer that quarterly earnings guidance is a dangerous thing that affects a lot of companies, and it is something that companies want to get out of.

Mr. BACHUS. Let me ask you this: Do you believe that the CEO or the board of directors or people inside the corporation, isn't one of the jobs of the CEO to look at performance and pay and set executive compensation as opposed to some independent board?

Ms. MINOW. Yes. It is the job of the board to set the CEO's compensation and to value his performance, including his performance in setting compensation.

Mr. BACHUS. So both the CEO and the board of directors, you all agree that they primarily should be responsible for setting compensation?

Ms. MINOW. Yes. Absolutely.

Mr. BACHUS. Professor Verret and Professor Bebchuk, as I understand it, the compensation proposal envisions linking executive compensation to performance of bank debt and preferred shares. What is your view of that proposal?

Mr. VERRET. I would offer just with respect to the idea of using debt—linking debt to pay, I think three things are worth thinking about: First, an executive's ability to be rewarded on the upside would be limited the more you include debt in the mix. I also thinks he makes an assumption at least in the paper that I think is absolutely correct, the fact that the moral hazard of government bailouts means that debt tends to not to be affected too much when a bank's health is affected. I think that is an absolutely safe assumption. It is one of the reasons that debt holders don't police executives as much as they should. It also means if you were to link debt to executive's pay, it means that if the debt doesn't go down, the pay doesn't go down. So you limit the upside, and you also limit the downside. The amplitude you get is very flat rather than upward and downward incentives as you add pay into the mix.

Mr. CLEAVER. The gentleman from Texas is recognized.

Mr. GREEN. Thank you, Mr. Chairman, and thank you, members of the panel. If I interrupt, please forgive me. I don't mean to be rude, crude and unrefined, but I am trying to make a point.

Let me start by asking about the executives in the U.K. Do they in the main make more than executives in the United States?

Mr. MURPHY. No.

Mr. GREEN. Executives in Germany, do they in the main make more than executives in the United States?

Mr. MURPHY. No.

Mr. GREEN. Executives in France, do they in the main make more than executives in the United States?

Mr. MURPHY. No.

Mr. GREEN. The question becomes this then, to those who contend that if we do anything to encroach upon the current system, people will flee to other places and make inordinate amounts of money in other places, leaving us with a brain drain; the question becomes: Where do they go?

Mr. MURPHY. They go to private equity and hedge funds.

Mr. GREEN. Private equity and hedge funds in the United States?

Mr. MURPHY. Within the United States. And no one is going to Europe.

Mr. GREEN. The percentage of private equity and hedge funds cannot accommodate the number of executives that we are talking about, so some may go. But the truth be told, the argument is that we are going to lose them to other countries. That is the argument that is being made, and there is no other country that they are going to go to and fare as well as they are faring in the United States of America.

Mr. VERRET. Except that could change if we link pay.

Mr. GREEN. Excuse me, it could change if the U.K. would change its laws. It could. It could change if Germany and France changed their laws. That doesn't seem to be the case because they seem to be leaning even more towards executive regulation.

By the way, I am not a proponent of trying to stifle the free market. I want to see people make as much as they can. But I don't want to see people at AIG drive a company into the ground and then walk away with huge bonuses. There is something wrong with this, and the American people know there is something wrong with it. And they are going to chastise us if we don't do something about it. I appreciate the notion that there are other places for people to go, but they won't find the coffer in these other places that they find in the United States of America.

And those who want the auto workers at Ford, Chrysler, and GM to get salaries comparable to Nissan and Toyota, they don't look at what the salaries of those CEOs at Nissan and Toyota are making. Their salaries are not in line with the salaries of the American auto industry executives in this country. They are not. Nobody that I have heard, and there may be a voice that I haven't heard, I confess that I don't hear everything that is said, but nobody that I have heard has indicated in any way that we need to make sure that the salaries of the auto executives in this country are in line with the salaries of the auto executives in other countries. It is just not being made.

Now, at some point, we have to 'fess up and say we have some business to take care of, and take care of the business that we must take care of. If we don't do this, this is our hour, our moment, this is our time to do what is right; not to try to manage this, not to try to make sure that we do it, do this thing right, but do the right thing. That is what we have to try to do here.

So I am not for taking control of a company. I don't want to see stockholders micromanage a company. I am not interested in that. But I contend that the chairman is right when he talks about how we have promoted excessive risk without consequences for the failure, not serious personal consequences for the failure. So we have people who are trying to do all that they can to make as much as they can, understanding if they don't, I will just take my bonus and my golden parachute and fly out. That kind of behavior is what we are talking about, as I see it, and I think there is room for us to do something, and I would like to see it done in a bipartisan way, by the way. I am amenable to working with folks on the other side to come to a sensible center on this so we can have bipartisan legislation.

But I still contend that those workers who took that cut at GM and who were taking cuts, they didn't get bonuses cut. They got bread and butter cut, and there is a difference. And there is not a big to-do about what is happening to them.

Mr. Chairman, I yield back the balance of my time after having the opportunity to speak for those who are not here to speak for themselves.

Mr. CLEAVER. Let the church say, "Amen."

The gentleman from Florida is recognized.

Mr. GRAYSON. Thank you, Mr. Chairman.

We are trying to make policy on the basis of recent memory. For the past few months, we have seen banks that have brought themselves to the brink of ruin, brought the whole U.S. economy to the brink of ruin. And what people see, which is so frustrating to them, is that they see that nobody is being held accountable for that. Nobody is being punished for that. Maybe the gravy train has slowed down a little bit for them, but it is still rolling. And I think people find that frustrating, and rightfully so.

I am worried that proposals like this don't go far enough. They don't say, you don't get paid extra if you destroy your company. You don't get paid extra if you hand the taxpayers a hundred billion dollar bill. What I want to hear is I want to hear your best ideas about how we should hold accountable the people who have already screwed up, the people who have already caused the destruction of their own banks and caused the taxpayers to have to give out billions upon billions of dollars, and I want to know what we should do in the future about people like that.

Let's start with Ms. Minow.

Ms. MINOW. Well, there is the limitation on ex post facto laws. There is not much you can do about what has already happened. But I would certainly strongly urge Congress to make sure that anyone involved could never serve on the board of a public company or as an officer of a public company ever again. It is unthinkable to me that these people continue to be involved.

Mr. GRAYSON. Let us be specific, when you say "anyone involved," who would you include in that?

Ms. MINOW. I would include the executives and the boards of directors of all of the main TARP companies, the ones that are still participating in the program.

Mr. GRAYSON. So you would apply the same sort of punishment that the SEC actually frequently applies to people who are engaged in illegal trading?

Ms. MINOW. Yes, I would.

Mr. GRAYSON. Mr. Turner, your best ideas?

Mr. TURNER. I totally agree with you about the frustration and that there needs to be accountability. I think the SEC in their announcement just in the last week about Countrywide and going after them is exactly what we are looking for. I think there have also been cases filed with respect to fraudulent reporting by companies such as Citicorp, and I think DOJ and SEC need to work those through the courts in the most diligent way. And I think some of the same question applies to Fannie and Freddie as well with some of their practices. Just as Nell has said with those who, after due process, people are found not to do the job; due process is important in this country, and we don't want to run into cowboy justice, but where due process is, these people ought to be barred and the SEC has the authority to bar these people from ever being an officer and director again, and they haven't had a good track record in doing it in the past, and they need to do it. And if they don't do it, then you guys ought to haul the SEC up here and ask them why.

Mr. GRAYSON. Mr. Turner, you are talking about cases of fraud. I am talking about something a little different. I am talking about cases of gross, gross mismanagement that literally led to the destruction of a multibillion dollar institution. How should we treat people like that, not people who file false statements with the government and the SEC, but people who destroy their companies and right now maintain control of those companies only at the benefit—only through the largess of the taxpayers, what should we do with those people?

Mr. TURNER. When you passed the Sarbanes-Oxley Act, you gave the SEC to find that when they look at officers and directors and find that they are substantially unfit to fulfill those roles, they can bar them forever from serving in those roles at a public company. I think in some of the instances of these companies, we are going to find that some of these directors are in fact substantially unfit to fulfill that role, haven't demonstrated the fitness ability, and the SEC should forever bar them from being an officer or director of another public company.

Mr. GRAYSON. Mr. Bebchuk, what do you think we should do in a situation where somebody who heads a bank, or a group of people who head a bank, have run that bank into ruin and handed the taxpayers a hundred billion dollar bill? What should we do with those people?

Mr. BEBCHUK. I very much understand the frustration, but I am concerned about retroactively changing the rules of the game. So to the extent, and this is hypothetical, if you have someone who acted completely according to the law, I would try to—

Mr. GRAYSON. What should the law be? That is what we do around here, determine that.

Mr. BEBCHUK. But the law we had on the books up to this point was a law that did not make it criminal, as well as limited private actions.

Mr. GRAYSON. Right. Mr. Bebchuk, it is legal to destroy your company and hand the taxpayer a hundred billion dollar bill. We understand that. We want to change that. What should we do?

Mr. BEBCHUK. About people going forward?

Mr. GRAYSON. If you wish.

Mr. BEBCHUK. Going forward, you can reconsider the legal rules that right now completely insulate someone from legal liability when they engage in gross negligence. So we could reconsider those legal rules and open them to legal liabilities and circumstances.

Mr. GRAYSON. My time is up. Thank you, Mr. Chairman.

If any other members of the panel want to comment on this, please feel free to write to me and let me know.

Mr. CLEAVER. The Chair recognizes the gentleman from California.

Mr. SHERMAN. Or better yet, you could furnish your answer for the record, and we would all know.

Mr. GRAYSON. Thank you. That is a good suggestion.

Mr. SHERMAN. I would point out that criminal law can't be ex post facto, but as Mr. Turner pointed out, we can ban some of these people from ever serving on the board of a publicly traded corporation again. And we might also look at the civil law to see whether those whose actions have cost us perhaps $700 billion, perhaps less, would be liable to the Federal Government. Ex post facto criminal laws are much more constrained by the Constitution.

I would think that Wall Street itself would keep some of these people off the boards, except I can see some of them saying these folks didn't show remarkably bad financial judgment; they showed tremendous political skill. They separated the taxpayers from $700 billion worth of assets.

Mr. Verret, you have been talking about how we need to keep talent motivated, but I think it has been pretty well illustrated by the gentlemen from Texas, nobody is moving to London let alone Tokyo to make more money, or very few are.

Is there any economic theory that would say, if 10 percent of the executives who worked for publicly traded banks then found themselves at the hedge funds, that would mean a diminution in the quality of financial management in this country? Would a slight change of talent moving from the publicly traded sector to the not publicly traded sector, has anyone proven that would hurt you?

Mr. VERRET. I am not an economist specifically.

Mr. SHERMAN. Are you aware of any such study?

Mr. VERRET. I am not aware of any such study.

Mr. SHERMAN. Okay, thank you.

Professor Bebchuk, I don't believe that we are going to control or should control compensation for a company, except if it is publicly traded, in which case we want to make sure that shareholders are empowered, systemically it puts the country at risk or is governmentally subsidized, assured, insured, etc.

This leaves the hedge funds, where it is my understanding that for the most part you do have incentive to take enormous risks. There is a lot of talk about, well, if the investment does well, the management should do well. If the investment does poorly, the management should do poorly. I know of no hedge fund that is structured that if they lose money, the management writes a check out of their own pocket.

Is the typical structure of a hedge fund one that encourages excess risk? By typical structure, I mean one where the management puts in none of its own money, shares only in the profits, has no real compensation except for the profits, and in some cases doesn't share until a 5 or 10 percent rate of return is achieved. And if so, are some of these hedge funds a systemic risk to the country?

Mr. BEBCHUK. I agree with you that the government should not constrain the substantive choices that are made in the fee arrangement between hedge fund managers and their investors.

But I also agree with you that, as part of this general reconsideration that is now taking place, investors in hedge funds should take a serious look at those arrangements because I do share your sentiment that the same sort of focus problems that we have now witnessed with publicly traded companies exist in the hedge fund areas. So what we have, there are many hedge funds where usually the arrangement is they don't give back money, but there are those high water marks. Therefore, there is a situation where they might not be able to get extra funds which creates a lot of distortion because either they fold the fund or they work without high incentives, so I think it would be a good idea for investors to reconsider.

Mr. SHERMAN. Are investors given enough information about management compensation at hedge funds?

Mr. BEBCHUK. Yes. Those are arrangements that are negotiated with a small number of investors, and they are fully disclosed.

Mr. SHERMAN. My next question is, is a fight between management and insurgent shareholders a fair fight, or is it more like an election in Venezuela? Do the minority shareholders have any access to corporate funds, and is management allowed to use corporate funds as they will to call and propagandize?

Ms. MINOW. I think I am the only one on the panel who has actually tried to do this. I can tell you that management will spend every last dime of your money against you. I am not saying that it needs to be a level playing field, but right now it is pretty perpendicular.

Mr. SHERMAN. So much for shareholder democracy. I yield back.

Mr. CLEAVER. I have just one question. Morgan Stanley has instituted this clawback provision. Are you familiar with it? It is after the fact, where if a CEO has jeopardized the company, they will then repossess any bonuses or special compensation. Is that something that you think would be applicable for legislation that this committee will consider?

Mr. MURPHY. At Morgan Stanley, it is not just the CEO; it is any executive that they determine has caused harm. I would have gone further and said, even if you didn't cause harm, if you got money that you shouldn't have gotten, you should give it back. But that is the role of good corporate governance and compensation policy, not the role of government regulation.

Ms. MINOW. On the other hand, the executives have raised their base pay to make up for some of the additional risk they are taking on, so I don't approve of that.

Mr. CLEAVER. Of course, it would be government business if we put it into legislation.

Mr. MURPHY. I understand that.

Mr. TURNER. I do support and noted in my testimony the right of investors. When someone has operated in a reckless or fraudulent way, I do support giving investors the right to go for that clawback. In that manner, either the board can ask for the clawback and get it back or the shareholders can, because someone ought to go get that money back.

Mr. VERRET. I think this goes to the disclosure issue and the SEC's work in 2006 and Chairman Shapiro's current work in this area. The right question is, did the board go for a clawback? If not, it should have to explain why to the shareholders.

Mr. CLEAVER. Thank you. I appreciate all of the time you have spent with us. And the ranking member has a question.

Mr. BACHUS. Professor Verret, Treasury yesterday released a statement on executive compensation that supported the passage of say-on-pay. Will say-on-pay be effective, in your opinion?

Mr. VERRET. Well, I think one of the problems that I hope I get across is what we have seen in Britain is that concentration of the proxy advisory firms has caused sort of a one-size-fits-all solution to take hold in pay. I think it is better to have a flexible approach, that compensation committees should have the flexibility to design compensation proposals appropriate for their own businesses.

I also worry about the possibility that say-on-pay could minimize a board's ability to change compensation as required by major changes in markets and events in midstream between the annual advisory vote on say-on-pay.

I also worry about the effects of say-on-pay on severance packages and the ability to negotiate a so-called golden handshake to facilitate an efficient merger acquisition. Even if you do a vote, sometimes negotiations happen overnight with respect to negotiating mergers and acquisitions, and I think those sort of agreements are very important, and sometimes they need to be approved very quickly, not with enough time to do a shareholder advisory vote.

Mr. CLEAVER. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

This is the end of this hearing. We thank you for participating.

[Whereupon, at 2:25 p.m., the hearing was adjourned.]

A P P E N D I X

June 11, 2009

ANDRÉ CARSON
7TH DISTRICT, INDIANA

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Statement of Congressman André Carson
"Compensation Structure and Systemic Risk"
June 11, 2009

Thank you, Mr. Chairman for your tremendous leadership on the issue of executive compensation and for holding this important hearing today. This issue promises to be one of the most important in upcoming regulatory reform legislation.

Recently, there have been a number of interesting characterizations of efforts to reform executive compensation structures on Wall Street. In the wake of the worst economic crisis since the Great Depression, many financial industry leaders have insisted that CEO compensation is "self correcting." They urge inaction on reform, insisting that shareholder and media scrutiny has already moderated pay for leaders of poorly-performing companies. They claim if we enact stronger reforms, our financial talent will be driven overseas and our economic recovery will be delayed.

What is missing from that argument is both clarity and reason.

For the 175 executives whose companies helped fuel the current economic crisis that ultimately required hundreds of billions of dollars in taxpayer assistance, I believe a capable compensation overseer should have the discretion to determine whether or not these companies' compensation packages are reasonable. In any other industry, when someone takes excessive risks that lead to monumental failures, there are repercussions. Wall Street seems to expect a separate set of rules.

For my constituents, this double standard is nothing new. They know that thirty years ago, CEO's took home 30-40 times what average workers made and now that number has exploded to 344 times an average worker's pay. They know that while the average CEO pay dropped by a million dollars last year, many average workers were laid off. They know that the average bonus payment to Wall Street executives represents more than they hope to earn over a lifetime. And they also know that once again, Main Street is paying for the actions of Wall Street.

My hope it that industry leaders understand that calls for executive pay reform are not a retaliation for our current economic reality, but rather, an attempt to usher in a new era of real corporate responsibility. I hope that executives realize that performance incentives that are tied to the long term success and soundness of an institution are essential, if we hope to monitor systemic risk and restore confidence in our markets.

With that in mind, I look forward to working with the Administration, the Chairman, and my colleagues on this Committee to enact legislation that includes these common sense reforms. Thank you.

PRINTED ON RECYCLED PAPER

OPENING STATEMENT BY REPRESENTATIVE CAROLYN MCCARTHY

COMMITTEE ON FINANCIAL SERVICES

HEARING ON COMPENSATION STRUCTURE AND SYSTEMATIC RISK

JUNE 11, 2009

I commend Chairman Frank for his remarks on the issue of executive compensation. I, too, believe that the Financial Services Committee and Congress have an obligation to do everything possible to prevent future crises. This Committee and Congress should move forward legislation that helps the private sector by providing the tools necessary to create an adequate compensation system that is based on performance principles and not on incentives backed by excessively risky business decisions. I fully agree with the Chairman that it is not the role of the federal government to dictate what is considered excessive compensation, and what is considered fair compensation—rather, that decision should be left to those who have ownership of a company.

I look forward to working with the Chairman and my colleagues on the Financial Services Committee to create principles and guidelines that will help aid in the creation and adoption of a new compensation structure. Future compensation should promote competition, innovation and put the U.S. economy and our business community back on the road to success.

Opening Statement of Congressman Tom Price, M.D.
House Committee on Financial Services
Hearing on "Compensation Structure and Systemic Risk"
Thursday, June 11, 2009

Chairman Frank, Ranking Member Bachus, thank you for holding this important hearing about executive compensation and systemic risk.

As has been noted, determining compensation can be a delicate and inexact process. On June 10, 2009, the Administration issued new rules for executive compensation based on five points. First, compensation plans should properly measure and reward performance. Second, compensation should be structured to account for the time horizon of risks. Third, compensation practices should be aligned with sound risk management. Fourth, reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders. Finally, promote transparency and accountability in the process of setting compensation.

Regrettably, the foundation of these points is flawed. Specifically, the notion executive compensation is a cause of systemic risk and thus a cause of the financial crisis is absurd. Although the concept that businesses are in business to make money might be foreign to some, businesses indeed make decisions which their leadership believes will make a profit. Included in these decisions are incenting their executives and employees to reach their business goals.

A government mandate on business practices is precisely the wrong direction – especially when there are already better, real world solutions available. As one would rightfully expect, the marketplace is already adapting. AFLAC was the first of at least 23 companies to voluntarily offer a so-called "say-on-pay" vote. Zero. That's right, zero, votes by shareholders against executive pay packages have succeeded to date. And, if these votes aren't providing a substantive benefit to the shareholder we ought to think twice before Congress mandates new practices that will have new costs, further harming job creation.

Recovery of the American economy will require that business decisions may involve risk. American industry would not be world leaders without taking risks. If the President and this Congress legislate away all risk, they will only stifle the same American innovation and freedom that made America the greatest nation in the world. The President cannot continue his heavy-handed meddling in the private sector and expect it to function, much less flourish. Where there is no risk, there can be no reward.

Thank you again Chairman Frank and Ranking Member Bachus for holding this hearing.

Statement for Financial Services Committee hearing:

Compensation Structure and Systemic Risk

June 11, 2009

Thank you, Mr. Chairman

This is a very important hearing, which should help us understand why our financial system collapsed and what we can and need to do to prevent such a crisis in the future.

Recently, former Fed Chairman Paul Volker told us - very succinctly, I thought - that the demise of the financial services industry was the direct result of executive compensation being tied to more and more risk.

I could not agree more.

Now, I understand that the executives who run large financial institutions play an important and vital role in our economy. But the same can be said of emergency room doctors, teachers, firefighters and any number of hard-working, educated professionals who - no matter how many lives they save or young minds they expand or children they rescue - will never earn as much as a Wall Street executive drops between the couch cushions in his corner office. In fact, these crucial members of society will work a lifetime just to equal the amount of a single Wall Street bonus.

Yet, among the top executives of corporate America today, the expectation of million dollar bonuses is so pervasive that long-term performance of their

clients, hedge funds and corporations is rarely even taken into consideration. Instead, the reward comes from gaming this quarter's statement or next month's profit, encouraging deceitful - or, at best, wishful - accounting practices. To paraphrase the always poetic James Carville, "It's the culture, stupid!"

One only has to look to recent history to see the remarkable disconnect between performance and compensation. As financial markets were beginning to collapse in 2007, Wall Street's five largest firms paid a record $39 billion in bonuses. Common sense will tell us that the out-going CEO of Citigroup - who presided over the freefall of the company's value - did not deserve a $68 million exit package on top of his $1.7 million pension. Granted, it's not easy making $64 billion in market value disappear, but even David Copperfield doesn't get $70 million for that trick.

Meanwhile, dozens of top executives at AIG and Merril Lynch reaped bonuses in the millions while wading through puddles of red ink. What's more, despite the loud and angry public outcry, it is quite clear that many executives and boards of directors still don't get it.

Even now, it appears some TARP recipients are using accounting smoke and mirrors to make it appear that they're turning a profit so they can again take a ride on the bonus train this year. Recent reports claim that these companies are setting aside billions for that purpose, with some dramatically increasing base pay to get around bonus restrictions. There is a much-quoted old saying: "Those who do not remember the past are doomed to repeat it." In this context, I don't think

it's too much to say that Wall Street is praying that Congress does not remember the past so that they will be lucky enough to repeat it.

It is absolutely essential that we pass strong and real reform to ensure that the excesses of the past are not repeated over and over again.

I am not one that thinks Congress should dictate how much people are paid. But it is absolutely appropriate that we ensure that corporate boards of directors are accountable to their shareholders and not just to their fellow directors and executives. "Say on pay" is an important start, but not nearly enough. Boards of directors should have a fiduciary duty to protect their shareholders - both large and small - who are depending on the investments for retirement or their children's education, and they should have some liability for their decisions. In the interests of transparency and accountability, shareholders with a minimum ownership level must be given proxy access, directors should not be allowed to win an election with just one vote, and companies should be required to do no less than fully and clearly disclose all terms and forms of executive compensation and severance packages. Further, compensation committees need to be truly independent from management and not just a rubber stamp for predetermined increases designed to spare under-performing executives from the embarrassment of lagging behind peers in the salary race.

The United States did not invent banking or capitalism, but we seem to have mastered the art of over-payment. Compensation in most other countries, within the same industries, is well below the US. I would argue that is because, in

countries like the United Kingdom, shareholders have actual power and have kept much tighter control on excessive compensation.

Finally, any hearing on this issue would be a sham if we didn't admit that Congress shares much of the blame. I would also add financial regulators to that. It is imperative that we take strong and forward-looking legislative action that empowers effective and independent regulators who understand and accept that they represent the 90 million Americans who invest in capital markets. This is essential if we are committed to making sure that we do not see a repeat of this debacle.

Thank you Mr. Chair, I yield back.

Opening Statement by Congressman Charlie Wilson
Committee on Financial Services
June 11, 2009

Chairman, thank you for holding this timely hearing. Panel, thank you for being with us today.

I was so pleased to hear the President's announcement yesterday about the creation of a "compensation czar." Many of my colleagues and I have thought for a long time that executive pay was on an uncontrollable path.

It is scary that for years, Wall Street has rewarded its employees for risky behavior with outrageous bonuses. I have no doubt that it contributed to our financial crisis.

The action that the President proposed yesterday is right in line with my thinking on this issue. In fact, earlier this year I introduced a bill, the TARP Wage Accountability Act that would target some of the more egregious actions that Wall Street has taken in the past year.

Up until recently, most large banks have utilized a compensation approach where bonuses make up a majority of the total income package for more senior employees. Salaries are kept relatively low and bonuses are, by comparison, huge. Due to the critical eye of Congress and American taxpayers on bonuses, there is now an effort by the companies to flip that compensation structure from bonuses to salaries. The intent of my bill is to stop TARP recipients that are scheming to change their pay structure to reward themselves with double or triple their salaries. I want to make sure that taxpayer money does not go to outrageous raises — raises that are not deserved.

My bill would force companies that took 10 billion dollars or more in TARP funds to abide by the government Cost of Living Adjustment (COLA) structure set for our military and government employees. For example, this year that would mean that salaries for employees at AIG couldn't be raised more than 3.9%. If the COLA is good enough for our soldiers and government employees, it should be good enough for Wall Streeters taking government money.

I hope that the announcement by the White House about a compensation czar will make my legislation unnecessary. I would encourage the new czar to be fair and equitable with his decisions regarding senior level salaries within banks receiving TARP funds.

Thank you again Chairman. Panel I look forward to hearing from you.

For release on delivery
10:00 a.m. EDT
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Statement 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

June 11, 2009

Chairman Frank, Ranking Member Bachus, and other members of the Committee, thank you for the opportunity to offer some perspectives on the subject of incentive compensation in banking and financial services. Recent events have highlighted that improper compensation practices can contribute to safety and soundness problems at financial institutions and to financial instability. Compensation practices were not the sole cause of the crisis, but they certainly were a contributing cause--a fact recognized by 98 percent of the respondents to a recent survey conducted by the Institute of International Finance of banking organizations engaged in wholesale banking activities.[1] And, importantly, problematic compensation practices were not limited to the most senior executives at financial firms. As the events of the past 18 months demonstrate, compensation practices throughout a firm 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.

Financial firms and supervisors have learned important lessons from this recent episode. Having witnessed the painful consequences that can result from misaligned incentives, many financial firms are now reexamining their compensation structures with the goal of better aligning the interests of managers and other employees with the long-term health of the firm. And we, as supervisors, have been reminded that risk management and internal control systems alone may not be sufficient to constrain excessive risk-taking if the firm's compensation structure provides managers and employees with financial incentives to take such risks. Accordingly, the Federal Reserve is developing enhanced and expanded supervisory guidance in this area to reflect the lessons learned in this financial crisis about ways in which compensation practices can encourage excessive or improper risk-taking.

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[1] The Institute of International Finance, Inc. (2009), *Compensation in Financial Services: Industry Progress and the Agenda for Change,* March (Washington: IIF).

In my statement, I will review some of the compensation and related risk management and corporate governance deficiencies that contributed to the financial crisis. In addition, I will review some possible explanations as to *why* such problems exist--even when they run contrary to the long-term interests of shareholders and the organization. I also will outline the existing rules and guidelines that the Federal Reserve has in place to help address compensation problems at banking organizations that may pose a risk to safety and soundness. Finally, I will describe some of the elements that are key to the design and implementation of sound compensation systems at financial institutions.

Compensation and Corporate Governance and Risk Management Breakdowns

Compensation arrangements are critical tools in the successful management of financial institutions. They serve several important and worthy objectives, including attracting skilled staff, promoting better firm and employee performance, promoting employee retention, providing retirement security to employees, and allowing the firm's personnel costs to move along with revenues.

It is clear, however, that compensation arrangements at many financial institutions provided executives and employees with incentives to take excessive risks that were not consistent with the long-term health of the organization. Some managers and employees were offered large payments for producing sizable amounts of short-term revenue or profit for their financial institution despite the potentially substantial short- or long-term risks associated with those revenue or profits. Although the existence of misaligned incentives surely is not limited to financial institutions, they can pose special problems for financial institutions given the ability of financial institutions to quickly generate large volumes of transactions and the access of some institutions to the federal safety net.

The compensation programs of many financial institutions incorporated payment features and oversight, control, and review processes intended to help restrain inappropriate risk-taking. Moreover, banking organizations, with the support and urging of federal supervisors, developed risk-management controls and frameworks to identify, assess, and manage the firm's risk-taking.

However, in some cases, the incentives created by incentive compensation programs to undertake excessive risk appear to have been powerful enough to overcome the restraining influence of these processes and risk controls. In addition, the risk-management controls and frameworks of some financial institutions themselves suffered from deficiencies that limited their ability to act as a brake on excessive risk-taking. For example, the risk-management systems of many financial institutions did not fully recognize or "capture" all relevant risks with certain business activities, especially those associated with innovative or complex products, fast-growing business lines, or funding needs. And in many instances, risk-management frameworks did not adequately take account of the potential for compensation arrangements themselves to be a source of risk for the firm. The risk-management personnel and processes at financial institutions, thus, often played little or no role in decisions regarding compensation arrangements. It is possible that aggressive pursuit of highly skilled financial specialists in recent years caused some financial institutions to relax or forego usual safeguards and controls in the interest of hiring and retaining what they believed to be the best talent.

These weaknesses were not limited just to financial institutions in this country. These types of problems were widespread among major financial institutions worldwide, a fact recognized by the governments comprising the Group of Twenty, international bodies such as the Financial Stability Board (FSB), and the industry.

Need for Improvements

Looking forward, it is clear that more must be done by financial institutions and supervisors to better align compensation practices with sound operations and long-term performance. Major banking organizations appear to be aware of the need for better practices. The boards of directors and senior management of many organizations are taking a much-needed look at their existing compensation arrangements. In many cases, they are doing so with the strong encouragement of institutional investors and other shareholders.

Correcting these weaknesses will require improvements in both corporate governance and risk management at financial institutions. Boards of directors and senior management of major financial institutions must act to limit the excessive risk-taking incentives within compensation structures and bolster the risk controls designed to prevent incentives from promoting excessive risk-taking. In many cases, boards of directors that have analyzed the connections between incentive compensation and risk-taking have focused only on a handful of top managers. However, incentive problems may have been more severe a few levels down the management structure than for chief executive officers (CEOs) and other top managers. Indeed, recent experience indicates that poorly designed compensation arrangements for business-line employees--such as mortgage brokers, investment bankers, and traders--may create substantial risks for some firms. Thus, boards of directors must expand the scope of their reviews of compensation arrangements.

The Federal Reserve also is actively working to incorporate the lessons learned from recent experience into our supervision activities. As part of these efforts, we are in the process of developing enhanced guidance on compensation practices at U.S. banking organizations. The broad goal is to make incentives provided by compensation systems at bank holding companies

consistent with prudent risk-taking and safety and soundness. In developing this guidance, we are giving careful thought to the fundamental sources of incentive problems, as well as to the rationale for, and role of, possible action by supervisors in this area. This process includes drawing on the broad range of expertise within the Federal Reserve, as well as on available research concerning the underlying economic forces at work and how they may influence the design, implementation, and likely effects of incentive compensation systems. In addition, we are drawing on our experience in implementing existing regulations and guidance in order to ensure that our efforts are balanced, effective, and work in concert with other supervisory and management tools in pursuit of prudent risk-taking.

Forces Giving Rise to Incentive Misalignment

At least two factors directly influence how compensation might affect the safety and soundness of financial institutions. First, shareholders cannot directly control the day-to-day operations of a firm--especially a large and complex firm--and must rely on the firm's management to do so, subject to direction and oversight by shareholder-elected boards of directors. Incentive compensation arrangements are one way that firms can encourage managers to take actions that are in the interests of shareholders and the long-term health of the firm. However, compensation programs can incentivize employees to take additional risk beyond the firm's tolerance for, or ability to manage, risk in the course of reaching for more revenue, profits, or other measures that increase employee compensation. Second, where managers have substantial influence over compensation arrangements, they may use that influence to create or administer incentive arrangements in ways that primarily advance the short-term interests of managers and other employees, rather than the long-term soundness of the firm.

Collective action or "first mover" problems may make it difficult for individual firms to act alone in addressing misaligned incentives. Even if the owners of an individual firm do not like the way compensation is structured at their firm, they may be unwilling to make unilateral changes because doing so might mean losing valuable employees and business to other firms. In this context, the problems are a side-effect of labor market competition, which itself has positive societal benefits.

Supervisors can play an important and constructive role in counteracting the impact of these forces on the safety and soundness of financial institutions. First, supervisors can press all financial institutions, especially those active in business lines for which incentive payments are common and large, to adopt sound compensation practices that restrain inappropriate incentives, but that each institution might be wary of adopting alone. By doing so, supervisors can help to better align the interests of managers and other employees with the long-term health of the organization, and also reduce firms' concerns about the potential for adverse competitive consequences from prudently modifying their compensation arrangements. Second, supervisors can usefully add to the impetus for improvement in compensation practices that is already coming from shareholders, directors, and other stakeholders.

Existing Policies and Practices Related to Compensation

Our supervisory experience also provides important perspectives as we seek to move forward. Since 1995, the Federal Reserve and the other federal banking agencies have had in place interagency standards for safety and soundness (Standards) for all insured depository institutions.[2] These Standards, which were adopted pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), prohibit as an unsafe or unsound practice both

[2] See Regulation H--Membership of State Banking Institutions in the Federal Reserve, 12 C.F.R. part 208, appendix D-1.

excessive compensation and any compensation that could lead to material financial loss to the insured depository institution. The Standards provide that compensation will be considered excessive if the amounts paid are unreasonable or disproportionate to the services performed by the relevant executive officer, employee, director, or principal shareholder and set forth a variety of factors that will be considered in determining whether compensation paid in a particular instance is unreasonable or disproportionate. Importantly, FDICIA specifically prohibits the agencies from using the Standards to prescribe a specific level or range of compensation permissible for directors, officers, or employees of insured depository institutions.

More recently, in November 2008, the Federal Reserve, in conjunction with the other federal banking agencies, issued an interagency statement reminding banking organizations that they are expected to regularly review their management compensation policies to ensure that they are consistent with the longer-run objectives of the organization and sound lending and risk-management policies.[3] This statement provides that management compensation policies should be aligned with the long-term prudential interests of the institution, should provide appropriate incentives for safe and sound behavior, and should structure compensation to prevent short-term payments for transactions with long-term horizons. In addition, it states that management compensation practices should balance the ongoing earnings capacity and financial resources of the banking organization, such as capital levels and reserves, with the need to retain and provide proper incentives for strong management.

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[3] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," joint press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

The Federal Reserve also was actively involved in the development of the Principles for Sound Compensation Practices issued by the Financial Stability Board in April 2009.[4] These principles, which are aimed primarily at large financial institutions, establish a common set of guidelines designed to help address the compensation-related lessons learned from the crisis and ensure that compensation practices at large financial institutions do not encourage imprudent risk-taking. The international nature of the FSB is particularly important because competition among financial institutions--both for business and talent--is increasingly global in nature.

Enhancing Compensation Practices, Corporate Governance and the Risk-Sensitivity of Compensation Arrangements

Designing and implementing compensation arrangements that properly incent managers and employees to pursue the firm's long-term well being is a highly complex task. Indeed, there is no generally accepted view as to the optimal way to achieve these objectives at an individual firm or across the financial sector. Our recent and continuing work in this area, however, suggests that there are certain key principles that can serve as important guides to efforts by financial institutions and supervisors to better align compensation practices with the safety and soundness of financial institutions.

Broad Review of Compensation Practices. First, care must be taken to properly align the incentives of compensation paid to employees throughout an organization. It is not sufficient to focus only on compensation paid to senior executives. Employees throughout a firm may expose the firm to significant risk, and improperly designed compensation programs may incent a wide range of employees to take on risk that, in the aggregate, is inappropriate or excessive. For

[4] The FSB was established to address vulnerabilities and to develop and implement strong regulatory, supervisory, and other policies in the interest of financial stability. It is composed of senior representatives of national financial authorities (central banks, regulatory and supervisory authorities, and ministries of finance), international financial institutions, standard setting bodies, and committees of central bank experts. For more information on the FSB, see www.financialstabilityboard.org/index.htm.

example, sales employees who are compensated based on the volume of transactions without adjustments for noncompliance with legal requirements may be incented to ignore--or at least pay insufficient attention to--applicable laws and regulations.

Making Compensation More Sensitive to Risk. Second, compensation practices should not reward employees with substantial financial awards for meeting or exceeding volume, revenue, or other performance targets without due regard for the risks of the activities or transactions that allowed these targets to be met. One key to achieving a more balanced approach between compensation and risk is for financial institutions to adjust compensation so that employees bear some of the risk associated with their activities as well as sharing in increased profit or revenue. An employee is less likely to take an imprudent risk if incentive payments are reduced or eliminated for activity that ends up imposing higher than expected losses on the firm.

There are several ways that compensation can be adjusted for risk. For example, one approach involves deferring some or all of an incentive compensation award and reducing the amount ultimately paid if the earnings from the transactions or business giving rise to the award turn out to be less than had been projected. Another way to improve the risk sensitivity of compensation is to take explicit account of the risk associated with a business line or employee's activities--such as loan origination or trading activities--in the performance measures and targets that determine the amount of incentive compensation initially awarded.

Both approaches offer promise, but both have important limitations as well. For example, ready job mobility poses a major challenge to deferral-oriented restraints on incentives, especially if the employee is able to receive some or all of the deferred amounts upon departure or the employee's new firm is willing to provide a signing bonus equivalent in value to any

deferred compensation left behind at the prior firm. Deferral arrangements also can pose a variety of contractual, legal, tax, and technical challenges. In addition, adjusting incentive compensation targets and amounts to account for risk requires an institution to have reasonably accurate indicators of *all* risks relevant to the business line or activity being rewarded. However, the quality of risk indicators is uneven across activities and types of risk. For example, substantial challenges exist to the development of reliable indicators for certain types of risk, such as reputational, liquidity, and compliance risk. The aggregation of different types of risks into a single risk metric also is a highly complex and difficult process that involves substantial judgments. Moreover, organizations, experts, and researchers to date have not focused much attention on how proper risk-adjusted compensation arrangements could be designed for the many lower-level employees outside the ranks of senior management. Developing and implementing an appropriately risk-sensitive compensation system across the full range of a large firm's businesses will be a highly complicated and difficult task.

Firms have had some success in incorporating risk into deferred compensation, particularly for senior management, by paying performance awards in the form of company stock with multi-year vesting requirements. However, while this might be one important component of a sound incentive compensation system, stock-based compensation has not proven to be a panacea. Compensating top executives in the form of stock and deferring payouts through multi-year vesting and holding requirements did not prevent executives at some firms from permitting their firms to take on risks that endangered the firm's health and, by implication, a substantial part of the executives' own wealth. Experience suggests that it is difficult to incentivize senior managers to reduce risk by altering business practices that have been lucrative in the past or that appear to be profitable for competing firms. In addition, equity-based incentive compensation

may be less effective in aligning the incentives of mid- and lower-level employees with the interests of the firm because these employees may view the outcome of their decisions as unlikely to have much effect on the firm or its stock price.

Let me be clear--these limitations do not suggest that supervisors and firms should not move quickly to improve compensation arrangements. Rather, they simply highlight that more work and attention must be devoted to understanding and developing compensation practices that promote the proper incentives, which will require some time and perhaps investment by the industry. It also means that judgment and common sense will and should play a continuing and important role in the compensation structures of financial institutions, particularly while institutions work towards developing better quantitative measures for risk-adjusting compensation. In addition, these limitations highlight the need for both experimentation and flexibility in approaches by financial institutions. One size certainly does not fit all, and institutions will need to have flexibility as they work toward implementing appropriate risk-sensitive incentive compensation across the wide diversity of their operations.

Risk Management and Corporate Governance. Third, more can and should be done to improve risk management and corporate governance as it relates to compensation practices. Our discussions with market participants and supervisory experience suggest that risk controls are a necessary complement to--and not a substitute for--prudent compensation systems in protecting against excessive risk-taking. Risk controls take many forms, but they can have their full effect only if governance processes are sound and risk managers have the influence, incentives, and resources to play their proper role. For these reasons, it is critical that the compensation for risk management and control functions at financial firms be adequate to attract personnel with

appropriate expertise and that these personnel not be compensated based on the financial performance of the business line for which they are responsible.

Review of a firm's compensation practices also must involve the board of directors. The board of directors provides an important link between the shareholders of a firm and its management and employees. Active engagement by the board of directors or, as appropriate, its compensation committee, in the design and implementation of compensation arrangements promotes alignment of the interests of employees with the long-term health of the organization.

Boards of directors will need to take a more informed and active hand in making sure that compensation arrangements throughout the firm strike the proper balance between risk and profit, not only at the initiation of a compensation program, but on an ongoing basis. For example, the role of the board of directors or, in appropriate circumstances, its compensation committee should include review and approval of the key elements of the firm's compensation system, after-the-fact evaluations of how well the firm's compensation systems have achieved their objectives, and an understanding and evaluation of the internal controls and risk-management processes related to compensation. For this engagement to be most effective, members of the boards of directors and, where appropriate, their compensation committees must have the experience, knowledge, and resources needed to understand and address the complex interactions and incentives created by compensation programs firm-wide.

Importantly, if incentive compensation arrangements are going to achieve their intended purposes--including managing risk and improving performance--the standards governing the arrangements at each firm must be regularly and symmetrically applied. Firms must not only provide rewards when performance standards are met or exceeded, they must also reduce compensation when standards are not met.

Conclusion

Improving compensation practices at financial institutions is important. Compensation arrangements must continue to allow financial institutions to attract, retain, and motivate talented employees, but they also must not provide incentives for managers and employees to take excessive risks. And while the issues and concerns associated with improperly designed compensation practices are common, no single compensation system will address all types of risks or work well in all types of firms. Each firm ultimately must determine how to address these matters in a way most suited to that firm's business, structure, and risks.

Improvements in compensation practices are likely to be harder to make and take longer than anyone would like. Companies compete for talented employees in a global market. This creates a collective action problem: No firm wants to be the first to appear to reduce compensation even if that would be in the firm's long-term interest. The risk of losing the firm's best employees or being unable to hire new quality personnel is likely to appear too great.

Encouragement by supervisors, shareholders, and others can help alleviate this problem. However, regulation that is too severe and that does not recognize that the market for quality employees is global will threaten more harm than it will do good. The Federal Reserve currently is developing enhanced guidance that seeks to strike this balance and promote safe and sound compensation practices at financial institutions under our jurisdiction.

I appreciate the Committee's interest in this important topic and am happy to answer any questions you may have.

Written Testimony Submitted by
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Before the
Committee on Financial Services
United States House of Representatives
Hearing on Compensation Structure and Systemic Risk
June 11, 2009

Mr. Chairman and distinguished members of the Committee, thank you very much for inviting me to testify today.[1]

Below I discuss how executive pay arrangements have produced incentives for excessive risk-taking and contributed to bringing about the current financial crisis, how compensation arrangements can be reformed to avoid such incentives, and what role the government should play in bringing about such reforms.

Section I describes the distortions that have been produced by the short-term focus of pay arrangements, and discusses the best ways for tying executive pay – particularly equity compensation – to long-term results. Section II describes another separate and important source of incentives that has thus far received little attention but that could well have contributed substantially to excessive risk-taking in financial firms: the tying of executive payoffs to levered bets on the value of the bank's capital. That section also discusses how this problem can be best addressed.

Finally, section III discusses the role of the government. For financial firms that pose systemic risks, bank regulators seeking to protect the safety and soundness of such firms should monitor and regulate the extent to which pay arrangements provide incentives for risk-taking. For other publicly traded firms, the government's role should be limited to strengthening the rights of shareholders and the governance processes inside firms, and the government should avoid intervening in the substantive choices made by the firms.

[1]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.

A fuller development of some of the points made in Section I can be found in "Equity Compensation for Long-term Performance," a forthcoming white paper co-authored with Jesse Fried. Sections II and III draw on "Regulating Bankers' Pay," a discussion paper co-authored with Holger Spamann, which develops more fully the points made in these sections and is attached as an Appendix.

For simplicity of exposition, I will use the term "banks" to refer also to any other financial institutions that are deemed to pose systemic risk and are therefore the subject of potential government support and government regulation.

I. PAYING FOR LONG-TERM PERFORMANCE

Much attention is now focused on the fact that pay arrangements have provided executives with incentives to focus on short-term results. This problem was first highlighted in a book that Jesse Fried and I published five years ago, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, [2] and in a series of accompanying articles.[3] It has recently become widely recognized.[4]

Standard pay arrangements reward executives for short-term results even when these results as subsequently reversed. The ability to take a large amount of compensation based on short-term results off the table provides executives with powerful incentives to seek short-term gains even when they come at the expense of long-term value, say, by creating latent risks of implosion later on.

Because there is now widespread consensus that executives' interests should be tied to long-term performance, the remaining question is how best to do so. The devil, as is often the case, is in the details. Because of the scope of this written testimony, I will limit myself in this section to a brief

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[2] Lucian A. Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE (2004).

[3] Lucian A. Bebchuk, Jesse Fried, & David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 UNIVERSITY OF CHICAGO LAW REVIEW 751-846 (2002); Lucian A. Bebchuk & Jesse Fried, *Executive Compensation as an Agency Problem*, 17 JOURNAL OF ECONOMIC PERSPECTIVES 71-92 (2003); Lucian A. Bebchuk & Jesse Fried, *Pay without Performance: Overview of the Issues*, JOURNAL OF APPLIED CORPORATE FINANCE 8-22 (2005).

[4] *See, e.g.*, the statement by the chairman of the Federal Reserve System, Ben S. Bernanke, *The Financial Crisis and Community Banking*, speech given at the Independent Community Bankers of America's National Convention and Techworld, Phoenix, Arizona (03/20/2009), available at http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm#fn3; Lloyd Blankfein, *Do not destroy the essential catalyst of risk*, FINANCIAL TIMES 02/09/2009, p. 7.

discussion of how best to tie equity-based compensation – a central component of standard pay arrangements – to long-term shareholder value.

Grants of equity incentives – options and restricted shares – usually vest gradually over a period of time. A specific number of options or shares vest each year, and the vesting schedule provides executives with incentives to remain with the company (the longer they stay, the greater their entitlement to vested options or shares). Once options and shares vest, however, executives typically have unrestricted freedom to cash them out, and executives often unload them quickly after vesting. This broad freedom to cash out equity incentives has contributed substantially to creating short-term distortions.

To address these distortions, it is desirable to separate, as Jesse Fried and I proposed in *Pay without Performance*, the time that options and restricted shares can be cashed out from the time in which they vest. As soon as an executive has completed an additional year at the firm, the options or shares that were promised as compensation for that year's work should vest, and they should belong to the executive even if the executive immediately leaves the firm. But vested options and shares should be "blocked" for a specified period after vesting – the executive should be allowed to cash them out only down the road, which would tie the executive's payoffs to long-term shareholder value.

Some shareholder proposals and compensation experts have recently been calling for allowing executives to cash out shares and options only upon retirement from the firm. Such a "hold-till-retirement" requirement, however, would not be the best way to go.

Most importantly, such a requirement would provide executives with a counter-productive incentive to leave the firm in order to cash out their stock 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 of an especially large value. Rather than supplying retention incentives, equity compensation with hold-till-retirement requirements would have the opposite effect.

Similar problems arise under any arrangement tying the freedom to cash out to an event that is at least partly under an executive's control. Consider, for example, the Administration's proposal last February that executives of companies receiving TARP funding be permitted to unload shares only after their firms return the funding to the government. Such an arrangement would incentivize executives to return TARP funding even when they shouldn't be doing so, and it would have little beneficial effect on executives who are anyway expecting to return the funding before too long.

To avoid the above problems, the period during which the vested options and shares are "blocked" and may not be cashed out should be fixed. For example, when options or shares of an executive vest, one-fifth of them could become unblocked, and the executive would be subsequently free to cash them out, in each of the subsequent five years. Because the executive would not be able to accelerate the time of cashing out, this arrangement wouldn't provide distorted incentives arising from desire to obtain such acceleration. And as long as the executive is working for the firm and options and shares continue to vest, the executives would always have an incentive to care about the company's share value several years down the road.

Restricting the freedom to cash out vested options and shares for a substantial period after vesting should be only one component (albeit an important one) of the necessary overhaul of equity compensation arrangements. Other elements are necessary to prevent "gaming" at either the front-end (the time of the award) or the back-end (the time of the cashing out) as well as to prevent executives from undoing the effects of the link to long-term share value by using hedging or derivative transactions. A detailed discussion of these elements can be found in my work with Jesse Fried.[5]

II. THE LEVERAGING OF BANK EXECUTIVES' PAYOFFS

I have thus far discussed problems arising from the short-term focus of standard pay arrangements. These problems have afflicted companies in general – though their consequences might have been especially severe in the case of financial firms – and reforms of the kind discussed in the preceding section should be adopted by both financial and non-financial firms. I now turn to a separate and important source of incentives for excessive risk-taking that is especially relevant for the case of banks.

An analysis of banks' financing structure and compensation arrangements shows that bank managers' incentives have been tied to a highly leveraged bet on banks' assets. Because top bank executives were paid with shares of a bank holding company or options on such shares, and both banks and bank holding companies obtained capital from debt-holders, executives faced asymmetric payoffs, expecting to benefit more from large gains than to lose from large losses of a similar magnitude. As institutions that receive much of their funding from deposits, banks are inherently levered. But the standard structure of large banks – whose equity is generally owned by bank holding companies and which pay their executives partly with stock options on the bank holding company's common shares – have added two or three additional layers of leverage.

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[5] *See* Lucian A. Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, unpublished manuscript, forthcoming as HARVARD LAW & ECONOMICS DISCUSSION PAPER No. _ (2009).

The basic point can be seen using a simple example. A bank has $100 of assets financed by $90 of deposits and $10 of capital, of which $4 come from the bank's bondholders and $6 are equity; the bank's equity is in turn held by a bank holding company, which is financed by $2 from the bank holding company's bondholders and $4 of equity and has no other assets; and the bank manager is compensated with some shares in the bank holding company. On the downside, limited liability protects the manager from the consequences of any losses beyond $4. By contrast, the benefits to the manager from gains on the upside are unlimited. If the manager does not own stock in the holding company but rather options on its stock, the incentives are even more skewed. For example, if the manager is paid only with options with an exercise price equal to the current stock price, and the manager makes a negative-expected-value bet, the manager may have a great deal to gain if the bet turns out well and little to lose if the bet turns out poorly.

The crisis has not eliminated the incentives of bank executives to take actions that are beneficial to common shareholders of the bank holding company (or holders of options on such common shares) but are costly to bondholders, depositors, and the government as guarantor of depositors. Indeed, for some banks, the crisis might have made the divergence of interest even worse by reducing the value of executives' shares, and options to buy shares, in the banks' holding companies. Such reductions increase the divergence between the interests of executives and the aggregate interests of the bondholders, depositors, and the government as guarantor of deposits (and preferred shareholder in some banks).

The measures adopted by Congress and proposed by the Treasury to regulate executive pay in banks receiving TARP funds – the use of restricted stock in incentive pay and say-on-pay advisory shareholder votes on compensation – attempt to tighten the alignment of the interests of executives and the common shareholders of bank holding companies. The above analysis of the divergence of interest between shareholders and contributors of capital to the bank that are senior to the shareholders indicates that this strategy would not address the identified problem. This is because the shareholders' interests could well be served by the taking of risks that are detrimental to the government's interests as preferred shareholder and guarantor of some or all of the banks' debt. Accordingly, these interests of the government would not be advanced by strengthening the link between executives' interests and those of the shareholders of bank holding companies.

How could pay arrangements be re-designed to address the identified distortion? To the extent that executive pay is tied to the value of specified securities, it could be based on a broader basket of securities and not only common shares. Rather than tying an executive's pay to a specified percentage of the value of the common shares of the bank holding company, it could be tied to a specified percentage of the aggregate value of the common shares, the preferred shares, and the bonds issued by either the bank holding company or the bank. In addition, it could be

useful to tie the executive's payoff also to changes in a measure (possibly based on the price of credit default swaps reflecting the probability of default) that reflects changes in the expected costs to the government from the prospect of having to bail out the bank down the road.

Similarly, to the extent that executives receive bonus compensation based on accounting measures, such bonuses could be based not on metrics that reflect the interests of common shareholders, such as earnings per share, but rather on broader metrics that reflects also the interests of preferred shareholders, bondholders, and the government as guarantor of deposits. Such changes in compensation structures would induce executives to take into account the effects of their decisions on preferred shareholders, bondholders, and depositors and thereby would curtail incentives to take excessive risks.

III. The Role of Government

Having discussed what changes in pay arrangements would curtail incentive to take excessive risks in banks as well as other firms, I turn to the question of what role if any the government should play in bringing about such changes. Some would argue that, even accepting the desirability of significant changes, making such changes should be left to unconstrained choices by private decision-makers and that, at least for firms not receiving public funding, the government should not play any role in the setting of executive compensation.

Non-financial firms

For public firms that are not banks (or other financial firms posing systemic risk), the government should not seek to limit the substantive arrangements from which private decision-makers may choose. For such firms, the government should solely focus on improving internal governance processes, and then not intervene in the substantive choices made by shareholders and the directors elected by them.

To improve the internal governance processes, it is desirable to strengthen shareholder rights and shareholders' role in corporate decision-making. I have already testified on this subject two years ago before this committee in a hearing on "Empowering Shareholders on Executive Compensation." As I stressed then, shareholders' rights in U.S. public firms are significantly weaker relative to the U.K. and other common law countries. In addition to introducing advisory say-on-pay votes, it is important to strengthen shareholder rights in a number of other ways. In

particular, it would be desirable to dismantle existing impediments to shareholders' ability to replace directors and to shape companies' corporate governance arrangements.[6]

Financial firms posing systemic risks

I now turn to banks (as well as any other financial firms that under our new financial order will be deemed to pose systemic risk and therefore be the subject both of government protection and regulation). To protect the safety and soundness of banks and limit risks to the government and the economy, regulators have long been monitoring and regulating the capital, lending, and investment decisions of banks.

Because the setting of pay arrangements can also have substantial consequences for the risks posed by a bank to the government and the economy, banks' regulators should going forward also monitor and regulate the structure of executive compensation in banks. Regulation of executive pay should be an important element of banking regulation in the new financial order, and should remain so long after no banks remain publicly supported.

It might be suggested that it would be sufficient for the government to ensure the adequacy of the internal governance processes that produce executive pay in banks. And government authorities around the world have been paying increasing attention to improving these processes within banks. The Basle committee of bank supervisors has been stressing the importance of the involvement of banks' boards in pay setting, and both the Obama administration and Congress have sought to facilitate shareholder involvement by introducing say-on-pay advisory votes.

As is the case for non-financial firms, the government should indeed seek to improve the internal governance and pay-setting processes within banks. In the case of banks, however, the government's role should go beyond ensuring the integrity of internal governance processes. Banks are special. And their special circumstances call for banking regulators' monitoring and limiting the structure – that is, the substantive terms of pay arrangements – and not only the processes producing them.

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[6] For a detailed discussion of why and how shareholders' power to replace directors should be strengthened, see Bebchuk, "The Myth of the Shareholder Franchise," 93 Virginia Law Review 675-732 (2007).

For a detailed discussion of why and how shareholders' power to adopt governance arrangements should be strengthened, see Bebchuk, "The Case for Increasing Shareholder Power," 118 *Harvard Law Review* 833-914 (2005); Bebchuk, "Letting Shareholders Set the Rules," 119 *Harvard Law Review* 1784-1813 (2006).

When a bank takes risks, shareholders can expect to capture the full upside but part of the downside might be borne by the government as guarantor of depositors. Because bank failure will impose costs on the government and the economy that shareholders do not internalize, shareholders' interests would be served by more risk-taking than would be in the interest of the government and the economy.

Because shareholders could be served by excessive risk-taking, private decision-making by banks is already substantially constrained by detailed body of regulations that, among other things, restricts private choices with respect to the investments and loans that a bank might make and the reserves it must maintain.

Shareholders' interest in more risk-taking implies that they could benefit from providing bank executives with incentives to take excessive risks. Executives with such incentives could use their informational advantages and whatever discretion traditional regulations leave them to increase 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. Thus, when executives have incentives to do so, they might be able to take risks beyond what is intended or assumed by the regulators, who might often be one step behind banks' executives.

Because shareholders may benefit from certain increases in risk-taking, they may have an interest in executives' having incentives to take excessive risks. As a result, substantive regulation of the terms of pay arrangements – limiting the use of structures that reward excessive risk-taking – can advance the goals of banking regulation. The regulators' focus should be on the structure of compensation – not the amount – with the aim of discouraging the taking of excessive risks. By doing so, regulators would induce bank executives to work for, not against, the goals of banking regulation.

Opponents of pay regulation in banks will argue that the government does not have a legitimate interest in telling bank shareholders how to spend their money. But it does. Given the government's interest in the safety and soundness of banks, government intervention here will be as legitimate as the traditional forms of intervention, which limit banks' investment and lending decisions.

Opponents of regulating executive pay in banks will also argue that regulators will be at an informational disadvantage when setting pay arrangements. But placing limits on compensation structures that incentivize risk-taking would be no more demanding in terms of information than regulators' direct intervention in investment, lending, and capital decisions Furthermore, the setting of pay arrangement should not be left to the unconstrained choices of informed players

inside banks because such players do not have incentives to take in account the interests of bondholders, depositors and the government in setting pay.

The regulation of bankers' pay could nicely supplement and reinforce the traditional, direct regulation of banks' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities could be less tight than it should otherwise be. 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 pay arrangements encourage risk-taking, regulators should monitor the bank more closely and should consider raising its capital requirements.

Monitoring and regulating the substantive terms of compensation of bank executives can and should be a critical instrument in the toolkit of banking regulators. It would help ensure that banks and the economy don't suffer in the future from the excessive risk-taking that we have witnessed in the years leading to the current financial crisis.

Appendix to written testimony submitted
by Professor Lucian A. Bebchuk

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REGULATING BANKERS' PAY

Lucian A. Bebchuk and Holger Spamann

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REGULATING BANKERS' PAY

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Abstract

This paper contributes to understanding the role of executive compensation as a possible cause of the current financial crisis, to assessing current legislative and regulatory attempts to discourage bank executives from taking excessive risks, and to identifying how bankers' pay should be reformed and regulated going forward.

Although there is now wide recognition that bank executives' decisions might have been distorted by the short-term focus of pay packages, we identify a separate and critical distortion that has received little attention. Because bank executives have been paid with shares in bank holding companies or options on such shares, and both banks and bank holding companies issued much debt to bondholders, executives' payoffs have been tied to highly levered bets on the value of the capital that banks have. These highly levered structures gave executives powerful incentives to take excessive risks.

We show that current legislative and regulatory attempts to discourage bank executives from taking excessive risks fail to address this identified distortion. In particular, adopted and proposed measures aimed at aligning the interests of executives tightly with those of the common shareholders of bank holding companies – through emphasizing awards of restricted common shares in these companies and introducing "say on pay" votes by these shareholders – do not eliminate the divergence between executives' interests and the aggregate interests of all those with a stake in the bank. The common shareholders of bank holding companies, especially now that the value of their investment has decreased considerably, would favor different strategies than that would be in the interest of the government as preferred shareholder and guarantor of some of the bank's obligations.

Finally, having identified the problems with current legislative and regulatory attempts, we analyze how best to implement recent legislative mandates that require banks receiving TARP funding to eliminate incentives to take excessive risks. Beyond banks receiving governmental support, we argue that monitoring and regulating bankers' pay should be an important element of banking regulation in general, and we analyze how banking regulators should assess and regulate bankers' pay.

Keywords: Executive compensation, banks, financial firms, financial crisis, TARP, restricted shares, options, moral hazard, risk-taking.
JEL Classification: G28, K23

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I. INTRODUCTION

Excessive risk in the banking sector seems to be the cause of what is now the deepest economic crisis since the Great Depression. There is widespread concern that executive compensation arrangements are partly to blame, and that fixing these arrangements will be extremely important in resolving the current crisis and preventing similar events in the future. But what exactly has been wrong with bank executives' pay and how should it be fixed going forward? These are the questions on which we focus in this paper.

We explain how banks' financing structures and incentive pay arrangements incentivized executives to take excessive risks, how these incentives were amplified by the crisis, and why understanding this problem is important for effective reform. In essence, the problem is that bank executives' payoffs have been tied to highly levered bets on the value of banks' assets. We show that the measures thus far adopted or proposed by Congress and the administration do not address the critical problem that we identify, and we suggest how compensation should be structured going forward to deal with the problem. Beyond the current crisis, we argue for employing the lever of executive compensation as an important element of banking regulation. Regulating executive pay in banks can nicely complement, and may partially substitute for, prudential regulation of banks' capital and risk.

Much attention is now focused on the fact that pay arrangements have provided executives with incentives to focus on short-term results.[7] They have enabled executives to take money off the table before it turned out that gains to earnings and stock prices were in fact illusory. This problem was first highlighted several years ago in a book and accompanying

[7] *See, e.g.*, the statement by the chairman of the Federal Reserve System, Ben S. Bernanke, *The Financial Crisis and Community Banking*, speech given at the Independent Community Bankers of America's National Convention and Techworld, Phoenix, Arizona (03/20/2009), available at http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm#fn3 (accessed 03/23/2009) (declaring "poorly designed compensation policies can create perverse incentives that can ultimately jeopardize the health of the banking organization. Management compensation policies should be aligned with the long-term prudential interests of the institution, be tied to the risks being borne by the organization, provide appropriate incentives for safe and sound behavior, and avoid short-term payments for transactions with long-term horizons.") and the statement by the CEO of Goldman Sachs, Lloyd Blankfein, *Do not destroy the essential catalyst of risk*, FINANCIAL TIMES 02/09/2009, p. 7 (arguing that "An individual's performance should be evaluated over time so as to avoid excessive risk-taking. To ensure this, all equity awards need to be subject to future delivery and/or deferred exercise. Senior executive officers should be required to retain most of the equity they receive at least until they retire, while equity delivery schedules should continue to apply after the individual has left the firm.")

articles co-authored by one of us,[8] and has recently become widely recognized.[9] There is no question that short-termism could have contributed to excessive risk-taking, and a contemporaneous paper co-authored by one of us with Jesse Fried shows how compensation arrangements can be best designed to eliminate the potential distortions from such short-termism.[10] But we identify in this paper some other key features or current and past pay arrangements that would lead to excessive risk-taking even in a world with one period in which there are naturally no problems related to the length of executives' horizon.

Both the Emergency Economic Stabilization Act of 2008 (also known as the TARP bill) and the American Recovery and Reinvestment Act of 2009 (the so-called stimulus bill) require the elimination of incentives to take "unnecessary and excessive risks" in firms receiving TARP funds.[11] The Treasury's recent statements on financial sector reform reaffirm the importance of this mandate.[12] To operationalize this mandate, however, a clear understanding of the factors that provided such harmful incentives is necessary. As commentators have noted, such an understanding has so far been lacking.[13] Our analysis elucidates the source of excessive risk-taking incentives in pay arrangements and thereby contributes to implementing the existing legislative mandate.

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[8] Lucian A. Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE (2004), Lucian A. Bebchuk, Jesse Fried, & David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 UNIVERSITY OF CHICAGO LAW REVIEW 751-846 (2002); Lucian A. Bebchuk & Jesse Fried, *Executive Compensation as an Agency Problem*, 17 JOURNAL OF ECONOMIC PERSPECTIVES 71-92 (2003); Lucian A. Bebchuk & Jesse Fried, *Pay without Performance: Overview of the Issues*, JOURNAL OF APPLIED CORPORATE FINANCE 8-22 (2005).

[9] *Cf., e.g.*, the shareholder proposals submitted by AFSCME during the 2009 proxy season suggesting that executives be required to hold their shares in the company until two years past retirement, *see* AFSCME press release of 01/27/2009 available at http://www.afscme.org/press/24815.cfm, accessed 03/29/2009. For a recent review of the literature, *see* Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, YALE LAW & ECONOMICS RESEARCH PAPER NO. 374 (February 2009).

[10] *See* Lucian A. Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, unpublished manuscript, forthcoming as HARVARD LAW & ECONOMICS DISCUSSION PAPER No. ____ (2009).

[11] *See infra* notes 55 and 56 and accompanying text.

[12] *Cf.* Treasury Secretary Timothy F. Geithner, Written Testimony House Financial Services Committee Hearing, March 26, 2009, available at http://www.treas.gov/press/releases/tg71.htm, accessed 03/31/2009 (arguing that "regulators must issue standards for executive compensation practices across all financial firms ... [that] encourage prudent risk-taking ... and should not otherwise create incentives that overwhelm risk management frameworks.").

[13] *See infra* note 57.

In addition to the general mandate, Congress and the Treasury have adopted a number of concrete provisions addressing executive compensation in firms receiving TARP funds. We show, however, that these provisions do not address the incentives to take excessive risks that we identify and may in fact make them worse. In particular, Congress and the administration have focused on requiring TARP recipients to pay incentive compensation only in the form of restricted stock and to submit pay arrangements to a non-binding shareholder vote ("say-on-pay"). These measures serve to align the incentives of executives with those of shareholders. But the interests of the shareholders of TARP recipients considerably differ from those of the government as a preferred shareholder and as a formal or implicit guarantor of obligations. These shareholders could well benefit from taking excessive risks at the expense of preferred shareholders and debt-holders.[14] We suggest that Congress should attempt to decouple bank managers' incentives from those of shareholders, rather than aligning them.

Our analysis of bankers' incentives and the role of executive compensation has implications far beyond the current crisis and compensation in banks receiving TARP funds. We argue for regulating the pay of bank executives as an important element of banking regulation. Our approach would structure executive compensation for banks to incentivize top bankers to take into account the effects of their decisions not on a thin slice of equity (or even just an option on the value of this equity) but rather on the value of all of the bank's assets – or at least on all the contributors to the bank's capital, including preferred shareholders and debt-holders. At the minimum, banking regulators should monitor executive pay in banks and take into account the existence of the problems we identify in carrying out their bank oversight functions.

Part II begins our analysis by describing the incentives of banks' top executives in the run-up to the current crisis. The analysis of banks' financing structure and compensation arrangements shows that bank managers' incentives arose from an extremely levered bet on banks' assets. Because top bank executives were paid with shares of a bank holding company or options on such shares, and both banks and bank holding companies obtained capital from debt-

[14] Some may wonder why the banks appear not to be lending at the moment if, as we argue, they have an incentive to take risks. But we do not argue that banks will take *any* gamble. If the perceived odds are too unfavorable, even risk-loving banks will hold back lending. One of us has argued elsewhere that banks might rationally withhold lending for reasons of coordination failure, *see* Lucian A. Bebchuk & Itay Goldstein, *Self-Fulfilling Credit Market Freezes*, HARVARD LAW & ECONOMICS DISCUSSION PAPER No. 623 (December 2008); and for a proposal how to solve that problem, Lucian A. Bebchuk, *Unfreezing Credit Markets*, HARVARD LAW & ECONOMICS DISCUSSION PAPER No. 622 (December 2008).

holders, executives faced asymmetric payoffs, expecting to benefit more from large gains than to lose from large losses of a similar magnitude. Transforming deposits into loans, banks are inherently levered institutions. But the standard structure of large banks – which are generally owned by bank holding companies and pay their executives partly with stock options – have added two additional layers of leverage. We illustrate the common capital and incentive structures of modern banks with numbers from Citigroup and Bank of America.

Our basic argument can be seen in a simple example. A bank has $100 of assets financed by $90 of deposits and $10 of capital, of which $4 are debt and $6 are equity; the bank's equity is in turn held by a bank holding company, which is financed by $2 of debt and $4 of equity and has no other assets; and the bank manager is compensated with some shares in the bank holding company. On the downside, limited liability protects the manager from the consequences of any losses beyond $4. By contrast, the benefits to the manager from gains on the upside are unlimited. If the manager does not own stock in the holding company but rather options on its stock, the incentives are even more skewed. For example, if the exercise price of the option is equal to the current stock price, and the manager makes a negative-expected-value bet, the manager may have a great deal to gain if the bet turns out well and little to lose if the bet turns out poorly.

In Part III, we show that the crisis has not alleviated the problem that executive compensation currently provides managers with incentives to enhance the value of common shares of bank holding companies or of options on the value of such shares even when such enhancement does not serve the interests of bondholders, depositors, and the government as guarantor of deposits. Indeed, for some banks, the crisis might have exacerbated the divergence between the interests of executives and the aggregate interests of those with a stake in the bank by reducing the value of executives' shares, and options to buy shares, in the banks' holding companies. Such reductions make executives' payoffs all the more asymmetric. In the current circumstances, such divergence might lead the executives to avoid raising additional capital even when doing so is desirable to strengthen the cushion available to bondholders and depositors and to take advantage of lending opportunities.

In Part IV, we assess against this background the measures adopted by Congress and proposed by the Treasury to regulate executive pay in banks receiving TARP funds. The main measures – the use of restricted stock in incentive pay and say-on-pay advisory shareholder votes

on compensation – attempt to tighten the alignment of executives' and shareholders' interests. Our analysis of the divergence of interest between shareholders and contributors of capital to the bank that are senior to the shareholders indicates that this strategy could well be counterproductive. For the shareholders' interests could well be served by taking risks that would be detrimental to the government's interests as preferred shareholder and guarantor of some or all of the banks' debt. The government has injected large amounts of money into the banks and in return has received preferred stock and other positions that are senior to equity. Moreover, the government guarantees deposits de jure up to $250,000 and might de facto have, or elect to shoulder, responsibility for deposits beyond this limit and other bank obligations. These interests of the government would not be well served by strengthening the link between executives' interests and those of the shareholders of bank holding companies.

In Part V, we explain better ways to regulate executive compensation in banks receiving TARP funds. More generally, we suggest that executive pay can be an important lever for banking regulation beyond both TARP recipients and the current crisis.

Moral hazard is inherent to banking, at least in the presence of deposit insurance. In principle, banking regulators are keenly aware of the problem and attempt to mitigate it by directly regulating banks' activities. But given the complexities of modern finance and the limited information and resources of regulators, such regulation is necessarily imperfect. Moreover, as long as management's incentives are tied to those of shareholders, management might have an incentive to increase risks beyond what is intended or assumed by the regulators, who might often be one step behind banks' executives. Regulators should attempt to make management incentives work for, rather than against, the goals of banking regulation.

In addition to regulating banks' behavior directly, the government could regulate the pay packages that shape how bank executives choose from the menu of actions allowed by this direct regulation. Such regulation of pay should focus on the structure of compensation – not the amount – with the aim of discouraging the taking of excessive risks. In terms of substance, to the extent that executive pay is tied to the value of specified securities, it should be based on a broader basket of securities and not only common shares. Rather than tying executive pay to a specified percentage of the value of the common shares of the bank holding company, it could be tied to a specified percentage of the aggregate value of the common shares, the preferred shares, and the bonds issued by either the bank holding company or the bank. Similarly, to the extent

that executives receive bonus compensation based on accounting measures, such bonuses should not be based on metrics that reflect the interests of common shareholders, such as earnings per share, but rather on broader metrics that reflects also the interests of preferred shareholders, bondholders, and the government as guarantor of deposits. Such changes in compensation structures would induce executives to take into account the effects of their decisions on preferred shareholders, bondholders, and depositors and thereby would curtail incentives to take excessive risks.

The proposed regulation of bankers' pay could nicely supplement and reinforce the traditional, direct regulation of banks' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities could be less tight than it should otherwise be. Conversely, as long as banks' executive pay arrangements are unconstrained, regulators should be more strict in their monitoring and direct regulation of banks' activities. At the minimum, bank regulators should closely monitor the structure of banks' pay arrangements and take the incentives they generate into account when assessing the risks posed by any given bank and deciding how strictly to monitor and directly regulate the bank's activities.

As is the case with any analysis of incentives, our own cannot show whether and to what extent any given executives were in fact driven by the incentives given to them. Individuals do not always act in ways that fully maximize their (monetary) payoffs. But, like other work by policy analysts and financial economists, we assume that incentives matter. This is why executives are in the first place given packages that seek to provide them with payoffs connected to performance. To the extent that the incentives generated by pay arrangements matter, our analysis seeks to identify the arrangements that produce perverse incentives and those that produce desirable ones.

Our analysis also complements others that focus on different aspects of the current crisis, and how to solve it. One set of pressing issues concerns the restoration of banks' ability to carry out their important normal role in the economy, by cleaning up banks' balance sheets, shoring up banks' capital positions, or other means.[15] While our paper does not directly address these

[15] *See, e.g.*, Lucian A. Bebchuk, *Buying Troubled Assets,* YALE JOURNAL OF REGULATION (forthcoming); John C. Coates IV & David S. Scharfstein, *Lowering the Cost of Bank Recapitalization*, YALE JOURNAL OF REGULATION (forthcoming); John Geanakoplos, *Solving the Present Crisis and Managing the Leverage Cycle*, available at http://cowles.econ.yale.edu/~gean/crisis/solving-present-crisis.pdf (accessed 03/26/2009).

issues, it shows that bankers' pay arrangements do not currently provide them with incentives to make optimal decisions, and how these arrangements should be adjusted to do so. There are also proposals for improving the traditional prudential regulation of banks' capital and activities.[16] We put forward an additional lever, executive compensation, that could usefully complement and perhaps partly substitute for the traditional prudential regulation.

Throughout, we focus on the compensation of the banks' top executives. Compensation structures at lower levels of the banks' hierarchy were certainly important for encouraging risk-taking at those levels, and for this reason they have been intensively discussed in the media. But lower-level compensation schedules are set by higher levels of management. Hence setting appropriate incentives for the highest level of management will have ripple effects throughout the entire banking organization without replacing decentralized private decision-making with government regulation. Top management's incentives are central to the behavior of banks as a whole. Our new approach to banking regulation proposes to use this key.

II. INTO THE CRISIS: THE TRIPLE LEVERAGING OF EXECUTIVES' INCENTIVES

Here we describe in more detail the financial structure of modern banking organizations and the compensation structures in such organizations that provided bank executives with incentives for excessive risk taking in the build-up to the present crisis. By taking excessive risks, we refer to taking actions that may either increase or decrease the value of the bank assets but whose expected effect on bank value is negative. The taking of such negative-expected-value "bets" may nevertheless be attractive from the perspective of a private actor if the actor expects to capture a share of possible gains but to bear a smaller share of possible losses. We suggest that this was the case for bank managers in the build-up to the present crisis, since compensation arrangements shielded these executives from a large fraction of possible losses. To be sure, the asymmetric payoffs that we analyze did not provide managers with incentives to take actions that

[16] *See, e.g.*, Gerard Caprio Jr., Aslı Demirgüç-Kunt & Edward J. Kane, *The 2007 Meltdown in Structured Securitization*, WORLD BANK POLICY RESEARCH WORKING PAPER 4756 (October 2008); Michael Solender, *How the Obama Administration should Regulate the Financial Sector*, YALE LAW & ECONOMICS RESEARCH PAPER No. 376 (February 2009), available at http://ssrn.com/abstract=1350005; Group of 30, FINANCIAL REFORM – A FRAMEWORK FOR FINANCIAL STABILITY (Washington DC, 2008); Calomiris, *supra* note 19.

would produce a loss with absolute certainty within the relevant period. Rather, we argue that they had incentives to take risks that had both an upside and a downside, and that were socially excessive yet privately optimal.

We begin in section A by briefly laying out the well-known problem of moral hazard in banks. Bank shareholders have an incentive to increase the volatility of bank assets, which government-protected bank creditors have no incentive to prevent. In section B, we describe features of the financial structure of modern banking organizations and their compensation structures that tie the interests of bank executives to highly levered bets on the value of bank assets. In section C, we explain how the use of options in executive pay arrangements added an additional layer of leverage, further exacerbating the moral hazard problem. In section D, we illustrate the analysis of this part with the financial incentives of the CEOs of Citibank and Bank of America.

Section E comments on why bondholders of banks and bank holding companies cannot be relied on to prevent pay arrangements that provide incentives for excessive risk-taking. Finally, Section F explains why our analysis of managers' private incentives to take excessive risks is fully consistent with the observation that some bank managers lost substantial amounts of private wealth in the current crisis.

A. Moral hazard in Banks

There is a fundamental and now well understood moral hazard problem in banks.[17] Those who provide (equity) capital have an excessive incentive to take risk. They will capture

[17] Moral hazard in banks is a special, particularly severe case of moral hazard of equity in general. On the general problem of moral hazard, *see* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 305 (1976), at 334-337. As we discuss at the end of this Subsection II.A, moral hazard is particularly severe in banks because by their very function banks have extraordinarly dispersed creditors, namely small depositors, who have neither the incentive nor the competence to evaluate banks' risk-taking behavior, or more generally their solvency, *see* Mathias Dewatripont & Jean Tirole, THE PRUDENTIAL REGULATION OF BANKS (1994), at 6. Depositors certainly have no incentive to protect themselves when they are protected by deposit insurance. *See* generally Gary Gorton & Andrew Winton, *Financial Intermediation*, in Constantinides, Harris & Stulz, this note, 431, at 520-529 with references to the abundant literature, including empirical literature documenting the incidence of moral hazard at the bank level in the presence of deposit insurance. Cross-country evidence also supports the importance of deposit insurance for moral hazard, *see* Aslı Demirgüç-Kunt & Harry Huizinga, *Market discipline and deposit*

the full upside, but some of the downside will be borne by the government as insurer of deposits if the bank goes bankrupt.

It will be helpful to use in this, and the subsequent section, a stylized example. In our analysis of the basic example and all subsequent modifications, we will assume for simplicity that there are only two periods – the present, when managers make decisions, and, the future, when gains or losses are realized and the manager gets paid. With multiple periods, the analysis would become more complex but our general conclusions would not change.

Consider a bank that has $100 in assets, funded by capital of $10 and $90 of deposits, which are senior to capital. In this case, the shareholders will have an excessive incentive to take risk. To see this, consider a strategy that would produce a fifty-fifty chance of increasing or decreasing the value of the bank's assets. In particular, suppose that the bank has to decide whether to pursue a risky strategy with a 50 percent chance of reducing the value of the assets by $20 and a 50 percent chance of increasing it by X. If X is less than $20, the risky strategy will have a negative expected value. However, taking the risky strategy would be in the interest of the shareholders for some values of X below $20.

The reason is that, in the event the risky strategy would produce a loss of $20, the shareholders will not bear this loss fully. Rather, they will lose only $10, their capital invested in the bank, with the remainder of $10 borne by depositors and/or the government as guarantor of depositors. In contrast, in the event that the risky strategy is successful, the shareholders will capture the full benefit of the increase X in the value of the assets. As a result, taking the risky strategy will have a positive expected value for the shareholders as long as X is more than $10. Thus, there is a range of values that X might take – between $10 and $20 – within which the risky strategy will have a negative expected value but will still be in the economic interest of the shareholders.

Another way of seeing the problem is by noting that, from the perspective of the shareholders' economic interests, there is no difference between a decline in the value of assets

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insurance, 51 JOURNAL OF MONETARY ECONOMICS 375 (2004) (finding in a sample of 30 countries that deposit insurance leads to greater risk-taking); James R. Barth, Gerard Caprio, Jr. & Ross Levine, RETHINKING BANK REGULATION – TILL ANGELS GOVERN (2006), at 213-223 (finding in a sample of over 150 countries that deposit insurance increases the likelihood of banking crises); Aslı Demirgüç-Kunt & Enrica Detragiache, *Does deposit insurance increase banking system stability? An empirical investigation*, 49 JOURNAL OF MONETARY ECONOMICS 1373 (2002) (same, for 61 countries).

of 10 and *any* larger decline that wipes out all or most of the value of the assets; in both cases, the shareholders will lose their capital. As a result, shareholders will have an incentive to under-weight the lower tail of the distribution of losses.

To see this, consider a bank that can keep things as they are or choose either one of two risky strategies A and B. Suppose that A will produce a gain of $2 with a 90 percent chance and a loss of $10 with a 10 percent chance, while B will produce a gain of $3 with a 90 percent chance and a loss of $50M with a 10 percent chance. In this case, taking A has a positive expected value and taking B has a negative expected value. But the economic interest of the shareholders will favor B over A, as the shareholders will lose the same amount if either A or B fails, and they will make more if B succeeds than if A succeeds.

It is widely acknowledged that taking excessive risks cannot be deterred by the prospect that depositors will avoid banks that do so. To begin, depositors whose deposits are guaranteed by the government have no incentives to investigate the banks' strategy before depositing their funds, or to withdraw these funds when they learn that the bank has embarked, or is about to embark, on a risky project, because they are protected by the government. And even if they were not protected by insurance, the vast majority of small depositors would have neither the incentives nor the resources to monitor the bank's behavior.

Given that depositors cannot be expected to prevent excessive risk-taking by banks, and that such risk-taking might lead to bank failure that would have an adverse effect on the government as insurer of deposits and on the economy, governments regulate and monitor banks' capital and activities.[18] It is widely recognized, however, that, given the limits to regulators' information, such prudential regulation can constrain but cannot be counted on to eliminate all excessive risk-taking by banks.[19] We discuss the reasons for this in Part V.B.

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[18] *See* Dewatripont & Tirole, previous note, at 29-45; Dirk Heremans, *Regulation of Banking and Financial Institutions*, in Boudewijn Bouckaert & Gerrit de Geest (eds.), 3 ENCYCLOPEDIA OF LAW AND ECONOMICS 950 (2000), at 954-956; Tommaso Padoa-Schioppa, REGULATING FINANCE – BALANCING FREEDOM AND RISK (2004), at 7. On other possible reasons for capital regulation, *see* Richard Herring & Robert E. Litan, FINANCIAL REGULATION IN THE GLOBAL ECONOMY (1995), at 49-63; Robert C. Clark, *The Soundness of Financial Intermediaries*, 86 YALE LAW JOURNAL 1 (1976), at 10-26 (emphasizing the protection of small depositors as the main motivation for prudential regulation).

[19] Many have observed that financial regulators have difficulty detecting all the risks taken by financial institutions, and perhaps difficulties acting based on vague notions of risk. *See, e.g.*, Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PENN. L.R. 333 (1989), especially at 392-412 (noting that financial innovation perpetually crosses

B. Capital and Compensation Structures

So far we have discussed the generic moral hazard problem inherent to all banks, especially when operating under a regime of deposit insurance. We now turn to modern U.S. banking organizations and to their executives. In such organizations, decisions are made not by those who collectively contribute the bank capital on which depositors rely but rather by executives, and the analysis should focus on the incentives of these executives.

In particular, we discuss below several special features of modern banking organizations that tend to aggravate the basic moral hazard problem discussed in the preceding section: (1) the capital of the bank is partly financed by debt instruments; and (2) the common equity of modern banks is held by bank holding companies that have an additional layer of debt financing; and (3) the interests of the executives who make decisions are tied to the value of common shares in the bank holding company. We also discuss why those providing debt financing at the bank or bank holding company level have only muted incentives to restrain the taking of excessive risks.

1. Debt at the Operating Bank Level

Banks have long been allowed to raise some of their required capital in forms other than common shares. Under both the original (Basel I) and the revised (Basel II) capital standards agreed upon by the Basel Committee on Banking Supervision, up to one-third of the required

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existing regulatory classifications, and that such innovation are hard to understand for regulators who have less resources than the private sector and are inevitably one step behind since they are reacting to private innovation); id., *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE LAW JOURNAL 1457 (1993), at 1463 ("Observers agree that regulators know less than the bankers, and that they know too little."); James R. Barth, Gerard Caprio, Jr. & Ross Levine, *Reassessing the Rationale and Practice of Bank Regulation and Supervision after Basel II*, in International Monetary Fund, CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW vol. 5, 225 (2008), at 227 (noting that "most supervisory agencies will never have sufficient human capital or budgets to implement Basel II successfully"); Richard J. Herring, The Known, The Unknown, and the Unknowable in Financial Policy: An Application to the Subprime Crisis, paper presented at the Weil, Gotshal and Manges Roundtable on the Future of Financial Regulation at Yale Law School on February 13, 2009, at 3-5; Charles W. Calomiris, *Financial Innovation, Regulation, and Reform*, CATO JOURNAL (forthcoming), manuscript at 1, 9-10 (noting that banks could keep risks off balance sheet, and game regulatory risk regulation by, inter alia, encouraging inflated debt ratings by credit rating agencies). Also *cf.* Philip A. Wellons, *Enforcement of Risk-Based Capital Rules*, in Hal S. Scott (ed.), CAPITAL ADEQUACY BEYOND BASEL 284 (2005) (reporting "very low levels of enforcement of capital requirements in the United States between 1993 and 2001, particularly for larger firms," but noting that "this may result from the fact that such firms are adequately capitalized.").

capital can consist of subordinated long-term debt.[20] In 2006, the largest U.S. bank holding companies maintained around 20 percent of their capital in the form of such debt: 18 percent at Citigroup, 20 percent at Bank of America, and 23 percent at J.P. Morgan.[21]

Suppose that the $10 of capital of the bank in our example is financed in the following way: $2 comes from note holders as debt, and $8M comes from common shareholders. The executives in charge hold common shares. In this case, the executives are insulated from the effects of any increase in the level of losses beyond $8M. Any loss beyond $8M will wipe out the value of common shares in the bank, and increases in the loss beyond that level would not affect the value of the common shares. In contrast, any gain in assets value will be fully captured by the common shares of the bank.

Another way to see the problem is to notice that the standard structures we observe in banks have exacerbated the problem of under-weighting of losses. In our example, executives will have an incentive not only to under-weight losses to assets that exceed $10, as was the case in the discussion of the preceding section, but also losses that are in the $8M to$10 range.

2. Debt at the Bank Holding Company Level

An additional distortion arises from the presence of an additional layer of debt financing at the level of the bank holding company. The biggest banks in the United States (as well as in some other major countries) are not stand-alone entities but subsidiaries of financial conglomerates, which in the United States are known as bank holding companies. Citibank, for example, is a subsidiary of Citigroup, which combines traditional consumer and commercial banking with investment banking, wealth management, and alternative investments such as private equity, hedge funds, and structured products.[22] Major strategic decisions are taken at the

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[20] *See* Basel Committee on Banking Supervision, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (Bank for International Settlements, 2006), para. 49(xii) and Annex 1a (Tier 2(e)). On these capital standards generally, *see, e.g.,* Michael P. Malloy, PRINCIPLES OF BANK REGULATION (2003), at 261-276.

[21] *See* Citigroup Annual Report 2006, Financial Information appendix, at 86; Bank of America Annual Report 2006, at 61; JPMorgan Chase & Co. Annual Report 2006, at 130.

[22] *See* Citigroup Annual Report 2006, previous note, at 2. In 2006, Citigroup earned 34 percent of its gross revenue from sources other than interest on loans, or 56 percent of net revenues (i.e., revenues net of interest expense). Ibid at 104.

holding company level, and the incentive pay of the top executives is tied to the share price of the holding company.

This structure is important for understanding incentives for risk-taking because bank holding companies also issue debt. To be sure, because capital adequacy requirements extend to bank holding companies on a consolidated (group) basis, they place limits on how much debt can be issued at the bank holding company level.[23] If they did not, there would be no limit on how much the common shareholders of the bank holding company could lever up their capital.[24] Still, the existence of debt and risky assets at the holding level alongside the holding's investment in the bank will alter the holding's incentives to manage the bank.

By definition, the bank holding company holds assets that are not in traditional banking, such as the hedge fund and investment banking subsidiaries of Citigroup mentioned above. Even though these assets may be subsidiaries, substantial amounts of debt financing are located at the holding level.[25] If the non-bank assets of the holding produce a loss, the value of equity in the

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[23] *See* for US law Pauline B. Heller & Melanie Fein, FEDERAL BANK HOLDING COMPANY LAW (looseleaf), XXX; and for the Basel rules and beyond Howell E. Jackson, *Consolidated Capital Regulation for Financial Conglomerates*, in Scott, *supra* note 19, 123. Prior to Basel II, some countries pursued a different approach to the regulation of holding companies, *see* Howell E. Jackson, *Regulation of Financial Holding Companies*, in Peter Newman (ed.), 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 232 (1998), at 234.

[24] *See* Jackson, in Newman (ed.), previous note, at 233-234 (noting that this would not matter if the solvency regulation of the bank itself worked perfectly). In our numerical example, suppose that the 8 percent equity in the bank were held by a holding company, which was in turn financed by 50 percent equity and 50 percent debt (and, for simplicity, has no further assets). In this case, the first $4 paid by the bank to the holding company would accrue to the creditors of the holding company. If the assets of the bank fell below $96, the shareholders of the holding company would be wiped out, and further losses would be of no concern to them. Shareholders, in other words, would underweight any losses that exceed $4. To prevent this, banking regulation prohibits such additional leveraging at the holding level. This being said, bank holding companies were allowed to lever up more than banks because up to 15 percent (for "internationally active banking organizations") of their tier 1 capital could be contributed through "qualifying trust preferred securities," which, from the bank's point of view, is essentially long term debt (default only occurs if the bank misses interest payments for at least five years), *see* 12 CFR 225 Appendix A.II.A.1.b (Regulation Y).

[25] *Cf.* Citigroup Annual Report 2006, *supra* note 21, at 139-140 (reporting $116bn of long term loans at the holding company, exclusive of $10bn of junior subordinated notes relating to trust preferred securities, as well as at least $42bn of short term debt through Citigroup Funding Inc. [which is guaranteed by the holding company, *see* p. 12]); Bank of America Annual Report 2006, *supra* note 21, at 148 (reporting $148bn of debt at the holding level).

holding company will be reduced, in effect levering the holding and hence increasing the incentives for risk-taking.[26]

To see this, consider again our numerical example of a bank with $100 in assets, $90 in deposits, $2 in other debt, and hence $8 in equity. Now suppose that the equity is owned by a holding company, and that the holding company also owns another business with $100 in assets. Thus, altogether, the holding company has $108 in assets. Further suppose that the holding company is financed with $92 in debt and $16 of equity. Let us call the additional business a fund, and suppose that the fund is moderately risky – with equal probability, the fund will either lose or gain $10.

What happens when the fund produces the loss of $10? The fund's assets will then be reduced to $90. But the holding company still has the bank shares (worth $8) to satisfy the holding creditors. Creditors will be paid in full from proceeds of the shares (dividends or sale), and the common shareholders of the bank holding company will receive $6. If the fund produces a gain instead of a loss, the shareholders will receive $26. On average, they will receive $16.

The shareholders and the executives holding shares in the bank holding company will do better, however, if the bank itself adopts a risky strategy. Suppose, for example, that the bank could adopt a value-neutral strategy that produces an $8 loss or gain with equal probability, and suppose that the success of this bank strategy is independent of the success of the fund. Then half of the time that the fund turns a loss, so will the bank, in which case the book value of the bank's equity will be zero, the bank shares will be worthless, and the creditors of the holding company will be left empty-handed. Since the bank strategy was value-neutral, the question is where did the money go? It accrues (probabilistically) to the shareholders when both the bank and the fund are successful. On average, they will receive $16.50.

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[26] *See* Jackson, previous note, at 234-235. Empirically, Howell E. Jackson, *The Superior Performance of Savings and Loan Associations With Substantial Holding Companies*, 22 JOURNAL OF LEGAL STUDIES 405 (1993) finds in a sample of 175 thrifts in Arizona, California, and Nevada between 1986 and 1991 that those owned by holding companies were less likely to fail and, when they did, imposed less cost on the deposit insurer (at 416-419). But he also finds that the stand-alone thrifts were considerably smaller and younger than the integrated thrifts (at 415). In any event, if there were beneficial effects of thrift holding companies present in Jackson's sample in the 1980s, they may not be present with the bank holding companies we are concerned with here because they are larger and hence themselves subject to "too large to fail" moral hazard.

The flipside of this is that executives seeking to maximize the value of common shares in the bank holding company would accept a risky strategy for the bank even if the possible gain were less than $8. In the example, they would accept the risky strategy for a possible upside of at least $7. This is what is important from the point of view of bank creditors, because it means that of available risky strategies, more will be attractive to shareholders than if the bank were a stand-alone business (as before, shareholders will not bear any losses beyond $8 at the bank level).

There are several interesting aspects to this example. The capital ratio of the overall structure on a consolidated basis – $200 in assets, and $16 of equity – is equivalent to the capital ratio of the bank, namely 8 percent. The bank's assets are separate from those of the fund and hence protected from any losses that the fund might incur.[27] And yet, the existence of the fund is not irrelevant for the bank's creditors.

The severity of the problem depends on the riskiness of the fund, and the correlation of possible risky bank strategies with returns at the fund. Consider the following example which may be an admittedly extreme stylized version of what happened when big financial conglomerates got into the hedge fund business. Assume that the possible fund losses or gains are $16, a still rather modest 16 percent of fund assets. Also assume that the bank has access to a strategy that is perfectly positively correlated with fund returns – if the fund loses $16, the bank loses Y; if the fund gains $16, the bank gains X. One might think of bank and fund strategies that are strongly correlated with market returns. Since a loss of $16 by the fund wipes out the initial equity, shareholders are indifferent about Y – from their financial point of view, once the fund has lost $16, it makes no difference whether the bank loses nothing or $100. On the other hand, the common shareholders of the bank holding company will receive any additional gain X when the fund has turned a profit. In this case, executives seeking to maximize the value of the bank holding company's common shares will be willing to accept any gain X in the good state for any loss Y in the bad state. In other words, they will be willing to literally bet the bank for a penny.[28]

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[27] Even if the fund lost all its assets, creditors of the holding company could not touch any of the assets of the bank before the bank's own creditors, most importantly the depositors, were paid in full. On this essential role of corporate law for the partitioning of assets, *see* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE LAW JOURNAL 387 (2000).

[28] An interesting corollary is that executives seeking to maximize the value of the bank holding company's common shares have an incentive *not* to diversify the sources of income the company derives from its bank subsidiaries on the one hand, and its other financial subsidiaries on the other.

To conclude this section, we acknowledge that banking regulators impose limits on the non-bank activities of bank holding companies, and on the risks they can take.[29] As with the regulation of the bank themselves, however, this regulation is inevitably imperfect, and as a factual matter, non-bank activities of bank holding companies are riskier than their banking activities.[30] This observation is consistent with the factor pushing toward risk-taking identified in this section. Determining how important this factor was in the buildup to the current crisis will require further empirical work.[31]

C. The Use of Stock Options

We have seen that the organization and compensation structures of modern banking organizations have increased the incentives of executives whose interests are tied to the value of common shares of bank holding companies to take excessive risks – that is, to take gambles that have a negative present value but that, due to the insulation of common shareholders from downside risks, carried a positive expected value to these shareholders. The problem resulted from the fact that these capital structures insulated shareholders from the effect of declines in the

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[29] *See, e.g.*, Heller & Fein, *supra* note 23, at _ (reviewing such regulations in the US).

[30] Empirically, non-interest (i.e., fee based) income of financial holding companies is much more volatile than income from interest, *see* Robert DeYoung & Karin P. Roland, *Product Mix and Earnings Volatility at Commercial Banks: Evidence from a Degree of Total Leverage Model*, 10 JOURNAL OF FINANCIAL INTERMEDIATION 54 (2001), at 68-70 (finding in data for 472 US commercial banks from 1988 to 1995 that diversifying from deposits and loans into non-interest revenue activities, particularly trading, strongly increase revenue volatility); and *cf.* Kevin J. Stroh & Adrienne Rumble, *The dark side of diversification: The case of US financial holding companies*, 30 JOURNAL OF BANKING & FINANCE 2131 (2006) (finding in data of over 1,800 financial holding companies in the US from 1997 to 2002 that any gains from diversification into non-interest revenue generation are more than offset by the costs of increased exposure to volatile activities).

[31] Researchers affiliated with the FDIC and the Federal Reserve have argued that bank holding companies are a source of strength for their banks because the FDIC has authority to force bank holding companies to cross-guarantee the bank's obligations, *see* Adam B. Ashcraft, *Are Bank Holding Companies a Source of Strength to Their Banking Subsidiaries?*, 40 JOURNAL OF MONEY, CREDIT AND BANKING 273 (2008); Christine M. Bradley & Kenneth D. Jones, *Loss Sharing Rules for Bank Holding Companies: An Assessment of the Federal Reserve's Source-of-Strength Policy and the FDIC's Cross Guarantee Authority*, 17 FINANCIAL MARKETS, INSTITUTIONS & INSTRUMENTS 249 (2008). This argument only operates, however, as long as the bank holding companies themselves are solvent. Our argument relates to the opposite situation when they are not, and the *ex ante* incentives set by this possibility. The current crisis may correspond to our scenario.

value of bank assets on the capital that comes from bondholders at either the bank level or the bank holding company level.

It might be suggested that bank executives holding common shares in the bank holding company would have an incentive to be more conservative than would be in the interest of other common shareholders. To begin, to the extent that the ownership of common shares in the bank holding company represents a substantial fraction of an executive's wealth, such a large stake might lead the executive to be more risk-averse than shareholders who are more diversified. In addition, a failure of the bank might impose significant personal costs on the bank's managers that would not be borne by other common shareholders.[32] Empirical studies have documented that CEOs who are insulated from shareholder pressure and do not receive high-powered pay are less prone to engage in risk-taking.[33]

To counter CEO incentives for a more "quiet life,"[34] however, incentive pay in the form of stock and options has steadily increased over the last two decades.[35] With options, executives

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[32] Among other things, executives will bear costs to the extent that they have firm-specific human capital and that their professional standing would be adversely affected by such failure. In addition, banks may have deferred compensation programs and supplemental retirement accounts for their executives, and executives' rights under these programs might be adversely affected by a bank failure. For evidence on the extensive use of such programs and accounts, see Lucian Bebchuk and Robert Jackson, *Executive Pensions*, 30 JOURNAL OF CORPORATION LAW 823 (2009); Rangarajan Sundaram and David Yermack, *Pay me Later: Inside Debt and its Role in Managerial Compensation*, 62 JOURNAL OF FINANCE 1551 (2007). As Bebchuk and Jackson explain, however, arrangements and practices indicate that executives' benefits under these arrangements may not suffer even in the event of bank failure.

[33] *See* Shams Pathan, *Strong Boards, CEO power and bank risk-taking*, JOURNAL OF BANKING & FINANCE (forthcoming 2009); and generally Gorton & Winton, *supra* note 17 (reviewing other studies with similar findings).

[34] *See, e.g.*, Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111JOURNAL OF POLITICAL ECONOMY 1043 (2003) (documenting the behavior of managers protected from takeovers in the 1980s, when incentive pay was much less common).

[35] *Cf.* Elijah Brewer III, William Curt Hunter & William Jackson III, *Deregulation and the Relationship between Bank CEO Compensation and Risk-Taking*, FEDERAL RESERVE BANK OF CHICAGO WORKING PAPER 2003-32 (2003) (documenting the increase of equity-based compensation in the banking sector after deregulation in the 1990s, and an associated increase in risk-taking). The trend towards more incentive compensation also affected banks' directors during that same time, *see* David A. Brecher, Terry L. Campbell II & Melissa B. Frye, *Incentive Compensation for Bank Directors: The Impact of Deregulation*, 78 JOURNAL OF BUSINESS 1753 (2005). On the rapid growth of executive compensation's performance sensitivity from the 1980s to the present in general, *see* Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005*, working paper,

can have *even more* incentives for risk-taking than the common shareholders of bank holding companies. When executives are paid with options, they are also to some extent insulated from losses suffered by these common shareholders due to asset value decline, which can further exacerbate the moral hazard problem and the incentive to take excessive risks. The executive's calculus will not be the same as that of the common shareholders of the bank holding company, because he or she will fully capture gains in stock price but will not fully bear the losses, as common shareholders would.

Consider again the bank in our example. Suppose that the executive did not get restricted shares in the bank holding company but rather options on such shares. And examine again the choice whether to take a risky strategy that would create a 50 percent chance of a $20 decline in assets value and a 50 percent chance of an increase in asset value of X. And let us examine how the use of options will affect the value of X above which the executive's interest will favor choosing the risky strategy.

Let us consider two scenarios. In one, the market does not recognize the possibility that the executive will take the risky strategy and the potential loss from asset declines is not yet factored into the stock price of the common shares. In this case, the distortion in favor of excessive risk taking is especially excessive. For in this case, taking the risky strategy will have a positive expected value effect on the executive's payoffs for any positive value of X. The executive's options will gain in value if the risky strategy produces an increase and will retain a zero value, which not taking the risky strategy will do as well, if the executive does not take the risky strategy.

In the scenario considered above, the executive cannot gain from not taking the risky strategy, because doing so would never increase the stock price as it has not yet factored in the possible decline in value due to the risky strategy. If the market takes into account the possibility that the executive will take a negative-expected-value risky strategy, the analysis becomes more complicated—for in that case, not taking the risky strategy might produce some increase in the value of common shares. But it can be shown that the use of options still exacerbates the distortion in favor of risk taking relative to the situation in which the executive has common shares in the bank holding company. For as long as the common shares have positive value when

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Massachusetts Institute of Technology (August 2008), available at http://web.mit.edu/frydman/www/trends_frydmansaks_0808.pdf, accessed 03/31/2009.

options are granted, the structure of the option holder's payoffs will be different from that of the common shareholders – the option holder will be insulated from some of the effect on common shareholders that an asset value decline could bring. In fact, it can be shown that the option holder will always choose the risky option as long as X is greater than $1.34, even if this is fully anticipated by the market.[36] (For values of X below $1.34, the manager will sometimes choose the safe strategy and other times the risky strategy.[37])

Essentially, the problem can be viewed as follows. When the executive has options on the shares of the bank holding company, the executive's position is equivalent to holding shares with a nonrecourse loan on those shares equal to the current price of the shares.[38] This makes the executive's position with respect to the bank's capital even more leveraged. This is an additional layer of leverage added on top of the deposits and loans. And each layer of leverage strengthens the incentive to take risks.

D. Citigroup and Bank of America

It is useful to illustrate the claims made in the analysis above by looking at the two biggest banks in the United States in terms of assets and examining the incentives of their top

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[36] If the market anticipates that the executive will choose the risky option with certainty, the value of common stock will be $\frac{1}{2}\cdot 0 + \frac{1}{2}\cdot(\$4+X) = \$2+X/2$. If the executive unexpectedly chooses the safe option, the value of common stock will increase to $4, a certain gain of $2-X/2. If the executive chooses the risky option, the value of the common stock will either fall to zero or, if the gamble succeeds, increase to $4+X, a gain of $2+X/2. Hence the expected gain from the risky strategy is $\frac{1}{2}\cdot 0 + \frac{1}{2}\cdot(\$2+X/2) = \$1+X/4$. This is greater than the certain gain from the safe strategy as long as X is greater than $(4/3). Consequently, for X greater than $1.34, the executive can be expected to choose the risky option, and the market's expectation will be borne out. We have already discussed in the main text that the executive's incentive to gamble is even higher if the market does not anticipate it. So we conclude that for X greater than $1.34, the only equilibrium is for the executive to always gamble, and the market to fully anticipate this.

[37] Since the executive will always gamble if the market does not anticipate gambling, it cannot be an equilibrium for the executive not to gamble if X is less than $1.34. On the other hand, if the market anticipated that the executive will gamble for sure, the share price would be sufficiently depressed to make it profitable for the executive to raise the share price by following the safe strategy, rather than gambling – in other words, the expectation of the market would not be borne out in equilibrium. It follows that for values of X between 0 and $1.34, the only equilibrium is a mixed one in which the manager gambles with some probability, which the market anticipates.

[38] The analysis of stocks as options (or the other way around) using arbitrage arguments is due to Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 JOURNAL OF POLITICAL ECONOMY 637 (1973).

executives to see how the executives were affected by risk taking. For simplicity we will look at their situations at the end of 2006.

At that time, Citigroup and Bank of America were both heavily leveraged, although not exceptionally so. Both met the Federal Reserve Board's requirements for "well-capitalized institutions": a ratio of total capital to risk-weighted of at least 10 percent, and a ratio of tier 1 capital to assets of at least 6 percent.[39] Their leverage ratios – the ratio of tier 1 capital (mainly equity) to adjusted average assets[40] – were high, although not higher than that of the next biggest US bank, J.P. Morgan. Citigroup's leverage ratio in 2006 was 5.2 percent, Bank of America's 6.4 percent, and J.P. Morgan's 6.2 percent.[41]

At the end of 2006, Citigroup's CEO Chuck Prince held 1.6m Citigroup shares, and over 1.1m options at exercise prices between $32 and $54 (all but 225,000 options had an exercise price of at least $42).[42] The closing price of Citigroup's stock on December 29, 2006, was $55.70.[43] Bank of America's CEO Ken Lewis held 2.9m shares in his company as well as 1.925m options at exercise prices between $40 and $47.[44] The closing price of Bank of America's stock on December 29, 2006, was $53.39.[45]

Both executives were heavily invested in their companies' stock but, presumably, not in their companies' bonds. As explained above, this alone created powerful incentives to underweight the possible downside of a strategy relative to its upside.

Their options, however, encouraged even more risk-taking. Most of them had exercise prices at around 20 percent below the current stock price. This means that any loss to the company's equity beyond 20 percent would not have had any impact on the value of the options,

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[39] *Cf.* 12 C.F.R. 225.2(r) (defining "well capitalized").

[40] "Adjusted average assets" is total assets net of certain deductions for intangible capital and other assets, *see* 12 C.F.R. 225 Annex D.II.b.

[41] *See* Citigroup Annual Report 2006, Financial Information appendix, at 86; Bank of America Annual Report 2006, at 93; JPMorgan Chase & Co. Annual Report 2006, at 130.

[42] *See* Citigroup's 2007 Proxy Statement, at 16 (reporting stock ownership as of 02/28/2007) and 51 (reporting outstanding options and their exercise prices).

[43] *See* "Historical Price Lookup" on Citigroup's investor relations website (http://www.citigroup.com/citi/fin/index.htm), accessed 03/23/2009.

[44] *See* Bank of America's 2007 Proxy Statement, at 17-18 (reporting stock ownership, including 1m shares corresponding to possible option exercises) and 35 (reporting outstanding options).

[45] *See* "Historical Price Lookup" on Bank of America's investor relations website (http://phx.corporate-ir.net/phoenix.zhtml?c=71595&p=irol-stocklookup), accessed 03/24/2009.

which would then be zero.[46] By contrast, any increase in the value of equity would have been fully reflected in the value of the options.

Overall, the above discussion indicates that the payoffs facing the CEOs of Citigroup and Bank of America at the end of 2006 were quite asymmetric. Their monetary gain from a given large increase in the value of their firm's assets was greater than their monetary loss from an equally large decline in the value of these assets. In these circumstances, there was a wide range of negative-expected-value bets that would have had a positive expected value effect on the CEOs' monetary position. In short, the equity-based compensation given to these executives provided them with strong incentives to take excessive risks.

E. Why Bondholders Cannot be Relied on to Regulate Pay

The foregoing analysis of bank executives' incentives to take excessive risks raises the question of why bondholders of banks and bank holding companies do not prevent banks from using executive pay arrangements that produce such incentives. In theory, bondholders could insist on covenants that would preclude such pay arrangements or, in the absence of such covenants and the presence of such pay arrangements, they could insist on an interest rate premium so large that it would deter banks from using such pay arrangements. Unlike depositors, many bondholders have incentives, and can be expected, to monitor banks to which they lend.

However, bondholders cannot be relied upon to prevent pay arrangements that induce excessive risk-taking because they do not bear fully the costs of such arrangements. In the event that excessive risk-taking will produce a bank failure, a substantial part of the costs will be borne by the government as guarantor of deposits. The bondholders would not bear this major cost of excessive risk-taking, and, conversely, would not capture the benefits that limiting excessive risk-taking would confer on depositors and the government.

Furthermore, the expected costs to bondholders from excessive risk-asking, and their incentives to limit it, are further reduced by the prospect that, in the event of bank failure, bondholders may benefit directly or indirectly from a government bailout event though they are

[46] We remain in the framework of our one-period model, so that a drop in equity value is final. In a more fully specified model, stock prices might recover, and hence options would retain some positive value if their exercise price is above the current stock price. One can think of the one-period model as a simple way to describe the stock price development until the expiration date of the options.

not formally insured by the government. As financial institutions have grown larger over the last two decades, partly as a result of deregulation, it has become even more difficult for the government to commit not to bail them out.[47] For example, in the recent crisis, the government has injected substantial capital into many banks in the form of preferred shares that are junior to the claims of bondholders, insured some banks against a decline in the value of some of their toxic assets, and initiated a program to provide government subsidies to funds that will purchase toxic assets from banks – all actions that benefitted bondholders and provided them with partial protection against the consequences of the banks' losses. Of course, the prospect of such government interventions dampens the incentives of bondholders to seek, and offer interest rate concessions in return for, limits on executive pay arrangements that induce excessive risk-taking. The effect of "too big to fail" interventions is similar to the moral hazard engendered by deposit insurance discussed in the previous section.[48] When bondholders are insulated from some of the effects of bank losses by such interventions, they cannot be relied upon to curb excessive risk-taking.

F. Consistency of Our Analysis with the Wiping out of Some Executives' Wealth

In the preceding four sections, we have explained how excessive risk-taking was in the rational self-interest of bank managers given the structure of their monetary incentives. Some may wonder if this analysis is consistent with the fact that some CEOs at the helm of major US banks lost much of their personal wealth in the present crisis. If this is the outcome, one might ask, how could the strategy have been in the managers' self-interest?

The answer is that ex ante the losses that later occurred were only one of a number of possibilities. Bank managers could recognize the possibility of such losses, yet rationally decide that they were outweighed by the possibility of continued profitability of the risky lines of

[47] On the consolidation of the banking industry through the 1990s, *see* Gary A. Dymski, THE BANK MERGER WAVE (1999). On the reinforcement of "too big to fail" moral hazard by this development, *see* Stern & Feldman, previous note, at 2 and 60-66.

[48] *See* Gary H. Stern & Ron J. Feldman, TOO BIG TO FAIL: THE HAZARD OF BANK BAILOUTS (2004), at 9-85 (discussing the theory and empirical evidence of moral hazard engendered by "too big to fail"); Gorton & Winton, *supra* note 17, at 487 and 524 (discussing the empirical evidence on the risk-taking incentives engendered by "too big to fail"); David G. Mayes, *An Overview of the Issues*, in David G. Mayes & Aarno Liuksila (eds.), WHO PAYS FOR BANK INSOLVENCY? 27 (2004), at 29.

business and an opportunity to exit them later but before a possible collapse. The possibility of losses is a normal feature of rational business decisions, and our discussion above has acknowledged such possibilities throughout. The mere fact that a risky strategy turned out to produce losses ex post does not mean that it was not rational to follow the strategy ex ante.

Let us illustrate the point with a purposefully extreme example. Imagine an individual who is given the opportunity to bet all her wealth on one or more spins of a roulette wheel. A rational, risk-averse individual who does not obtain any utility from the act of gambling itself would decline this opportunity: any chance of winning would be counterbalanced by an equally large or even slightly larger chance of losing, and a risk-averse individual would shun such a gamble. Now imagine a fictitious roulette game with asymmetric payoffs. In particular, imagine that bets on black yield four times the betted amount if successful. *This* bet on black could be attractive even to a rational and (moderately) risk-averse individual. We do not need to resolve here what number of rounds we should expect the individual to play as long as the individual keeps winning. But we would not be surprised to see the individual play one or more rounds. If the individual happened to lose all of her wealth playing this game, we would expect the individual to regret ex post having made the bet. But we would hardly conclude from this ex post loss of the individual's personal wealth that this rules out, or is in any way inconsistent with, her choosing rationally to make the bet and her being drawn to it by the asymmetric pay-offs.

It should be clear therefore that the observation of ex post losses does not imply that those choosing the ultimately unsuccessful strategy did not understand the environment they were operating in. What with the benefit of hindsight appears to be a losing strategy may have been a winning if risky strategy ex ante. In the present context, bank managers may have anticipated the possibility of a crisis, and may even have considered some degree of turmoil inevitable. Yet as long as the precise timing and dimension of the crisis were not foreseeable, bank managers could rationally pursue risky strategies in the hope of pocketing profits before the crisis hits, and exiting in time. The mere fact that the crisis hit the banks at a moment when they were still invested in "toxic securities" and other risky investments does not mean that such investments were not in the ex ante rational self-interest of the bank managers.

In fact, it is in the nature of the moral hazard problem of banks that it becomes visible mainly in situations in which, ex post, the strategy chosen turned out badly for all parties involved, including the parties responsible for the taking of excessive risks. Moral hazard during

the savings and loan crisis of the 1980s came to light when the thrifts involved became insolvent, and hence its shareholders were wiped out. Ex post, the risky strategies chosen did not pay off for the shareholders of these thrifts. Ex ante, however, they were privately optimal for shareholders (yet harmful from a social point of view).

III. The Current Situation: The Effects of the Crisis on Incentives

Before proceeding, we would like to comment on the effects of the current financial circumstances in which banks operate on executives' incentives. The financial and economic crisis of 2008-2009 has eroded the value of banks' assets and hence the capital of banks, with a disproportionate effect on the value of shares in the bank holding companies. For example, the shares of Citigroup lost 94 percent of their value in the two years ending March 20, 2009. [49] In that same period, the shares of Bank of America lost 82 percent of their value. [50] The value of the bank's assets and of the bonds issued by both banks declined to a much lesser extent.[51] Because executives hold common shares in the bank holding company and options on such shares, the reduction in the value of these common shares increased the divergence between the interests of executives and the interests of bondholders, depositors, and the government as a guarantor of deposits. The increased divergence can lead to substantial distortions in decision-making.

The following two sections describe two ways in which this problem may manifest itself. At some point down the road, bank executives may resume excessive risk-taking. The reduction in the value of common shares makes executives' payoffs from taking risks all the more asymmetric. A reduction in the value of common shares (and of options on common shares) reduces how much bank executives have to lose from a bet that turns out poorly; as a result, there

[49] The closing share price of Citigroup on March 20 was $50.64 in 2007, $22.50 in 2008, and $2.62 in 2009. *See* "Historical Price Lookup" on Citigroup's investor relations website (http://www.citigroup.com/citi/fin/index.htm), accessed 03/21/2009.

[50] The closing share price of Bank of America on March 20 was $50.76 in 2007, $41.86 in 2008, and $6.19 in 2009. *See* "Historical Price Lookup" on Bank of America's investor relations website (http://phx.corporate-ir.net/phoenix.zhtml?c=71595&p=irol-stocklookup), accessed 03/21/2009.

[51] *Cf.* Dena Aubin, *Bailout hopes so far limit Citigroup bonds' downside*, Reuters News 01/14/2009 (reporting that Citigroup's bonds lost only 3 to 5 percent in value on 01/14/2009 when Citigroup's share lost 22 percent, and that market participants assumed the debt to be paid, if only because of a government bailout). As of 03/24/2009, Citigroup's bonds were trading at discounts of at most 10 percent on their face value (source: Bloomberg bond quotes).

will be more negative expected value strategies for which the possible private gains to the managers and other common shareholders will outweigh the private possible losses to them. We explain this point in more detail in section A.

In the current circumstances, the divergence between executives' interests and the interests of the bank as a whole may manifest itself in executives' reluctance to make additional loans that would have a positive expected value but require them to raise additional equity capital. Making such loans would be efficient from the perspective of the aggregate interests of those who have a stake in the bank. Given regulatory capital requirements, however, making such loans might require the bank to raise additional equity capital. In the current circumstances, it might be in the interests of the common shareholders (and holders of options on common shares) to avoid this: if the economy performs poorly, the benefits of the new equity capital will accrue to bondholders and depositors; and if the economy performs well, the investors contributing new equity capital will dilute the existing common shareholders' claim on profits.

The two distortions we discuss in this part are manifestations of the same underlying problem. Both arise because managers compensated with common shares and options of the bank holding company will seek to maximize the value to current common shareholders, rather than the value of the bank assets as a whole. With the erosion of the value of common shares in the bank holding company brought about by the financial crisis, this problem is as acute as ever.

A. Excessive Risk-Taking

Let us first consider how the erosion of banks' equity capital will affect down the road the problem of excessive risk incentives. Consider the bank in our running example. Suppose that the value of the assets decreases from $100 to $97. This decrease reduces the book value of the common shares of the bank holding company from $4 million to $1. This reduction in turn decreases the maximum amount the holding company's common shareholders can lose from taking a risky strategy relative to the situation analyzed earlier. Whereas before the common shareholders would bear the first $4 of losses, the changes mean that they will now bear losses only up to $1. This will of course increase their incentive to take excessive risks. They simply have less to lose from making bets.

Indeed, some of the banks might now be in a situation in which the common shares of the bank holding company have a negative book value. The value that the common shares have

might be simply due to their being an out of the money option, based on the possibility that the book value of the bank's assets will increase and become positive in the future.

Suppose that the assets of the bank in our example went down to $85. In this case, the bank has $5 less in assets than in obligations to depositors. In this situation, the common shares might still trade at a positive price even though they have a negative book value. This is because the shares will have a value of zero if the book value does not improve but might have a positive value if the assets' value appreciates, say, back to $100.

Although a decline in the book value of a bank to a low, razor-thin but still positive value increases the incentive to take excessive risks, a decline into negative territory makes things even worse. Consider our example in which the value of assets went down to $85. And suppose that the executives have a choice of taking a risky negative-expected-value strategy.

In this case, if the risky strategy is taken, the downside to the common shareholders of the bank holding company and the executives is no longer limited – it is non-existent. With negative book value for the bank and for the bank holding company, common shareholders and the executives with equity-based incentives tied to the bank holding company shares have nothing to lose from further erosion of book value. In contrast, if they gamble and the book value goes up sufficiently, they might end up with something.

In fact, in the case of negative book value, executives' incentives will be distorted not only in under-weighting downside risks but also in underweighting low positive returns relative to large positive returns. A limited increase in book value that will not bring the book value of the equity of the bank holding company into positive territory will not give the common shareholders and executives of the bank holding company anything. Hence executives seeking to maximize the value of common shares will attach little value to such limited increases in the cost-benefit calculus. In the example under consideration, such executives will favor a strategy that would increase the value of the assets by $15 with a 10 percent chance and fail to increase it with a 90 percent chance over a strategy that would increase the value of the assets of the bank by $5 for sure. Even though the effect of the latter strategy on the value of the banks' assets will have a higher expected value, the executives will favor the former strategy because a $5 increase in the value of the assets would be insufficient to bring the value of the common shares of the bank holding company back into positive territory.

Finally, even when the common shares of the bank holding company retain a positive book value, a similar effect to their having a negative book value can arise when executives have options that are out of the money because they were given with strike prices equal to the then current stock price at times when stock prices were much higher than now. For example, the stock options that Bank of America granted its top executives in the years before the crisis have exercise prices between $42.70 and $53.85.[52] As we mentioned above, however, the stock price of Bank of America has dropped dramatically over the last two years, and is now only $11.21 (as of June 1, 2009).[53] Hence these options are now deeply out-of-the-money, and will pay off for their holders only if the stock price increases by a factor of 4 or more. The presence of these options gives executives an incentive to favor strategies with large improbable gains over strategies with small probable gains, for small gains would not be able to pull up the stock price above the exercise price of the stock options they have.

B. Excessive Reluctance to Raising and Deploying Capital

We now turn to discuss another way in which, in the current circumstances, the divergence between executives' interests and the aggregate interests of those with a stake in the bank may manifest itself. Executives' incentives may lead them to refrain from engaging in some new lending transactions that have positive expected value. The reason is that unlike cash holdings, new lending may need to be backed by additional regulatory capital. Due to their losses in the current crisis, many banks may not have the necessary capital cushion for new lending now, or may put themselves in danger of falling below the required capital in the near future if they lend out available funds now but incur some additional losses shortly thereafter. In principle, banks could raise additional equity capital to overcome this problem. However, executives' compensation arrangements provide them with excessive incentives to avoid the raising of additional equity capital in the current circumstances. As a result, bank executives may excessively resist raising new equity capital and may pass on positive-expected-value lending

[52] *See* Bank of America's Proxy Statement for 2009 available at its investor relations website (http://media.corporate-ir.net/media_files/irol/71/71595/reports/2009_Proxy.pdf) accessed 03/21/2009, at p. 27 (reporting exercise prices of options granted between February 2005 and February 2008).

[53] *See* "Historical Price Lookup" on Bank of America's investor relations website (http://phx.corporate-ir.net/phoenix.zhtml?c=71595&p=irol-stocklookup), accessed 06/03/2009.

opportunities. The presence of such incentives may thus inefficiently reduce the availability of credit.

The common shareholders of bank holding companies, and executives aligned with their interests, currently have excessive incentives to avoid raising capital due to what is known in the financial literature as the debt overhang problem.[54] In the current situation where the exhaustion of the existing equity is a relevant scenario, the benefits of infusing new common equity would partly flow to a bank's bondholders and depositors (as well as the government as guarantor of depositors) by providing them with extra cushion should the bank perform poorly and the existing equity be wiped out. At the same time, the costs of infusing new equity will be borne fully by the existing common shareholders through a dilution of their stake. In other words, raising new common equity capital would confer a positive externality on bondholders and depositors at the expense of current common shareholders.

For this reason, bank executives will have excessive incentives to avoid raising new equity capital. Moreover, to avoid getting into a situation in which the regulator forces the bank to raise new equity capital, executives may avoid deploying even available cash reserves so as not to risk falling short of the regulatory capital thresholds in the near future as a result of losses they may be forced to recognize. In this scenario, even though they technically have sufficient capital to lend, banks might turn down positive expected value lending opportunities in order to protect current common shareholders from dilution in the future.

If the divergence between executives' interests and the aggregate interests of those with a stake in the bank manifests itself in reluctance to lend, it might appear to some as a reluctance to take risks and thus might seem to be in tension with the argument that executives' pay structures have provided them with excessive incentives to take risks. In the current circumstances, however, the reluctance to lend might be due to a reluctance to raise additional equity capital – and a desire to reduce the likelihood of being forced to raise such equity capital. And a desire to avoid raising additional capital even when the bank is just marginally (or even inadequately) capitalized is fully consistent with our earlier arguments.

Indeed, the reluctance to raise additional equity capital reflects the asymmetry between upside and downside payoffs on which we have been focusing throughout. As we have

[54] The idea was first clearly articulated by Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 JOURNAL OF FINANCIAL ECONOMICS 147 (1977).

explained, the common shareholders (and executives aligned with their interests) can expect to capture fully upside gains but to be limited in their exposure to large downside losses. These common shareholders (and executives aligned with them) have an excessive incentive to avoid raising equity capital because (i) the common shareholders will bear the costs of the new equity's capturing its share of the upside, and (ii) due to the common shareholders' insulation from large losses, the common shareholders will not internalize the full value of the new equity's contribution to absorbing such losses.

IV. CURRENT ATTEMPTS TO IMPROVE INCENTIVES

There is now widespread recognition that executive compensation is important and that compensation packages may have contributed to the excessive risk taking that has occurred. For this reason, the TARP legislation directed the Treasury Secretary to require TARP recipients not to have pay packages that provide incentives to take excessive risks.[55] The executive compensation provisions in the recent stimulus bill imposed additional restrictions on compensation in TARP recipients and adopted again the principle of avoiding incentives to take

[55] *See* Sections 111 and 302 of the Emergence Economic Stabilization Act of 2008 (EESA), P.L. 110-343 (Division A), codified as 12 U.S.C. 5221, and the explanation of these provisions by Joseph Bachelder, *EESA Limits on Executive Pay at Affected Institutions*, NEW YORK LAW JOURNAL (11/14/2008); and Davis Polk & Wardwell, EXECUTIVE COMPENSATION RULES UNDER THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (October 23, 2008), available at http://www.dpw.com/1485409/10.23.08.epg.tarp.memo.pdf, accessed 03/21/2009. In particular, Section 111(b)(2)(A) EESA required the Treasury Secretary to ensure that financial institutions selling troubled assets to the Treasury outside of a competitive bidding process in exchange for a financial stake in the institution had to have "limits on compensation that exclude incentives for senior executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary holds an equity or debt position in the financial institution." The Treasury promulgated such guidelines on 02/04/2009, which impose, in particular, that executive base pay be limited to $500,000 and any incentive pay be granted in the form of restricted stock, although these rules can be waived by shareholders of all TARP recipients except those receiving "exception financial recovery assistance." *See* US Department of the Treasury, press release of 02/04/2009 available at http://www.ustreas.gov/press/releases/tg15.htm, accessed 03/29/2009. On the Treasury's guidelines, *see* Davis Polk & Wardwell, NEW EXECUTIVE COMPENSATION RESTRICTIONS UNDER THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (February 6, 2009), available at http://www.dpw.com/1485409/clientmemos/2009/02.05.09.ec.pdf, accessed 03/21/2009.

excessive risks.[56] Various observers have pointed out that what this means is fairly vague,[57] and to our knowledge there has thus far been little effort to operationalize this principle. Furthermore, as we explain below, the main measures that have been thus far adopted or proposed by Congress or the administration – limiting incentive pay to restricted stock, introducing say-on-pay votes, and constraining the amount of incentive pay – do not, or only very imperfectly, address the major harmful incentives we identified above. Below, we discuss in turn each of these three measures.

A. Mandating the use of restricted stock?

Restrictions proposed by the administration sought to encourage TARP recipients to use restricted stock. For companies getting special assistance, this use was mandated for any compensation above $500K.[58] For other companies getting TARP financing, this use was mandated if the company did not opt out.[59] The stimulus bill tightened this rule by eliminating the opt-out possibility. Incentive compensation for top officers and employees of TARP recipients must be exclusively in long-term restricted stock.[60]

Is the use of restricted stock a good way of providing executives with good incentives to deal with risks? Not at all.

To be sure, restricted stock does not involve the extra problems resulting from the use of options discussed above. And to the extent that the unloading of shares is restricted, this might address the problems discussed by other work, concerning distortions arising from the freedom to unload incentives.[61] But the analysis in this paper has shown that, even assuming there is only

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[56] *See* Title VII of the American Recovery and Reinvestment Act of 2009, 111 H.R. 1, amending Sections 109(a) and 111 of the EESA (previous note), and the explanations in Davis Polk & Wardwell, COMPENSATION PROVISIONS IN THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009 (February 17, 2009) available at http://www.dpw.com/1485409/clientmemos/02.17.09.stimulus.bill.memo.pdf (accessed 03/21/2009).

[57] *See, e.g.,* Davis Polk & Wardwell, previous note, at 10.

[58] *See* the Treasury guidelines issued on 02/04/2009, *supra* note 55, and the explanations in Davis Polk & Wardwell, NEW EXECUTIVE COMPENSATION RESTRICTIONS, *supra* note 55.

[59] Ibid.

[60] *See* section 111(b)(3)(D) of EESA as amended by the American Recovery and Reinvestment Act of 2009, *supra* note 55.

[61] The statute requires that the long-term restricted stock not fully vest during the time that the company owes TARP money to the government, *see* section 111(b)(3)(D)(I) of EESA as amended (previous note).

one period at the end of which results are realized, the use of restricted stock in bank holding companies provides incentives to take excessive risks, and this is especially the case in the current circumstances.

Even when the market capitalization of the bank holding companies was substantial, tying executive payoffs to the value of the shares of the holding companies linked the payoffs of executives to a limited part of the capital invested in the operating banks. In the example considered above, the executives were tied to a position in the bank's assets levered by 96 percent when putting together the claims of depositors and debt-holders at the levels of the bank and the bank holding company. Now that the value of bank assets has declined, so that the book value of the common shares in the bank holding company is substantially reduced – and might be negative – restricted stock will tie executive payoffs to an extremely levered bet on the value of the assets of the bank and thus give executives highly distorted incentives.

One way of seeing the flaw in using restricted common shares in bank holding companies as the exclusive instrument of executives' incentive pay is by noting the divergence of interests between common shares in bank holding companies and the preferred shares owned by the government in some banks that have received TARP funding. Because the common shareholders have claims that are junior to those of preferred shareholders, the common shareholders would benefit from taking more risks than would be in the interest of preferred shareholders. Thus, a government mandate to use restricted common shares will induce executives to deviate from the course of action that would best protect the interests of the government as preferred shareholder.

B. Say on Pay?

Another approach pursued by the administration and Congress is to subject compensation in TARP recipients to advisory "say on pay" votes. The Treasury's proposed guidelines for recipients of exceptional TARP assistance required that "[t]he senior executive compensation structure and the rationale for how compensation is tied to sound risk management must be submitted to a non-binding shareholder resolution."[62] More generally, the Treasury proposed

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Similarly, the Treasury guidelines, *supra* note 55, require that restricted stock awards to senior executives of companies receiving "exceptional recovery assistance" vest only after the government has been paid back in full with interest.

[62] *See* Treasury guidelines of 02/04/2009, *supra* note 55.

that in the future, "[e]ven beyond companies receiving financial recovery assistance, owners of financial institutions – the shareholders – should have a non-binding resolution on both the levels of executive compensation as well as how the structure of compensation incentives help promote risk management and long-term value creation for the firm and the economy as a whole."[63] The stimulus bill extended the advisory say-on-pay requirement to all TARP recipients.[64]

There is a lot that can be said in favor of say on pay in companies in general, and one of us testified in Congress in favor of say on pay proposals.[65] But say on pay proposals are intended to contribute to aligning the interests of executives with those of shareholders, which is desirable in companies in general. In the case of banks receiving TARP financing, however, tightening the link between the interests of executives and common shareholders is not the objective the government should pursue. Quite the contrary, such alignment might push executives in a direction that considerably diverges from the interests of the government as investor in the banks and as de jure and de facto guarantor of some of their obligations.

As an investor, the government has put a lot of money into preferred shares that are senior in the capital structure to the common shares. In addition, the government guarantees deposits up to $250,000 de jure ($100,000 from 01/01/2010), and possibly beyond that de facto. Making executive pay more responsive to the preferences of common shareholders cannot be expected to produce incentives to take into account the interests of preferred shareholders, bondholders, and depositors.

To the contrary, as we have seen, the common shareholders of the bank holding companies, especially under current circumstances, will benefit from taking excessive risks and have an interest in encouraging executives to take such risks. Empirical studies have documented that bank executives take more risks when their incentives are more aligned with shareholders'.[66] Thus, the fact that shareholders of bank holding companies voted in favor of a pay structure, and

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[63] Ibid.

[64] *See* section 111(e) of EESA as amended by the American Recovery and Reinvestment Act of 2009, *supra* note 56. For explanations of this provision, *see* Davis Polk & Wardwell, "SAY ON PAY" NOW A REALITY FOR TARP PARTICIPANTS (February 25, 2009), available at http://www.dpw.com/1485409/clientmemos/2009/02.25.09.say.on.pay.pdf, accessed 03/25/2009.

[65] *See* Lucian A. Bebchuk, Written Testimony Before the Committee on Financial Services – United States House of Representatives – Hearing on Empowering Shareholders on Executive Compensation – March 8, 2007, available at http://www.law.harvard.edu/faculty/bebchuk/pdfs/2007_HFSC.pdf (accessed 03/25/2009).

[66] *See* Brewer, Hunter & Jackson, *supra* note 35; Gorton & Winton, *supra* note 17, at 526-529.

the fact that pay structures might be set with the prospect of such a vote, hardly indicate that pay structures will avoid incentives that encourage excessive risk taking. Thus, introducing say-on-pay votes cannot be expected to contribute to eliminating incentives to take excessive risks.

C. Limits on incentive pay?

The Stimulus Bill limited the fraction of executive pay in TARP recipients that can take the form of incentive pay. The Bill stipulated that, under rules to be promulgated by the Treasury Secretary, senior executive officers and the highest-paid employees of major TARP recipients will not be allowed to receive "any bonus, retention award, or incentive compensation … except … long-term restricted stock … in an amount … not greater than 1/3 of the total amount of compensation of the employee receiving the stock," subject to certain further restrictions.[67] While some of these terms raise difficult issues of interpretation[68], we will assume that these provisions effectively limit any incentive pay to one-third of the total annual salary of the executive or employee in question.

In principle, well-designed incentive pay can improve the management of firms.[69] We share the view that incentives matter, and we will explain below how appropriately designed incentive pay can help to stabilize our banks in the current crisis and beyond.

That being said, our analysis above identified major problems with the current incentive structure for bank executives. From this perspective, scaling down financial incentives may be a good thing. *No* financial incentives may be better than *bad* ones. Thus, if incentive compensation remains structured in ways that provide perverse incentives, limits on incentive pay can actually improve matters. Rather than discussing this question, however, we move on to what is an

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[67] *See* section 111(b)(D)(i) of EESA as amended by the American Recovery and Reinvestment Act of 2009, *supra* note 56. The provision covers the senior executive officers of companies receiving at least $250m in TARP financing, as well various numbers of highest paid employees depending on the amount of TARP funds received, ibid section 111(b)(D)(ii). The provision is not directly applicable but requires the Treasury Secretary to adopt rules implementing the limitations; the Treasury Secretary can impose further terms and conditions, ibid section 111(b)(D)(i)(III).

[68] *See* Davis Polk & Wardwell, *supra* note 56, at 4-7.

[69] Focusing on this aspect, most commentary from the academic and business world was very critical of the incentive pay cap. *See, e.g.*, Wachtell, Lipton, Rosen & Katz, FINANCIAL INSTITUTIONS DEVELOPMENT – CONGRESSIONAL LEADERS AGREE TO ELIMINATE INCENTIVE COMPENSATION AND IMPOSE OTHER COMPENSATION RESTRICTIONS FOR TARP PARTICIPANTS (February 13, 2009), available at http://blogs.law.harvard.edu/corpgov/files/2009/02/wlrk-16493-09.pdf (accessed 03/26/2009).

unambiguously superior alternative to both bad incentives and no incentives: well-designed incentives.

V. THE WAY FORWARD – GETTING INCENTIVES RIGHT

In the preceding parts II through IV, we laid out the problems inherent in current executive pay arrangements in banks. Deposit insurance and "too big to fail" policies for banks create the standard moral hazard problem – an incentive for bank shareholders to gamble with the bank's assets at the expense of the government. The structure of banks and of bankers' pay provides incentives to engage in excessive risk-taking even beyond what is suggested by the standard moral hazard problem. The depletion of banks' assets in the current crisis has further levered bank shareholders' positions, exacerbating the identified problem. And none of the current legislative and regulatory proposals deals effectively with this problem.

In this part V, we argue for including a regulation of bankers' pay as part of banking regulation. In section A, we consider the traditional approach to banking regulation, which attempts to address the moral hazard problem by restricting the menu of choices available to banks. We highlight the limitations of this approach, and show that it can be usefully complemented with regulation of the incentives of those making the choices from the menu. In section B, we discuss in more detail the forms that such regulation of incentives should take. At a minimum, bank regulators should monitor the incentives of the banks' top management team. In addition, we argue that it might be desirable for regulators to encourage or even require certain arrangements, as well as to prohibit or at least discourage certain other arrangements. Finally, in section C, we emphasize the complementary nature of regulation of bankers' pay and the traditional approach. Optimal regulation should combine both approaches.

A. Supplementing the Traditional Approach

There is a substantial body of regulation – both in the U.S. and in other countries around the world – that attempts to deal with the moral hazard problem of banks.[70] This large body of

[70] On the international level, the current relevant regulation is contained in the revised Basel accord (Basel II), *see* Basel Committee on Banking Supervision, *supra* note 20; and for an historical overview, explanations of the main features, and possible extensions *see* Malloy, *supra* note 20; and Laurent

regulation addresses bank behavior directly. It prevents banks from taking certain actions, such as making certain investments or loans that are deemed too risky given the banks' capital and portfolio, and it requires them to take certain other actions, such as maintaining certain amounts of capital. Banking regulators monitor banks' activities and capital situations to enforce these criteria. In other words, this body of regulations attempts to limit the choices available to banks in order to preclude socially inefficient choices. The sweeping "Framework for Regulatory Reform" recently announced by the Treasury remains firmly within that paradigm.[71]

The traditional approach of limiting banks' choices is fraught with well-known difficulties. The regulation needs to rule out socially inefficient choices, but should not restrain socially efficient ones.[72] Discriminating between the two is hard. In particular, determining the riskiness of a bank's asset pool and the corresponding appropriate level of capital requires not only an extremely sophisticated understanding of risk modeling but also intimate knowledge of the positions that the bank is taking. As outsiders, regulators are bound to be at an information disadvantage vis-à-vis bank executives.[73] In practice, regulators will also often lag behind the banks in their capacity to process the information that they receive.[74] These difficulties have increased with the growth of financial institutions.[75] Most importantly, the incentives are such that banks can be expected to seek ways to get around regulations and take risks beyond the level sought by regulators.[76]

In principle, regulatory agencies and commentators understand the nature of this "game" between banks and their regulators and the resulting imperfections of traditional regulation very

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Balthazar, FROM BASEL 1 TO BASEL 3: THE INTEGRATION OF STATE-OF-THE-ART RISK MODELING IN BANKING REGULATION (2006). In the United States, the relevant regulation for bank holding companies is contained in regulation Y of the Federal Reserve (12 C.F.R. 225).

[71] *Cf.* U.S. Department of the Treasury, Press Release of March 26, 2009, "Treasury Outlines Framework for Regulatory Reform," available at http://www.treasury.gov/press/releases/tg72.htm, accessed 03/31/2009, and Treasury Secretary Geithner's congressional testimony of the same date, *supra* note 12 (mentioning the four components addressing systemic risk, protecting consumers and investors, eliminating gaps in the regulatory structure, and fostering international coordination, but not executive compensation as a crucial lever of regulatory reform).

[72] *See, e.g.,* Padoa-Schioppa, *supra* note 18, at 2-3.

[73] *See, e.g.,* Hu, *Misunderstood Derivatives*, *supra* note 19; and Calomiris, *supra* note 19.

[74] *See, e.g.,* Barth, Caprio & Levine, *supra* note 19; and Hu, *Swaps*, *supra* note 19, at 395-396.

[75] *See, e.g.,* Board of Governors of the Federal Reserve System, Staff Study 172 – Using Subordinated Debt as an Instrument of Market Discipline (December 1999), at 1.

[76] *See, e.g.,* Calomiris, *supra* note 19.

well. But they have paid insufficient attention to the crucial role of executive compensation in this game. Executive compensation shapes the incentives of those actually making the decisions on behalf of banks, namely their managers. Executive compensation that provides executives with powerful incentives to take risks, as current executive pay arrangements do, incentivizes managers to work against the goals of prudential regulation. At a minimum, banking regulators should monitor the strength of these incentives as part of their overall risk monitoring. Moreover, regulators should consider regulating executive compensation in banks to eliminate incentives to take risks that are inconsistent with the goals of prudential regulation. In this way, banking regulation might be able to harness bank managers' information and expertise, rather than fight against them.

We discuss how regulators should monitor and restrict bankers' pay in some detail in the following section. Here we want to emphasize how regulating bankers' pay conceptually differs from the traditional forms of banking regulation. While traditional banking regulation regulates and monitors the menu of choices available to bank executives, regulators may in addition elect to regulate and monitor the incentives shaping how bank executives make choices from this menu. As will be discussed further in section C below, both approaches can complement each other and work together to reduce the incidence of excessive risk-taking.

Even though the traditional focus of bank regulators and banking scholars has been on the moral hazard problem between shareholders and the government, the crucial decision makers in many banks are executives whose incentives are substantially influenced by pay arrangements. The importance of executives' incentives is confirmed by the evidence that banks whose managers have weaker incentives to serve shareholder interests take less risk.[77] Given the importance of these incentives, monitoring and regulating them can provide regulators with an additional and important instrument.

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[77] *See* Gorton & Winton, *supra* note 17, at 526-529 (reviewing the empirical literature up to 2003); Brewer, Hunter & Jackson, *supra* note 35 (documenting the increase in equity-based compensation and an associated increase in risk-taking). More generally, much of corporate governance research is concerned with the problem that managers will *not* implement shareholders' wishes, a problem first clearly articulated in Jensen & Meckling, *supra* note 17, at 312-330 (calling this the "agency cost of outside equity").

In 2006, the Basel Committee on Banking Regulation issued a report on the importance of enhancing corporate governance in banking organizations.[78] The report stresses the importance of banks' internal governance processes, including adequate board involvement in determining the pay of senior executives.[79] While the report appears to recognize that executive pay decisions are important, it fails to recognize that boards selected by shareholders cannot be generally counted on to eliminate risks for excessive risk taking – in the same way that they cannot be fully counted on to avoid excessive risks in deciding how much capital to maintain and how to invest the banks' assets. Banking regulators, therefore, should not limit themselves to confirming that boards are adequately involved in making executive pay decisions. Regulators do monitor and regulate banks' capital and investment decisions even when bank boards are adequately involved in such decisions. Similarly, we argue, banking regulators should monitor and possibly regulate banks' executive pay decisions, regardless of whether boards are adequately involved.

More recently, in April 2009, the Financial Stability Forum, which includes representatives of financial authorities from the advanced economies, issued a report, "FSF Principles for Sound Compensation Practices."[80] The report still appears to believe that involvement by shareholders and directors can bring about desirable compensation structures and seeks to facilitate disclosure to shareholders and engagement by them, and thus does not recognize the divergence between the pay arrangements that would be preferable by shareholders and those that would be optimal. But the report suggests that regulators should be willing to intervene when they observe deviations from sound practice. We view this as a very welcome development.

B. Monitoring and Regulating Bankers' Pay

We now discuss in more detail how banking regulators should take into account executive pay arrangements. At a minimum, banking regulators should monitor existing pay arrangements to identify constellations that would reward executives for excessive risk-taking.

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[78] *See* Basel Committee on Banking Supervision, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS (Bank for International Settlements, 2006).

[79] Ibid., paragraphs 44-47.

[80] See Financial Stability Forum, FSF Principles for Sound Compensation Practices, available at http://www.financialstabilityboard.org/publications/r_0904b.pdf.

We discuss this strategy in subsection 1. We discuss the possibility of regulating pay arrangements directly in subsection 2.

1. Monitoring Executives' Incentives

To begin, in the same way that regulators already monitor the balance sheets of banks and the positions that they take, regulators should also monitor and assess executives' pay packages, including option and stock holdings from years past. Such monitoring and assessment is important for assessing the risks posed by the bank. We have seen that pay arrangements can provide powerful incentives for excessive risk taking. Hence regulators need to understand these arrangements, and ring the alarm bell when these arrangements favor excessive risks, particularly when they give executives incentives to maximize the value of a thin junior slice of the bank's capital. We surmise that if banking regulators had seen the incentive structures in banks as we see them now, they would have been alarmed early on. In the future, monitoring executives' incentive structures should be a part of regulators' standard procedure.

Which aspects of executives' pay to monitor follows naturally from our analysis of the leveraged moral hazard problem above. We have seen that the problem results from executives' insulation from downside risk, which depends on the amount of debt at various levels of the banking organization, the amount of shares and options held by or promised to the executive, and the strike price of options, if any. Regulators already possess information on the level of debt, and can easily obtain information on shares and options held by executives. From this information, regulators can calculate the sensitivity of executive pay to value increases and decreases of the bank's assets, possibly conditional on value increases or decreases at the holding level.

If the executive's pay sensitivity is too asymmetric, i.e., if the executive is too protected from downside risk, regulators should adjust upwards their assessment of the risks posed by the bank. Such upward adjustment of risks may lead regulators to take the steps that they would take when making such an upward adjustment for other reasons (e.g., an increase in the perceived risk of a bank's loans pool). Regulators could, for example, demand additional reassurance from the bank, be it in the form of additional capital or otherwise. Regulators already wield significant powers to intervene when they detect a danger to the safety and soundness of a banking

institution. Regulators should also look to executive pay arrangements in determining whether and to what extent such a danger exists.

2. Regulating Executives' Incentives

We now turn to the possibility of directly regulating executive pay arrangements, or at least encouraging or discouraging certain arrangements. Such regulation should seek to limit the extent to which bank executives face asymmetric payoffs when considering options that have both an upside and a downside. Putting forward a comprehensive and detailed blueprint for such regulation is beyond the scope of this paper. What we would like to do, however, is to outline directions that such regulation should take and thereby provide a basis for subsequent discussions of the subject.

It is most straightforward to describe the direction we suggest when executives' payoffs are linked to the value of specified securities. At present, executives' payoffs are linked only to equity, or even a levered bet on equity to the extent they are granted options rather than straight equity. To encourage more prudent decision-making, we suggest that bank executives' equity-based compensation be replaced with compensation based on the value of a broader basket of securities representing a larger part of the corporate pie. To begin, now that the government has become a major investor in many banks in which it holds preferred stock, it naturally has an interest in having executives' payoffs linked also to the value of preferred stock. For example, instead of tying executives' compensation to the value of a specified percentage of the common shares, executives' compensation could be tied to the value of a specified percentage of the value of the common shares and the preferred shares.

More generally, executives' payoffs could be tied to an even broader basket of securities than common shares and preferred shares. In particular, executives' payoffs could be tied to a set percentage of the aggregate value of common shares, preferred shares, and all outstanding bonds. Because such compensation structure would expose executives to a broader fraction of the negative consequences of risks taken, it will reduce their incentives to take excessive risks.

Indeed, even the above structure would not lead bank executives to fully internalize and take into account the adverse consequences that the taking of risks might have for the interests of the government as guarantor of deposits. To do so, it would be necessary to broaden further the set of positions to whose aggregate value executive payoffs are tied, and it would be worth

considering how this can be best done. One could consider, for example, schemes in which executive payoffs are tied not to (a given percentage of) the aggregate value of the bank's common shares, preferred shares, and bonds but to this aggregate value minus any payments made by the government to the bank's depositors (as well as other payments made by the government in support of the bank) during a period ending one year after the executive's departure from the bank. Alternatively, one could consider tying executive payoffs to the aggregate value of the bank's common shares, preferred shares, and bonds minus the estimated increase (if any) in the expected value of government payments as proxied by the product of (i) the increase in the implied probability of default inferred from the price of credit default swaps, and (ii) the value of the bank's deposits. Until an effective way for doing so is identified, however, tying executive pay to the aggregate value of common shares, preferred shares, and bonds will already produce a significant improvement in incentives compared with existing arrangements.

Similarly, to the extent that executives receive bonus compensation that is tied to specified accounting measures, it also should be tied to broader measures. For example, the bonus compensation of some bank executives has been based on accounting measures such as return on equity or earning per common share that are of substantial interest to common shareholders. Our approach suggests that it would be worthwhile to consider basing bonus compensation on broader measures such as earnings before any payments made to bondholders.

One might wonder how our argument relates to the widespread view, which we share, that, in general, executive pay arrangements should be designed with a focus on aligning the interests of executives with those of shareholders.[81] In our view, banks present a special case because, given the systemic costs of bank failure and the government's guarantee of bank deposits, a body of regulation is in place to limit stockholders from making business decisions that would serve their interests but produce excessive risks and impose an externality. Because regulating executive pay can improve the effectiveness of banking regulation in achieving its

[81] One of us has written extensively on how executive compensation should be best designed to align executives' and shareholders' interests. *See* the sources cited *supra* in notes 8 and **Error! Bookmark not defined.**.

widely accepted goals, it could be appropriate to constrain banks' freedom to set pay structures while not imposing such constraints outside the banking sector.[82]

We expect that any regulation of executive pay would be viewed by some as excessive interference. Optimal setting of executive pay arrangements requires substantial information, it might be argued, and such decisions should therefore be left to private decisions by the banks themselves. In regulated banks, however, interference in business decisions is already commonplace under existing regulation anyway, and is viewed as justified by the fundamental moral hazard problem between shareholders and the government. Banking regulators already regulate decisions with respect to banks' capital and investments that are probably as (or even more) information-sensitive as decisions concerning executive pay. Furthermore, regulation of executive pay in banks could well take the form of setting some limits and principles while still allowing significant discretion to the banks. In addition, regulating bankers' pay might allow regulators to be less tough in other areas of banking regulation. Hence we do not believe that regulating bankers' pay would lead to more intrusive regulation overall.

Finally, we are aware that shareholders have other means of influencing management than explicit pay packages. Thus, even when executive pay in banks is regulated, shareholders vote on the election of directors who appoint and fire bank executives, and this voting power may by itself lead executives to give some weight to shareholders' preferences. But the fact that executives may have other incentives to take excessive risks to benefit common shareholders hardly implies that it would not be desirable to limit the extent to which pay arrangements provide them with such incentives. Doing so would at least move us in the right direction.

C. Combining Old and New Tools

In section A, we briefly reviewed the traditional approach to banking regulation, which monitors and restricts the menu of choices available to banks. In section B, we argued for

[82] While shareholders of firms outside the banking sector (or directors elected by such shareholders) should not be constrained by regulators in setting the structure of executive pay arrangements, firms seeking to reduce their borrowing costs should be free, of course, to agree to covenants that require them to tie executive pay also to the value of the firm's debt securities. For theoretical analyses of whether and when such covenants could be efficient, *see* David Hirshleifer and Anjan Thakor, *Managerial Conservatism, Project Choice, and Debt*, 5 REVIEW OF FINANCIAL STUDIES 437 (1992), *Teresa John and Kose John, Top-Management Compensation and Capital Structure*, 48 JOURNAL OF FINANCE 949 (1993), and, most recently, Alex Edmans, *Inside Debt*, Working Paper, Wharton School, December 2008.

supplementing it with a new approach, which monitors and possibly restricts the incentives provided to bank managers who choose from this menu. Here we offer additional comments on the complementary relationship between the two approaches.

As we have seen, both approaches are imperfect. The traditional approach provides banks with incentives to find ways to circumvent the regulations without breaking them, while regulators struggle to understand what exactly the banks are doing, and how to evaluate the ensuing risks. And we recognize that the proposed incentive-based approach can be expected to be imperfect as well.

It might therefore be often optimal to utilize and combine elements of both approaches. Regulators could focus both on the menu of choices available, and on the incentives influencing the choices from that menu. The two approaches may reinforce each other and work together to protect the safety and soundness of banks. At the same time, adding regulation of pay to the traditional approach does not necessarily mean that banking regulation should or will become overall more stringent. Adding a new tool allows less frequent or less constraining use of others.

Especially when bankers' pay is not directly regulated, monitoring executive pay should play an important role in determining the appropriate capital and other regulatory requirements specific to each institution, as explained in section 2.1 above. This does not mean that capital or other traditional regulation should become tougher across the board; rather, information about executive pay arrangements should be used to produce a better fit between regulatory requirements and individual banks' risk profiles.

Conversely, when bank regulators ensure or at least verify that executives do not have strong incentives to take risks, they can afford to give them more discretion to make choices. We do not believe that regulating executives' incentives alone would be sufficient to ensure the soundness of financial institutions, and hence we are not advocating a repeal of existing banking regulation. But we do believe that, with experience, banking regulators may sometimes be able to reduce traditional regulation of the menu of actions when bank executives' incentives are more in line with the regulation's goals. More importantly, combining traditional direct regulation of banks' actions and activities with the proposed regulation of bank executives' pay may well improve the overall effectiveness of banking regulation and thus contribute to securing the safety and soundness of the banking sector.

VI. CONCLUSION

This paper has identified some key factors that have encouraged bank executives to take excessive risks. It has also shown that these factors are still present and that current attempts to regulate bankers' compensation fail to address them. Furthermore, it has identified the compensation arrangements necessary to eliminate the identified incentives to take excessive risks both in banks receiving TARP support and in banks in general. .

Looking beyond the current crisis, executive compensation can serve as a powerful lever that can harness executives' information and expertise to the regulators' advantage. Going forward, monitoring and regulation of bank executives' compensation – along the lines we have put forward – can constitute a valuable component of banking regulation and complement nicely the monitoring and regulation of banks' investment and lending decisions. We hope that our analysis will contribute to an objective whose importance has been made clear by the financial crisis – ensuring that bank executives not have incentives to take excessive risks.

Testimony Concerning the Oversight and Regulation of Executive Compensation

By Brian V. Breheny,
Deputy Director, Division of Corporation Finance
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Before the United States House of Representatives Committee on Financial Services

June 11, 2009

Introduction

Good morning Chairman Frank, Ranking Member Bachus, and members of the Committee. As a Deputy Director of the Securities and Exchange Commission's Division of Corporation Finance, I am pleased to be with you today to testify on behalf of the Commission so that I may share with you our thoughts on the topic of executive compensation.

I appreciate the opportunity to discuss with you the Commission's ongoing efforts in this area. As the landscape of compensation practices continues to change, the Commission is committed to keeping the disclosure rules we administer up to date so that investors have the information they need to make informed investment and voting decisions.

Background

As you know, in recent years the issue of executive compensation has garnered significant public attention. There are numerous news stories about executives who have been enriched while the value of their companies has declined precipitously. As these revelations about executive compensation come to light, claims have been made that

bonuses and severance packages at some companies have been exorbitant. Executive compensation has been a lightning rod, amplified by the recent financial crisis, for concerns about the accountability and responsiveness of some boards of directors to the interests of their shareholders. These concerns have included whether boards are exercising appropriate oversight of management; whether boards are appropriately focused on shareholder interests; and whether boards need to be held more accountable for their decisions, particularly regarding such issues as compensation structure and risk management. Although these concerns have not been raised with regard to all public companies and the conduct of certain headline-grabbing companies should not be used to unfairly brand the actions of all boards or all board members, questions exist regarding the executive compensation market itself. For example, some have noted that compensation consultant recommendations are made by firms that may have conflicts of interest[1] and others have noted that compensation at one company may tend to inflate compensation at others because compensation is sometimes set by reference to comparable packages, creating a positive feedback loop.[2]

In order for public markets to function properly, it is crucial that shareholders – the owners of the company – be able to make informed decisions about their investments and boards of directors be accountable to shareholders for their decisions. This system is frustrated if shareholders are not provided with adequate information about their companies, including the compensation paid to management, or if they are unable to exercise effectively their rights to elect directors that they believe will best promote the

[1] See, for example, Comment Letter of James F. Reda on SEC File No. S7-03-06 (Proposed Rules on Executive Compensation and Related Party Disclosure), Apr. 6, 2006.

interests of shareholders. Disclosure in these areas also provides shareholders with information that is helpful when they choose to exercise their rights under state law because they believe that directors may have breached their fiduciary duties.

Executive Compensation Rules

Consistent with this approach, the Commission's rules governing the disclosure of executive compensation are designed to elicit comprehensive and detailed information about all elements of a company's compensation practices and procedures with respect to senior executives. The Commission's focus is on requiring companies to provide high quality, material and understandable information to investors. We believe that the information about executive compensation in disclosure documents must be straightforward and meaningful so that investors can properly assess the information. Armed with that information, investors can better judge whether the board of directors has acted appropriately in allocating assets for compensation and setting incentives and rewards for management. In keeping with this agency's mission, the design and purpose of the rules are to protect and advance the interests of shareholders. We seek to help shareholders receive the information they need to make informed voting and investment decisions.

Complementing the mandated disclosure of executive compensation, the Commission's proxy rules also provide shareholders with a mechanism to voice their views on compensation. Under the Commission's shareholder proposal rule, a shareholder can have a properly-structured proposal – for example, a proposal for "say on

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[2] See Viral V. Acharya and Paolo F. Volpin, Corporate Governance Externalities (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1140556.

pay" – included in the company's proxy materials. Indeed, during the most recent proxy season, approximately 125 shareholder proposals relating to executive compensation were included in the proxy statements of U.S. public companies.[3]

Notwithstanding the Commission's current rules, we recognize that there is an ongoing, vigorous debate between those who believe that there should be more substantive constraints on pay and those who believe that the federal government should never, or rarely, set pay parameters. It is important to note, however, that this debate is significantly more meaningful as a result of our disclosure rules. Without the Commission's rules, compensation information, which is the basis for the debate, would not be publicly available and the compensation practices that have been so controversial may never have come to light.

Consistent with the model developed by Congress in the securities laws, the Commission has mandated disclosure of compensation throughout its long history. Indeed, the Commission has had a form of compensation disclosure rules since the very early days of the agency in the late 1930s.[4] However, the challenge the Commission has always faced in promulgating and administering its executive compensation disclosure rules is that compensation practices are never static. Over the years, the manner and types of compensation have continually evolved and become increasingly complex. As a

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[3] Based on information publicly available from RiskMetrics Group, these proposals have received on average 42.7 percent support at meetings for which voting results are available, with at least 16 say-on-pay proposals receiving majority support.

[4] In 1938, the Commission adopted Regulation X-14, the predecessor of current Schedule 14A, which set forth specific disclosure requirements for proxy statements. Item 7(b) of these regulations required specified disclosure of compensation received by nominees if action was to be taken for director elections or other officials. For more information, see Securities and Exchange Act Release 1823, August 11, 1938.

consequence, the Commission has revised its disclosure rules as necessary to keep pace with new developments in compensation practices.[5]

Comprehensive 2006 Amendments

Most recently, in 2006, the Commission adopted a comprehensive package of amendments to the executive compensation rules that was intended to significantly improve the existing regime of executive and director compensation disclosure. The Commission took this action to once again keep pace with the changes in the marketplace. Prior to adopting the rules, the Commission and its staff conducted an exhaustive reassessment of the agency's previous disclosure requirements.

Building on the strengths of the previous disclosure requirements, the 2006 amendments combined a broader-based tabular presentation with improved narrative disclosure that is designed to give investors and shareholders information about how and why a company arrived at specific executive compensation decisions and policies. Among the more significant changes, the 2006 revisions included:

- the revision and reorganization of existing tabular disclosure of executive compensation, including requiring companies to provide disclosure of annual total compensation to named executive officers[6] and directors, distilled in one "bottom line" number;

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[5] See, for example: Securities Exchange Act Release No. 3347 (Dec. 18, 1942); Securities Exchange Act Release No. 4185 (Nov. 5, 1948); Securities Exchange Act Release No. 4775 (Dec. 11, 1952); Securities Exchange Act Release No. 4979 (Jan. 6, 1954); Securities Exchange Act Release No. 7775 (Dec. 22, 1965); Securities Act Release No. 5949 (Jul. 28, 1978); Securities Act Release No. 6003 (Dec. 4, 1978); Securities Act Release No. 6261 (Nov. 14, 1980); Securities Act Release No. 6486 (Sept. 23, 1983); Securities Act Release No. 6940 (Jun. 23, 1992); and Securities Act Release No. 8655 (Jan. 27, 2006).

[6] The definition of "named executive officer," often referred to by its acronym, "NEO," is provided in Item 402(a)(3) of Regulation S-K and includes:

- enhanced disclosure about executive perquisites;
- a new "Compensation Discussion and Analysis" section intended to serve as an overview of the material elements, policies and decisions related to the named executive officers' compensation;
- improved disclosure of retirement benefits; and
- detailed descriptions of payments that could be made to executives in the event of their termination or a change in control.

Shortly after implementation of the revised rules, in the spring of 2007, the staff of the Commission's Division of Corporation Finance undertook a review of the proxy statements of 350 public companies in an effort to both evaluate compliance with the revised rules and provide guidance on how companies could enhance their disclosures in this area. After the staff completed its review, it prepared a report of its observations of the quality of the disclosure and presented a summary of how it thought companies could improve. In the report, which was published (and is still available) on the Commission website,[7] the staff disclosed the principal comments it provided to companies that were subject to the review. Overall, the staff noted at the time that companies generally made a good faith effort to comply with the new rules, and investors had benefited from the

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(i) All individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year ("PEO"), regardless of compensation level;

(ii) All individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year ("PFO"), regardless of compensation level;

(iii) The registrant's three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year; and

(iv) Up to two additional individuals for whom disclosure would have been provided pursuant to paragraph (a)(3)(iii) of this Item but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.

[7] The report is available at http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm.

new disclosures.[8] At the same time, the staff's comments highlighted areas where it believed companies may need to provide additional or clearer disclosure in future filings. For example, the Commission made clear in adopting the rules in 2006 that it was looking for more than just the value of the components of compensation and a total value of compensation. Therefore, the staff emphasized in its report that companies should provide investors with a more robust discussion of the basis and the context for granting different types and amounts of executive compensation. The staff stressed that the reasons *why* boards arrived at specific executive compensation decisions, policies and awards are just as important as the disclosure of the particular awards themselves. In addition, the staff also encouraged companies to continue thinking about how executive compensation information – from the big picture to the details – can be better organized and presented for both the lay reader and the professional, in order to make the disclosure as useful and meaningful as possible.

The review of executive compensation disclosure remains a focal point of the Division's disclosure program and the staff continues to provide companies with individualized comments on how they can enhance their disclosure.

Upcoming Rulemaking Proposals

The adoption of the 2006 rule revisions significantly expanded the extent and strengthened the caliber of compensation disclosure that shareholders receive, but the Commission is once again considering possible enhancements.

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[8] See remarks from former Director of Corporation Finance, John White, dated Jan. 23, 2008, available at http://www.sec.gov/news/speech/2008/spch012308jww.htm and Oct. 9, 2007, available at http://www.sec.gov/news/speech/2007/spch100907jww.htm.

It has been suggested that, at some companies, executive compensation has become disconnected from long-term company performance because the interests of management, in the form of incentive compensation arrangements, and the interests of some classes of investors are not sufficiently aligned. Critics have complained that, in some cases, the incentive structure created by executive compensation may have driven management to make decisions that significantly, and inappropriately, increase company risk, without commensurate risk to management's compensation should the decision prove costly to the company. Companies, and in turn shareholders, can be negatively impacted where the design or operation of their compensation programs creates incentives that drive behavior inconsistent with the overall interests of the company and its shareholders. Indeed, one of the many contributing factors cited as a basis for the current market turmoil is the misalignment at a number of large financial institutions of management's financial interests with those of shareholders. It has been argued that risk in these cases was not calibrated with the long-term value of the company in mind and compensation structures may have incentivized risk-taking for short-term rewards, at the expense of the long-term health and viability of the company. For instance, the particular application of some stock-based compensation plans or undue concern with analyst expectations may encourage speculation by employees and a focus on short-term stock price movements to the detriment of the long-term interests of the company.

Compensation policies and incentive arrangements represent just one of the issues that the Commission plans to take up next month when it considers a broad package of proxy disclosure enhancements. Many of these enhancements are designed to provide shareholders with additional information about their company's key policies, procedures

and practices. For example, the Commission plans to consider whether greater disclosure is needed about how a company – and the company's board in particular – manages risks, including in the context of establishing compensation plans and setting compensation levels. The Commission also plans to consider whether greater disclosure is needed about a company's overall compensation approach, in particular as it relates to a company's risk-management and risk-taking, beyond decisions with respect only to the highest paid executive officers. Enhanced disclosure about compensation practices for those outside of the executive suite could provide important insights into the relationship between risks and rewards and the behaviors that those compensation practices encourage. The Commission also plans to consider proposing new disclosure requirements regarding compensation consultant conflicts of interest in order to better equip investors to assess the advice provided by these consultants.

In addition to these disclosure enhancements related to executive compensation, the Commission also plans to consider proposals related to the directors themselves. For example, it plans to consider whether to enhance disclosure of director nominee experience, qualifications and skills, so that shareholders can make more informed voting decisions. The Commission also plans to consider proposed disclosures to shareholders about why a board has chosen its particular leadership structure – such as whether that structure includes an independent chair or combines the positions of CEO and chair – so that shareholders can better evaluate the board.

Shareholder Director Nomination Process and Disclosure

A fundamental precept of corporate law is that a company's board of directors is accountable to its shareholders, who in turn have the authority to elect the directors.

Thus, boards are accountable for their decisions concerning, among other things, executive pay, and for their oversight of the companies' management and operations, including the risks that these companies undertake. For many years, shareholders have used the shareholder proposal process outlined in the Commission's proxy rules to voice concerns about executive compensation and other matters. There is a long-standing debate, however, about whether such precatory proposals provide a sufficient mechanism for shareholders to influence companies' boards, because individual shareholders, who generally have a right under corporate law to nominate candidates for a company's board of directors, often lack the resources to effectively run a proxy contest to have their nominees elected and unseat existing board members. Thus, over a number of decades, the Commission has repeatedly considered requiring that public companies allow shareholders to list their nominees for director in the companies' proxy statements and place their nominees on the companies' proxy ballots.

The value of the executive compensation disclosure the Commission mandates and shareholder proposals concerning executive compensation is minimized if shareholders are unable to exercise effectively their fundamental right to nominate and elect members to company boards of directors. The Commission's proxy rules seek to improve the corporate proxy process so that it functions, as nearly as possible, as a replacement for actual in-person participation at a meeting of shareholders, given that such meetings are no longer a feasible way for most shareholders to exercise their franchise rights. Yet those very proxy rules may place unnecessary burdens on this right, at the expense of the board's accountability to shareholders. Absent an effective way for shareholders to exercise their right to nominate and elect directors – a right that state

corporate law presumes shareholders have – the election of directors can become a self-sustaining process of the board determining its members, with little actual input from shareholders. Without more effective competition for director positions, directors may be less accountable to shareholders and may lose sight of their proper role as representatives of the company.

Accordingly, on May 20, the Commission voted to approve[9] for notice and comment proposals that are designed to help give shareholders a meaningful opportunity to effectuate the rights that they already have under state law to nominate directors.[10] Under the proposals, shareholders who otherwise have the right to nominate directors at a shareholder meeting would, subject to certain conditions, be able to have a limited number of nominees included in the company proxy materials that are sent to all voters. To have a nominee or nominees included in a company's proxy materials, a shareholder would have to meet certain security ownership requirements, meet specified criteria including independence standards, provide certifications about the shareholder's intent and file a notice with the Commission of its intent to nominate a candidate, which includes specified disclosure about themselves and their nominee, for inclusion in the company's proxy materials. This aspect of the proposals is designed to provide important

[9] The Commission's vote was 3-2 in favor of the proposal, with Chairman Schapiro and Commissioners Walter and Aguilar voting to approve the staff's recommendation to propose rules, and Commissioners Casey and Paredes voting not to approve the staff's recommendation. For the Commissioners' statements regarding the proposal at the Commission meeting at which the proposal was considered, see http://www.sec.gov/news/speech.shtml#chair.

[10] Regulation of the proxy process and disclosure is a core function of the Commission and is one of the original responsibilities that Congress assigned to the Commission in 1934. Section 14(a) of the Exchange Act stemmed from a Congressional belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange."

information to all the shareholders about qualifying shareholder board nominees, so that shareholders can make a more informed voting decision.

To further facilitate shareholder involvement in the director nomination process, the Commission proposed amending the "election exclusion" of the shareholder proposal rule. Currently, that provision allows a company to exclude from its proxy materials a shareholder proposal that relates to a nomination or an election for membership on the company's board of directors or a procedure for such nomination or election. The "election exclusion" therefore prevents a shareholder from proposing amendments to a company's governing documents that would address the company's procedures for inclusion of shareholder nominees in company proxy materials or disclosures related to those shareholder nomination provisions. Under the proposed amendment to the shareholder proposal rule, companies would have to include such proposals in their proxy materials, provided the other requirements of the rule are met.

If adopted, these new rules would afford shareholders a stronger voice in determining who will oversee management of the companies that they own. Although shareholders have the right to elect directors, the Commission's proxy rules may in some cases frustrate shareholders in carrying out that function. Strengthening the ability of shareholders to hold boards of directors accountable to them – including for their oversight of compensation and risk management – should further empower shareholders and help to restore investor trust in our markets, which has been badly damaged in the current economic climate.

We recognize that the issue of shareholder access is controversial, and that there will be many who oppose the proposal, in whole or in part. The proposing release (which is available on the Commission's website) includes dozens of questions that are designed to elicit both positive and negative comments. The Commission sincerely wants to hear from all interested parties, and I have no doubt that the rulemaking process will be better because of the comments.

Conclusion

Thank you again for inviting me to appear before you today. On behalf of the agency, we look forward to working with Congress and with this Committee going forward on these issues. I would be happy to answer any questions you may have.

Committee on Financial Services
Hearing on Compensation Structure and Systemic Risk
June 11, 2009

Testimony from Nell Minow
Editor, The Corporate Library

Mr. Chairman and Members of the Committee, thank you very much for inviting me back to continue the discussion of executive compensation and the role it has played in providing perverse incentives and rewarding strategic decisions that were contrary to sustainable growth. In previous appearances before this committee both before and after the economic meltdown of late last year, I have called executive compensation both example and symptom of the greater instability in the financial services sector and our capital markets.

I am here as a passionate capitalist. I want executives to create shareholder value and I want them to earn a lot of money when they are successful. But I do not want them to be paid a lot of money when they fail. Pay that is disconnected from performance is a critical element in the bad decisions that lead to economic catastrophe.

In a May 28 essay in the Wall Street Journal, Professor Alan Blinder summarized the problem in an essay titled, "Crazy Compensation and the Crisis: We're all paying now because skewered financial incentives led to too many big bets." He describes the "skewed incentives," a heads you win, tails we lose pay plan that based on the "simple" notion that we "give smart people go-for-broke incentives and they will go for broke." He summarizes the consequences succinctly with a technical economic term: "Duh."

Blinder describes the past well but his most important point is that nothing has changed.

> Amazingly, despite the devastating losses, these perverse pay incentives remain the rule on Wall Street today, though exceptions are growing. For now, excessive risk-taking is being held in check by rampant fear. But when fear again gives way to greed, most traders and CEOs will have the bad old incentives they had before – unless we reform the system.

Americans are generous in times of need and forgiving of mistakes. But we are outraged at injustice. If people make poor choices, we understand. But if they profit at our expense from the consequences of those choices, we are appalled.

Out-of-control pay has damaged our financial markets in every category, not just because it rewards bad choices but because it fundamentally undermines the

credibility of our financial markets. The meltdown has opened up the market to new exchanges and new financial centers. Along with globalization and technology, these factors will have the potential for devastating long-term impairment of our ability to maintain primacy in the world markets. We have no ability or wish to hold back technology or globalization. That is all the more reason that the elements we do have control of, the transparency and alignment of interests between the providers of capital and the people who deploy that capital, must be immediately and indisputably credible, competitive, and incorruptible.

Unfortunately, that does not seem to be the way things are going. So I will speak briefly about what went wrong in the past but will spend most of my time on my concerns about what is happening now that repeats and even expands on our biggest pre-meltdown mistakes.

It is not difficult to figure out the problem with the structure of pre-meltdown compensation by focusing on the results. The markets crashed and the same people who made the choices that led to the crashes got paid more money than most people who do their jobs right. A little over three years ago, in my previous testimony before this committee, I said:

> In the 1990s, the cult of the CEO was based on the idea that vision and the ability to inspire were what made the CEOs worth the hundreds of millions of dollars they were paid. But a book by Harvard Business School professor Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*, makes a compelling case that corporate boards err seriously when they pick chief executives based on "leadership" and "vision" or when they pay huge premium pay that is not sensitive to performance to attract a "superstar." Bringing in a CEO with a great record at another company may give the stock price a short-term boost. But high-profile transplants such as Al Dunlap at Sunbeam (which went into bankruptcy) and Gary Wendt at Conseco (which went into bankruptcy), CEOs should have to make the same disclaimers that money managers do: "Past performance is no guarantee of future performance."
>
> Disclosure is important. The SEC's proposed rules are a step in the right direction. But disclosure only matters if the people who absorb this information have the ability to act on it, and that is not currently the case. Executive compensation is a hydra-headed monster – every attempt to cut off one-head results in the growth of two more. Current abuses include these seven deadly sins of executive compensation:
>
> 1. Accelerated vesting of options
> 2. Manipulation of earnings to support bonuses
> 3. Imputed years of service
> 4. Setting the bar too low (guaranteed bonus)

5. Outrageous departure and retirement packages
6. Stock options that are not performance-based (including back-dating)
7. Perquisites and gross-ups

I emphasized in 2006 that compensation must be looked at like any other asset allocation, in terms of return on investment. Instead, compensation consultants – selected by management and board compensation committees – selected by management rely on highly artificial formulas tied to even more artificial comparables that constantly ratchet upward in a sort of Lake Wobegone where all CEOs are above average.

The most pernicious elements of past bad pay were:

1. Payments based on a performance targets that have no relationship to sustainable value. At Bear Stearns, bonuses were to be awarded on the basis of nine metrics. But it was within the discretion of the directors to award all of the bonus for the achievement of any of the metrics. That is like throwing a dart at the wall and then drawing the bull's eye around it. Indeed, the board at Bear Stearns did decide to award all of the bonuses for the achievement of only one of the metrics. And we all know what the result was – the company imploded.

2. Incentives tied to the quantity of transactions rather than the quality of transactions.

3. Payments based on numbers retrospectively adjusted due to mistake or fraud with no obligation to return the money even though it was not actually earned.

The most pernicious elements of current and future pay plans are:

1. De facto or de jure repricing of options. Most current options are under water. As a shareholder, I would like that fact to be very motivating for managers to work harder to get the stock price to rise above the option strike price. But instead, it is very motivating for managers to get new options, essentially to reboot their compensation. Shareholders, of course, get no such luxury. It is infuriating – and unjust – for managers to get the benefit of the overall market when times are good but not to bear any of the risk of the overall market when times are bad. Some calculations show that as much as 70 percent of stock option gains are attributable to the market as a whole. This is indefensible. What we are seeing now is companies awarding new options to replace those that are underwater so that executives will benefit from the stimulus package and the inevitable market cycle instead of benefiting from increasing value at their own companies.

2. Awarding options without regard to particular performance goals and without indexing. Option grants that are not indexed to the peer group or the market as a

whole and that are not tied to performance goals within the power of the individual receiving the award do not have any meaningful motivational impact.

3. Increases in base pay to make up for reductions in performance-based awards or perquisites. Our senior research associate, Paul Hodgson, notes that companies like to use the term "adjustment" when what they mean is "increase." He points to Morgan Stanley as a good bad example. He wrote:

> The American Recovery and Reinvestment Act? Limit incentive compensation to one third of total annual compensation with delivery in stock to vest after the U.S Treasury investment has been paid back. The reaction? Double everyone's base salaries....This is what Morgan Stanley said in its May: 8-K filing
>
> The base salary for Chairman and Chief Executive Officer John J. Mack remains unchanged at USD 800,000. For other officers, new base salaries are as follows: USD 800,000 for James Gorman (Co-President), GBP 525,000 which is intended to be approximately USD 800,000 for Walid A. Chammah (Co-President)[formerly GBP 170,000 in 2008 and, until May 2009, GBP325,000], GBP 490,000 which is intended to be approximately USD 750,000 for Colm Kelleher (Chief Financial Officer) [formerly GBP 170,000 in 2008 and, until May 2009, GBP220,000] and USD 750,000 for each of Gary G. Lynch (Chief Legal Officer and Vice Chairman) and Thomas R. Nides (Chief Administrative Officer) [formerly USD 400,000 in 2008].... The base salary changes, which are effective as of May 1, 2009, were made after consultation by the Committee with its independent compensation consultant [Hay Management Consultancy].
>
> These salary "adjustments" [it's funny how salaries are never increased, they are only ever "adjusted"] were approved as part of the changes to compensation policy announced in the company's 2009 proxy statement, refocusing compensation away from being based on annual incentives to a mix of fixed pay, short and long-term incentives. Hardly a pay revolution. The Compensation, Management Development and Succession Committee also goes on to state that the "salary adjustments" are not intended to increase total annual compensation but merely to "adjust" the mix of pay.
>
> O.K., so let's look at annual compensation lately for Morgan Stanley executives. Neither Mr. Mack, Mr, Chammah, nor Mr. Gorman received annual bonuses in 2008. So, for Mr. Chammah, for example, instead of the $322,903 total annual compensation he received in 2008, he will receive approximately $673,016, at least, in 2009. That seems like an increase in total annual compensation to me.

Of course, Morgan Stanley's peer group for pay has not so much changed as disappeared. With the merger of Bear Stearns with JPMorgan Chase, the bankruptcy of Lehman Brothers and the sale of Merrill Lynch to Bank of America last year, its investment bank competitor group has changed beyond recognition. Salaries were pretty low at these investment banks, but now that Morgan Stanley is "competing" with the likes of Bank of America, Wachovia, and so on, base salaries are somewhat higher in the peer group. Job doesn't change, but the peer group does, so salaries go up. Doesn't happen in any other office but the C-suite.

Now, I don't want to discourage a bank from refocusing on long-term performance rather than dishing out huge rewards for hitting annual earnings targets, but increasing – let's call a spade a spade for once – base salaries is not the way to do it.

4. That last point is worth reiterating: we need to watch for manipulation of the peer group to support higher pay. When pay would be higher by assigning a peer group based on sector rather than market cap, the board will adjust the peer group accordingly. When it goes the other way, so will the board.

5. Gross-ups. There is no justification under any circumstances for having the shareholders pay an executive's taxes.

6. Phony reductions. Greg Ruel of our company reported on 41 CEOs who were paid just one dollar a year in salary but collectively were paid more than $173 million through other means. We have observed a general weakening of the target-setting process – if the targets are easier to achieve, then the pay will stay the same while performance deteriorates.

I wish I could point you to a company that we think does it right but we do not have one. I can tell you some of the elements of pay plans that seem to the best job of aligning pay and performance, but caution you that there is a very big however coming up.

These elements of pay are consistently correlated with superior returns:

moderate severance benefits;

moderate, frozen or capped retirement benefits;

plans that allow officers to defer income and/or bonuses into restricted stock or other deferred accounts, but no discounts are applied to the stock and no matching shares or awards are granted;

benefits that are generally company-wide, or, if there are executive level benefits, they were moderate and were not grossed-up for income tax.

We like to see:

1. Indexing options and tying option grants to specific performance goals, as discussed above. Regardless of the form of compensation, if relative performance is being measured, executives should only be rewarded for levels of performance that are at or above the median of the peer group.

2. Banking of bonuses, preferable to clawbacks, a kind of escrow to ensure that any adjustments to the financial reports will result in adjustments to the bonus. This is essential not just in cases of fraud but also in cases of mistake, even honest mistake, because (a) there is no reason that executives should be unfairly enriched due to a mistake, (b) there is no reason that shareholders should have to pay for a mistake within the authority of the executives, (c) a bonus that is all upside and no downside provides a perverse incentive to be careless at best and manipulative at worst in preparing financial reports, and (d) intention is relevant to proving fraud but it is not relevant to determining the appropriate level of bonus. Just because a clerk at a retail store makes a mistake in giving you too much change does not mean you are entitled to keep it.

In the case of cash compensation deferral should be mandated for a minimum of three years and should apply to at least 50 percent of any award. In the case of equity compensation deferral should be mandated until three years into the executive's retirement and should apply to at least 75 percent of any award

3. Severance under any "not for cause" termination should be limited to a single year's salary and benefits, plus any unvested stock awards should continue to vest on their normal schedule for only that 12-month period.

4. Incentive compensation should be based on more than one performance metric. Different performance metrics should be rewarded from within a single incentive plan rather than multiple plans each measuring a single metric

5. Incentive compensation should measure performance over periods of one year or more. Multi-year vesting schedules do not measure long-term performance, so any long-term incentive compensation must be based on the measurement of two or more performance metrics over periods of three years or more.

6. Different incentive awards should measure different kinds of performance

7. Companies should ensure that compensation policies are easy for both executives and shareholders to understand and should avoid multiplication of compensation plans, particularly incentive plans

8. Long-term compensation should always make up the majority of total realizable compensation for the most senior executives at the company.

We find that works is when compensation which is not performance-related plays a fairly small role in total compensation. Many of the companies that do best pay executives below-median base salaries. And they are careful about what their performance goals are. It works well to base performance pay on some form of return on capital measure – often a better measure of value growth than earnings – and, in many cases, these return measures also take into account the cost of capital, rendering the metric an even more efficient measure of value growth. There is no one best practice for the form of long-term incentive practice. Some companies opt solely for stock options, some for time and/or performance-restricted stock, and some for other performance-related long-term incentives.

Paul Hodgson, who wrote both our "Pay for Failure" and "Pay for Success" reports, said that at the best performers the

> presiding compensation philosophy was twofold: simplicity and moderation. In most cases, a single form of long-term incentive was used, supplemented occasionally with additional types of grant. Where there was more than one kind used, at least one of the elements was granted at very restrained levels. In contrast, many of the Pay for Failure companies were guilty of throwing every kind of long-term incentive at their executives, in the hopes that one of them, at least, would pay out.

I promised a "however," though, and here it is. The tricky part is getting there. Even if I could come up with an ideal template for executive compensation at financial companies, we have to recognize that there is no structure that cannot and will not be immediately subverted. The corporate community and its service providers, including lawyers and compensation consultants, will always be more motivated and more agile than any legislator or regulator can anticipate. While I think it could be worthwhile for Congress and the Treasury Department to come up with a template to be applied on a "comply or explain" basis, nothing meaningful will change until we change the boards of directors. And as long as the government is a provider of capital, it should be in a position to reject an opt-out of the template as inadequately justified.

But the key is the board. It is unfathomable to me that most of the very same directors who approved the outrageous pay packages that led to the financial crisis continue to serve on boards. We speak of this company or that company paying the executives but it is really the boards and especially their compensation committees and until we change the way they are selected,

informed, paid, and replaced we will continue to have the same result. Until we remove the impediments to shareholder oversight of the board, we cannot hope for an efficient, market-based system of executive compensation.

Directors should not be allowed to serve unless they have received majority vote of the shares cast. That way, investors will be able to remove directors who approve dysfunctional pay packages. I support "proxy access," to permit shareholders to have their candidates for the board on the company's proxy, but I expect that to be used in a fraction of a percent of the elections each year. "Say on pay" would be useful but not sufficient for meaningful change. Every director should have to earn the support of a majority of investors every year; that will do more than any other change to ensure that directors remember where they owe their loyalty.

The government has done a poor job of making it possible for regulated institutional investors like mutual funds, banks, money managers, pension funds, and foundations to cast proxy votes in an economically optimal manner. Due to the collective choice problem and conflicts of interest, proxy voting has too often been compromised and "rationally ignorant." As we look at the "supply side" of executive compensation, management and boards, we must also look at the "demand side" to make sure our investor community has the information, tools, and ability to respond effectively.

I would like to thank Paul Hodgson and the staff of The Corporate Library for their assistance in preparing this testimony and the underlying data and analysis. I look forward to your questions.

United States House of Representatives

Committee on Financial Services

Hearing

"Compensation Structure and Systemic Risk"

Testimony of

Kevin J. Murphy

Kenneth L. Trefftzs Chair in Finance
University of Southern California
Marshall School of Business

Washington, DC
June 11, 2009

Testimony of Kevin J. Murphy[1]

Introduction and Summary

Compensation in the financial services industry became highly controversial in early 2009 amid revelations that Merrill Lynch paid substantial year-end bonuses to its executives and employees after receiving Federal bailout funds and just prior to completion of its acquisition by Bank of America. The outrage heightened following the revelation that AIG (which had received over $170 billion of federal bailout funds) was in the process of paying $168 million in "retention bonuses" to its executives. The anger over these bonuses – coupled with suspicions that the Wall Street bonus culture is a root cause of excessive risk taking that helped create the ongoing global financial crisis – has led to an effective prohibition on cash bonuses for participants in the government's Troubled Asset Relief Program (TARP), and is leading us today towards more-sweeping regulation of compensation in financial services firms.

Political pressures to reform pay have escalated in spite of limited evidence that compensation structures have, in fact, been responsible for excessive risk taking in the financial services industry. Indeed, the pressures have emerged even without a definition of "excessive risk taking" or how we might distinguish excessive risk from the normal risks inherent in all successful business ventures. While inappropriately designed compensation structures can certainly encourage risk taking, the risk-taking incentives caused by compensation in financial services are small relative to those created by "Too Big to Fail" guarantees, loose monetary policies, social policies on home ownership, and poorly implemented financial innovations such as exotic mortgages, securitization, and collateralized debt obligations. Moreover, the compensation constraints currently on TARP recipients will likely destroy these organizations unless they can quickly repay the government and avoid the constraints. Furthermore, regulating compensation in financial

[1] This testimony is based in part on my joint work with Michael C. Jensen to be published in *CEO Pay and What to Do About It: Restoring Integrity to Both Executive Compensation and Capital-Market Relations* (forthcoming, Harvard Business School Press, 2010).

services will cripple one of our nations most important, and historically most productive, industries.

Risk Taking and the Wall Street Bonus Culture

The heavy reliance on bonuses has been a defining feature of Wall Street compensation for decades, going back to the days when investment banks were privately held partnerships. Such firms kept fixed costs under control by keeping base salaries low and paying most of the compensation in the form of cash bonuses that varied with profitability. This basic structure remained intact when the investment banks went public, but the cash bonuses were replaced with a combination of cash, restricted stock, and stock options.

The primary way that such structures might encourage excessive risk taking is through asymmetric rewards and penalties; that is, high rewards for superior performance but no real penalties for failure. Financial services firms provide significant penalties for failure in their cash bonus plans by keeping salaries below competitive market levels, so that earning a zero bonus represents a penalty. Indeed, much of the outrage over bonuses in financial services reflects the fact that, in most industries, a "bonus" connotes an extraordinary reward for extraordinary performance added on top of generous above-market salaries. But, the facts are that salaries in financial service firms represent a small portion of total compensation and the "bonuses" are not bonuses on top of normal salaries, but are rather a fundamental part of competitive compensation. Take away the bonuses, and the banks will have to raise salaries or find other ways to pay, or they will lose their top talent.

Table 1 shows that bonuses for Chief Executive Officers (CEOs) in companies receiving TARP funding declined substantially from 2007 to 2008. The sample is based on all companies in the S&P 500, S&P MidCap 400, and S&P SmallCap 600 in which the same executive served as CEO in both 2007 and 2008. Average CEO bonuses in 36 TARP-recipient companies fell 84.3% from over $2.3 million in 2007 to only $363,082 in 2008. In contrast, CEO bonuses in 23 financial services firms not receiving TARP funds fell by only 13%, while CEO bonuses in 684 other non-TARP firms fell by 9.9%.

Table 1
Comparison of 2007 and 2008 Bonuses for CEOs of TARP and Non-TARP Recipients

	TARP Recipients	Non-TARP Banks	Other Non-TARP Companies
Number of CEOS	36	23	684
Average 2007 Bonus	$2,307,430	$1,809,640	$1,641,880
Average 2008 Bonus	$363,082	$1,573,910	$1,479,360
Change in Bonus from 2007 to 2008	-$1,944,348 (-84.3%)	-$235,730 (-13.0%)	-$162,520 (-9.9%)

Notes: Sample includes executives in S&P 500, S&P MidCap 400, and S&P Small Cap 600 Firms who held the title of Chief Executive Officer in both 2007 and 2008. Compensation data from S&P's ExecuComp database. TARP recipients include companies receiving money from the TARP as of May 7, 2009, extracted from http://www.usatoday.com/money/economy/tarp-chart.htm. Non-TARP banks defined as companies with SIC codes between 6020 and 6211 and include commercial banks, savings institutions, mortgage banks, and security and commodity brokers. Bonuses include discretionary bonuses and payments under non-equity incentive plans.

Table 2 repeats the analysis in Table 1 for all proxy-named executives (typically the four highest-paid executives in addition to the CEO). Average bonuses for 170 executives in TARP-recipient companies fell by 82%, compared to a 24% decline for 119 executives in financial services not receiving TARP funding, and a 13% decline for 3,454 executives in non-TARP non-financial firms.

Table 2
Comparison of 2007 and 2008 Bonuses for *All Executives* of TARP and Non-TARP Recipients

	TARP Recipients	Non-TARP Banks	Other Non-TARP Companies
Number of Executives	170	119	3,454
Average 2007 Bonus	$1,800,090	$912,585	$806,249
Average 2008 Bonus	$323,663	$690,326	$703,207
Change in Bonus from 2007 to 2008	-$1,476,427 (-82.0%)	-$222,259 (-24.4%)	-$103,042 (-12.8%)

Notes: Sample includes proxy-named (top 5) executives in S&P 500, S&P MidCap 400, and S&P Small Cap 600 Firms serving in both 2007 and 2008. Compensation data from S&P's ExecuComp database. TARP recipients include companies receiving money from the TARP as of May 7, 2009, extracted from http://www.usatoday.com/money/economy/tarp-chart.htm. Non-TARP banks defined as companies with SIC codes between 6020 and 6211 and include commercial banks, savings institutions, mortgage banks, and security and commodity brokers. Bonuses include discretionary bonuses and payments under non-equity incentive plans.

Table 3

Comparison of 2007 and 2008 Year-End Values of Stock Options and Restricted Stock for CEOs of TARP and Non-TARP Recipients

	TARP Recipients	Non-TARP Banks	Other Non-TARP Companies
Number of CEOs	36	23	684
Percentage of Options in the Money			
2007 Fiscal Year-End	41.8%	92.1%	71.5%
2008 Fiscal Year-End	10.6%	53.0%	38.4%
Average Intrinsic Value of In-The-Money Stock Options			
2007 Fiscal Year-End	$8,694,980	$21,909,390	$17,977,100
2008 Fiscal Year-End	$428,880	$7,550,710	$6,379,220
Change in Intrinsic Value of Options	-$8,266,100 (-95.1%)	-$14,358,680 (-65.5%)	-$11,597,880 (-64.5%)
Average Value of Restricted Shares			
2007 Fiscal Year-End	$6,802,410	$2,447,470	$4,414,270
2008 Fiscal Year-End	$1,284,590	$1,390,980	$2,744,920
Change in Intrinsic Value of Options	-$5,517,820 (-81.1%)	-$1,056,490 (-43.2%)	-$1,669,350 (-37.8%)

Notes: Sample includes executives in S&P 500, S&P MidCap 400, and S&P Small Cap 600 Firms who held the title of Chief Executive Officer in both 2007 and 2008. Option and stock data from S&P's ExecuComp database. TARP recipients include companies receiving money from the TARP as of May 7, 2009, extracted from http://www.usatoday.com/money/economy/tarp-chart.htm. Non-TARP banks defined as companies with SIC codes between 6020 and 6211 and include commercial banks, savings institutions, mortgage banks, and security and commodity brokers. Intrinsic value equals the year-end spread between the stock price and exercise price for all in-the-money options. Average value equals the restricted shares held at the end of the fiscal year multiplied by the year-end stock price.

In addition to cash bonuses, executives and senior managers in financial services receive much of their compensation in the form of restricted stock and options, and these instruments also provide strong penalties for failure. Table 3 shows that less than half (41.8%) stock options held by CEOs of TARP recipients were "in the money" (that is, had a stock price above the exercise price) at the end of the 2007 fiscal year, and that these stock options had an average "intrinsic value" (that is, the positive spread between the stock price and exercise price) of $8.7 million. Stock prices for companies that would become subsequent TARP recipients were already depressed by year-end 2007, as reflected by the relatively low percentage of options in the money compared to companies that would not require TARP funding. But, by year-end 2008, only 10.6% of the CEO options were in the

Table 4

Comparison of 2007 and 2008 Year-End Values of Stock Options and Restricted Stock for *All Executives* of TARP and Non-TARP Recipients

	TARP Recipients	Non-TARP Banks	Other Non-TARP Companies
Number of Executives	170	119	3,454
Percentage of Options in the Money			
2007 Fiscal Year-End	45.8%	71.9%	70.3%
2008 Fiscal Year-End	12.0%	42.2%	36.8%
Average Intrinsic Value of In-The-Money Stock Options			
2007 Fiscal Year-End	$5,196,570	$6,610,250	$7,408,160
2008 Fiscal Year-End	$334,458	$2,175,610	$2,412,230
Change in Intrinsic Value of Options	-$4,862,112 (-93.6%)	-$4,434,640 (-67.1%)	-$4,995,930 (-67.4%)
Average Value of Restricted Shares			
2007 Fiscal Year-End	$3,092,570	$1,624,700	$1,986,200
2008 Fiscal Year-End	$872,808	$818,858	$1,303,470
Change in Intrinsic Value of Options	-$2,219,762 (-71.8%)	-$805,842 (-49.6%)	-$682,730 (-34.4%)

Notes: Sample includes proxy-named (top 5) executives in S&P 500, S&P MidCap 400, and S&P Small Cap 600 Firms serving in both 2007 and 2008. Option and stock data from S&P's ExecuComp database. TARP recipients include companies receiving money from the TARP as of May 7, 2009, extracted from http://www.usatoday.com/money/economy/tarp-chart.htm. Non-TARP banks defined as companies with SIC codes between 6020 and 6211 and include commercial banks, savings institutions, mortgage banks, and security and commodity brokers. Intrinsic value equals the year-end spread between the stock price and exercise price for all in-the-money options. Average value equals the restricted shares held at the end of the fiscal year multiplied by the year-end stock price.

money, and the average intrinsic value had fallen by 95% to only $428,880. The average value of the CEO's restricted stockholdings also declined dramatically in 2008, falling over 80% from $6.8 million in 2007 to only $1.3 million at the end of 2008.

The statistics in Table 3 understate the losses incurred by individual CEOs, since they are based only on CEOs serving continuously through 2007 and 2008 and ignore losses realized by CEOs losing their jobs as a consequence of the crisis. Moreover, these statistics only include firms that continued to operate at the end of 2008, thus ignoring losses at Bear Stearns, Lehman Brothers, Washington Mutual, Wachovia, Countrywide, and other casualties of the crisis.

Table 4 shows that the losses in equity-based compensation for TARP recipients were not limited to CEOs. In particular, the average intrinsic value of options held by 170 executives in TARP-recipient companies fell by 94% in 2008, while the average value of restricted shares fell by 72%.

Given the penalties for poor performance inherent in both cash and equity incentive plans, there is nothing inherent in the current structure of compensation in financial service firms that lead to obvious incentives to take excessive risks. To the extent that the firms, indeed, took such risks, we need to look beyond the compensation structure to explain it. However, there are valid reasons to be concerned about excessive risk taking in future years. First, as shown in Table 4, most of the stock options held by financial services executives by the end of 2008 were well out-of-the-money, which provides the type of asymmetric rewards and penalties that can lead to risk taking. Even more troublesome is the concept of "Too Big to Fail" guarantees applied to the financial service firms that essentially operate in-house hedge funds with hedge-fund-style incentive arrangements. If the government is very clear that there is no "Too Big to Fail" guarantee, there is no need for government oversight. But, if the guarantee is offered or implied there are massive problems with monitoring and restraining executives from taking excessive risks. Assuming that "Too Big to Fail" survives as a policy, it is critical that boards enforce strong internal penalties for risk-management failures.

Risk and Performance Measurement

Another way that compensation can lead to risk taking is through inappropriate performance measures. For example, consider mortgage brokers paid for writing loans rather than writing loans that the borrowers will actually pay back. In the years leading up to its dramatic collapse and acquisition by JPMorgan Chase at fire-sale prices, Washington Mutual rewarded its brokers for writing loans with little or no verification of the borrowers' assets or income, and paid especially high commissions for selling more-profitable adjustable-rate

mortgages.[2] In the end, WaMu got what it paid for, and similar scenarios were being played out at Countrywide Finance, Wachovia, and scores of smaller lenders who collectively were not overly concerned about default risk as long as home prices kept increasing and as long as the lenders could keep packaging and selling their loans to Wall Street. But, home prices could not continue to increase when prices were being artificially bid up by borrowers who could not realistically qualify for or repay their loans. The record number of foreclosures in 2008, and the associated crash in home values, helped send the US economy (and ultimately the global economy) into a tailspin.

A solution to this performance-measurement problem is to pay people to write "good loans" and penalize them for writing "bad loans". The challenge is identifying a good loan without waiting up to 30 years to find out whether the loan is actually repaid. The answer involves basing bonuses on subjective assessments of loan quality. Unfortunately, most current and proposed regulations go in the opposite direction and require that bonuses be based solely on objective measures of performance, such as the quantity (rather than the quality) of loans. These regulatory demands reflect a suspicion that boards and managements will be unable to make and enforce the required subjective assessments, thus substituting the judgment of government for the business judgment of directors. This is a dangerous path to go down.

Fixing Compensation: Is Regulation the Answer?

Compensation practices in financial services can certainly be improved. For example, cash bonus plans in financial services can be improved by introducing and enforcing bonus banks or "clawback" provisions for recovery of rewards if and when there is future revision of critical indicators on which the rewards were based or received. Several banks, including Morgan Stanley, UBS, and Credit Suisse have introduced plans with clawback features over the past several months, and I applaud these plans as moves in the right direction.

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[2] See Peter S. Goodman and Gretchen Morgenson, "By Saying Yes, WaMu Built Empire on Shaky Loans," New York Times (December 27, 2008.

Bonus plans in financial services can also be improved by ensuring that bonuses are based on value creation rather than on the volume of transactions without regard to the quality of transactions. Measuring value creation is inherently subjective, and such plans will necessarily involve discretionary payments based on subjective assessments of performance.

Compensation practices in financial services can undoubtedly be improved through government oversight focused on rewarding value creation and punishing value destruction. However, it is highly unlikely that compensation practices can be improved through increased government rules and regulations. Indeed, Washington has a long history of attempts to regulate executive pay that have systematically created unanticipated side effects that have generally led to higher pay levels and less-efficient incentives. Consider, for example, the following case studies:

Golden Parachutes and Section 280(G)

In 1982, Bendix CEO William Agee launched a hostile takeover bid for Martin Marietta, which in turn made a hostile takeover bid for Bendix. Bendix ultimately found a "white knight" and was acquired by Allied Corp., but only after paying CEO Agee $4.1 million in a Golden Parachute payment. The payment sparked outrage in Congress, which quickly introduced Section 280(G) of the tax code, imposing severe personal and corporate tax penalties on golden parachute payments exceeding three times the executive's average recent compensation.

Ironically, although Section 280(G) was meant to reduce the generosity of parachute payments, the government action increased such payments: the new rules were followed by the introduction of golden parachutes in hundreds of companies that previously had no change-in-control agreements. Moreover, Section 280(G) triggered the proliferation of "employment agreements" for CEOs and other top-level executives in most large firms since the mid-1980s. Section 280(G) applies only to severance payments contractually tied to changes of control. Individual employment agreements typically provide for severance payments for all forms of terminations without cause, including (but not limited to) terminations following control changes. Therefore, companies could circumvent the Section 280(G) compensation limitations (at a potentially huge cost to shareholders) by making

payments available to all terminated executives, and not only those terminated following a change in control.

Unreasonable Compensation and Section 162(m)

The controversy over CEO pay became a major political issue during the 1992 US presidential campaign. After the 1992 election, president-elect Clinton re-iterated his promise to disallow deductions for all compensation above $1 million for all employees. Concerns about the loss of deductibility contributed to an unprecedented rush to exercise options before the end of the 1992 calendar year, as companies urged their employees to exercise their options while the company could still deduct the gain from the exercise as a compensation expense. In anticipation of the loss of deductibility, large investment banks accelerated their 1992 bonuses so that they would be paid in 1992 rather in 1993. In addition, several publicly traded Wall Street firms, including Merrill Lynch, Morgan Stanley, and Bear Stearns, announced that they were consider returning to a private partnership structure if Clinton's plan were implemented.

By February 1993, President Clinton backtracked on the idea of making all compensation above $1 million unreasonable and therefore non-deductible, suggesting that only pay "unrelated to the productivity of the enterprise" was unreasonable. In April, details of the considerably softened plan began to emerge. As proposed by the Treasury Department and eventually approved by Congress, Section 162(m) of the tax code applies only to public firms and not to privately held firms, and applies only to compensation paid to the CEO and the four highest-paid executive officers as disclosed in annual proxy statements (compensation for all others in the firm is fully deductible, even if in excess of the million-dollar limit). More importantly, Section 162(m) does not apply to compensation considered "performance-based" for the CEO and the four highest paid people in the firm.

Academic research has concluded that Section 162(m) has contributed to the increase in executive compensation. First, since compensation associated with stock options is generally considered "performance-based" and therefore deductible, Section 162(m) helped fuel the option explosion in the 1990s. Second, while there is some evidence that companies paying base salaries in excess of $1 million lowered salaries to $1 million following the

enactment of Section 162(m), many others raised salaries that were below $1 million to exactly $1 million. Finally, since discretionary bonuses are not considered performance based (and therefore subject to the $1 million cap), companies were encouraged to replace their discretionary plans with overly generous and less-effective formula-based plans.

Deferred Compensation and Section 409(A)

Enron, like many other large companies, allowed mid-level and senior executives to defer portions of their salaries and bonuses through the company's non-qualified deferred compensation program. When Enron filed for Chapter 11 bankruptcy protection in December 2002, about 400 senior and former executives became unsecured creditors of the corporation, eventually losing most (if not all) of the money in their accounts. However, just before the bankruptcy filing, Enron allowed a small number of employees to withdraw millions of dollars from their deferred compensation accounts. The disclosure of these payments generated significant outrage (and lawsuits) from Enron employees who lost their money, and attracted the ire of Congress.

As a direct response to the Enron situation, Section 409(A) was added to the Internal Revenue Code as part of the "American Jobs Creation Act of 2004." In essence, the objectives of Section 409(A) were to limit the flexibility in the timing of elections to defer compensation in nonqualified deferred compensation programs, to restrict withdrawals from the deferred accounts to pre-determined dates (and to prohibit the acceleration of withdrawals), and to prevent executives from receiving severance-related deferred compensation until six months after severance. Section 409(A) imposes taxes on individuals with deferred compensation as soon as the amounts payable under the plan are no longer subject to a "substantial risk of forfeiture." Individuals failing to pay taxes in the year the amounts are deemed to no longer be subject to the substantial forfeiture risk owe a 20% excise tax and interest penalties on the amount payable (even if the individual has not received or may never receive any of the income).

Section 409(A) restricts compensation committees from offering many incentive arrangements that are in the best interest of shareholders. For example, while restricted shares and traditional stock options (i.e., options with an exercise price equal to the market

price on the date of grant) are exempt from the guidelines, discount options (i.e., options with an exercise price below the market price on the date of grant) are subject to the new rules. Such options are often in the interest of shareholders, especially when employees "purchase" the discount options through explicit salary reductions or outright cash exchanges.

In each of the above cases, the regulations resulted in less-effective compensation arrangements and imposed large costs on shareholders. Part of the problem is that regulation – even when well-intended – inherently focuses on relatively narrow aspects of compensation allowing plenty of scope for costly circumvention. An apt analogy is the Dutch boy using his fingers to plug holes in a dike, only to see new leaks emerge. The only certainty with pay regulation is that new leaks will emerge in unsuspected places, and that the consequences will be both unintended and costly. I therefore strongly recommend that the Committee consider carefully this history before inevitably repeating the mistakes of the past.

Author's Statement and Qualifications

I am currently the Kenneth L. Trefftzs Chair in Finance at the University of Southern California Marshall School of Business. I have been a full professor of the Department of Finance and Business Economics at the USC Marshall School since 1995. In addition, I hold joint appointments in the USC School of Law (as Professor of Business and Law) and in the USC College of Letters, Arts, and Sciences (as Professor of Economics). I served as chair for the Marshall School's Department of Finance and Business Economics from 2003-2004, and as the Marshall School's Vice Dean of Faculty and Academic Affairs from 2004-2007. From 1991 to 1995, I was an Associate Professor of Business Administration at the Harvard Business School, and from 1983 to 1991, I was an Assistant and Associate Professor at the University of Rochester's William E. Simon Graduate School of Business Administration.

I received a Ph.D. in Economics from the University of Chicago in 1984, where my honors included a National Science Foundation Fellowship, Milton Friedman Fund Fellowship, and a Social Science Foundation Dissertation Fellowship. I also have an M.A. in Economics from the University of Chicago, and a B.A. degree (summa cum laude) from the

University of California, Los Angeles. I am a member of Phi Beta Kappa, the American Economic Association, and the American Finance Association. I am an associate editor of the *Journal of Financial Economics* and the *Journal of Corporate Finance,* a former associate editor of the *Journal of Accounting and Economics*, and serve as referee to over thirty professional and academic journals. I am the former chairman of the Academic Research Committee of the American Compensation Association.

I am a recognized expert on executive compensation, and have written and published extensively on issues related to executive compensation. During 1992 and 1993, I conducted annual surveys of executive compensation practices in the 1,000 largest U.S. corporations. The surveys, sponsored by the United Shareholders Association, were used extensively by institutional investors and large shareholders in evaluating and comparing the effectiveness of compensation policies. I also advised the SEC in formulating their 1992 disclosure rules for top management pay, and was a prominent member of the 1992 and 2003 National Association of Corporate Directors' Blue Ribbon Commissions on Executive Compensation, which issued reports calling for the overhaul of CEO pay practices. I have written more than forty articles, cases, or book chapters relating to compensation and incentives in organizations. Results from my research on executive compensation have been widely cited in the press (including the *Wall Street Journal, New York Times*, *Washington Post*, *Los Angeles Times*, *Chicago Tribune*, *USA Today*, *Economist*, *Fortune*, *Forbes*, *Business Week*, and *Time*) and on national television (including CNN and CBS news). I have given speeches and presentations on compensation and incentives to a variety of academic and practitioner audiences, including the Conference Board, the American Compensation Association, and the Board of Governors of the Federal Reserve.

My university teaching at USC, Harvard, and Rochester encompasses a wide variety of courses at the undergraduate, MBA, Ph.D., and executive levels. I have developed and taught undergraduate, MBA, and Ph.D. courses in compensation, incentives, human resource management, corporate finance (including mergers, acquisitions, and leveraged buyouts), and corporate governance.

I have testified as an expert witness in multiple proceedings in federal and state courts; my testimony has focused on virtually all aspects of compensation. I have consulted with

organizations and conducted research on compensation and incentives in professional partnerships and corporations. I have consulted with, or given speeches to, top managers and compensation committees at several large corporations, including IBM, AT&T, Merck, Bristol-Myers-Squibb, Genzyme, Procter & Gamble, Philip Morris, General Motors, Prudential, and Chubb. I spent the 1994-1995 academic year on leave from Harvard as the Visiting Scholar and Consultant at Towers Perrin, a major benefits and compensation consulting firm, where my activities included making formal presentations and leading informal roundtable discussions on executive compensation to clients nationwide, as well as being involved in a variety of consulting engagements.

I have not received any Federal grants or contracts (including subgrants or subcontracts) since October 1, 2006 related to my testimony, and I am not representing any organization that has received such grants related to my testimony.

Written Testimony Submitted by

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U.S. Department of the Treasury

Before the Committee on Financial Services

U.S. House of Representatives

June 11, 2009

Chairman Frank, Ranking Member Bachus, Members of the Committee, I appreciate the opportunity to testify before you on this important topic of systemic risk and executive compensation.

Each of us involved in economic policy has an obligation to fully understand the factors that contributed to this financial crisis and to make our best effort to find the policies that minimize the likelihood of its recurrence. There is little question that one contributing factor to the excessive risk taking that was central to the crisis was the prevalence of compensation practices at financial institutions that encouraged short-term gains to be realized with little regard to the potential economic damage such behavior could cause not only to those firms, but to the financial system and economy as a whole. As Secretary Geithner said yesterday, too often "incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage." Compensation structures that permitted key executives and other financial actors to avoid the potential long-term downsides of their actions discouraged a focus on determining long-term risk and underlying economic value, while reducing the number of financial market participants with an incentive to be a "canary in the coal mine."

After one large investment bank suffered large losses, it acknowledged – properly reflecting on what it should have done differently – that it had skewed its employees' incentives by simply measuring bonuses against gross revenue after personnel costs, with "no formal account taken of the quality or sustainability of those earnings." And the potential harm caused by compensation arrangements based on short-term results with little account for long-term risks went beyond top executives. Indeed, across the subprime mortgage industry, brokers were often compensated in ways that placed a high premium on the volume of their lending without regard to whether borrowers had the ability to make their payments. As a result, lenders, whose compensation normally did not require them to internalize long-term risk, had a strong incentive to increase volume by targeting riskier and riskier borrowers – and they did, contributing to the problems that spurred our current crisis.

As we work to restore financial stability, the focus on executive compensation at companies that have received governmental assistance is appropriate and understandable. But what is most important for our economy at large is the topic of this hearing: understanding how compensation practices contributed to this financial crisis and what steps we can take to ensure they do not cause excessive risk-taking in the future. And while the financial sector has been at the center of this issue, we believe that compensation

practices must be better aligned with long-term value and prudent risk management at all firms, and not just for the financial services industry.

Yesterday, Secretary Geithner laid out a set of principles for moving forward with compensation reforms. Our goal is to help ensure that there is a much closer alignment between compensation, sound risk management and long-term value creation for firms and the economy as a whole. Our goal is not to have the government micromanage private sector compensation. As Secretary Geithner said yesterday, "We are not capping pay. We are not setting forth precise prescriptions for how companies should set compensation, which can often be counterproductive." We also recognize these principles may evolve over time, and we look forward to engaging in a discussion with this Committee, the Congress, supervisors, academics and other compensation experts, shareholders and the business community about the best path. We begin this conversation recognizing that the reforms we put in place must be based not only on our best intentions, but also a clear-eyed understanding of the need to minimize unintended consequences. But we think these principles offer a promising way forward.

1. **Compensation plans should properly measure and reward performance**

There is little debate that compensation should be tied to performance in order to best align the incentives of executives with those of shareholders. But even compensation that is nominally performance-based has often rewarded failure or set benchmarks too low to have a meaningful impact.

There is increasing consensus in the expert community that performance-based compensation must involve a thoughtful combination of metrics that is indexed to relative performance as opposed to just following the ups and downs of the market. Performance pay based solely on stock price can on the one hand, "confuse brains for a bull-market" and in the other scenario, fail to recognize exceptional contributions by executives in difficult times. A thoughtful mix of performance metrics could include not only stock prices, but individual performance assessments, adherence to risk management and measures that account for the long-term soundness of the firm.

2. **Compensation should be structured in line with the time horizon of risks**

As I mention above, much of the damage caused by this crisis occurred when people were able to capture excessive and immediate gains without their compensation reflecting the long-term risks they were imposing on their companies, their shareholders, and ultimately, the economy as a whole. Financial firms offered incentives to invest heavily in complex financial instruments that yielded large gains in the short-term, but presented a "tail risk" of major losses. Inevitably, these practices contributed to an overwhelming focus on gains – as they allowed the payout of significant amounts of compensation today without any regard for the possible downside that might come tomorrow.

That is why we believe companies should seek to pay both executives and other employees in ways that are tightly aligned with the long-term value and soundness of the firm. One traditional way of doing so is to provide compensation for executives overwhelmingly in stock that must be held for a long period of time – even beyond retirement. Such compensation structures also reduce the risk that executives might walk away with large pay packages in one year only to see their firms crumble in the next year or two. In these cases, the dramatic decline in stock price would effectively "claw back" the previous year's pay.

Other firms keep bonuses "at risk," so that if large profits in one year are followed by poor performance in the next, the bonuses will be reduced.

Yet, as Harvard Professor Lucian Bebchuk has written, compensation packages based on restricted stock are not a fool-proof means of ensuring alignment with long-term value, as such pay structures can still incentivize well-timed strategies to manipulate the value of common equity or take "heads I win a lot, tails I lose a little" bets depending on the capital structure and degree of leverage of the firm.

3. **Compensation practices should be aligned with sound risk management**

Ensuring that compensation fosters sound risk-management requires pay strategies that do not allow market participants to completely externalize their long-term risk, while also ensuring that those responsible for risk management receive the compensation and the authority within firms to provide a check on excessive risk-taking. As the Financial Stability Forum recently stated, "staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm."

This authority and independence is all the more important in times of excessive optimism when consistent – though unsustainable – asset appreciation can temporarily make the reckless look wise and the prudent look overly risk-averse. Former Federal Reserve Chairman William McChesney Martin Jr. once said that "The job of the Federal Reserve is to take away the punch bowl just when the party starts getting interesting." Likewise, risk managers must have the independence, stature and pay to take the car keys away when they believe a temporary good-time may be creating even a small risk of a major financial accident down the road.

Yet there are several reports showing the degree to which risk managers lacked the appropriate authority during the run-up to this financial crisis. Accounts of one Wall Street firm discuss how risk managers who once roamed the trading floors to gain a better understanding of how the company worked and where weaknesses might exist were denied access to that necessary information and discouraged from expressing their concerns.

That is why we believe that compensation committees should conduct and publish a risk assessment of whether pay structures – not only for top executives, but for all employees – incentivize excessive risk-taking. As part of this process, committees should identify whether an employee or executive experiences a penalty if their exceptional performance is based on decisions that ultimately put the long-term health of the firm in danger. At the same time, managers should also have direct reporting access to the compensation committee to enhance their impact.

I should also note that in the rule we released yesterday concerning executive compensation for recipients of assistance through the Troubled Asset Relief Program, we put forward – as the Administration called for on February 4th – a requirement that compensation committees not only provide a full risk assessment for their compensation, but that they do so in a narrative form that explains the rationale for how their pay structure does not encourage excessive risk. We believe such a requirement not only increases transparency, but forces firms to think through the basic risk logic of their compensation plans, and we

hope it will help begin an important discussion between shareholders, directors and risk managers about the relationship between compensation and risk.

4. **We should reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders**

While golden parachutes were created to align executives' interests with those of shareholders during mergers, they have expanded in ways that may not be consistent with the long-term value of the firm, and – as of 2006 – were in place at over 80 percent of the largest firms. Likewise, supplemental retirement packages that are intended to provide financial security to employees are too often used obscure the full amount of "walkaway" pay due a top executive once they leave the firm. Indeed, Lucian Bebchuk and Jesse Fried have shown that there is substantial evidence that "firms use retirement benefits to provide executives with substantial amounts of 'stealth compensation' — compensation not transparent to shareholders – that is largely decoupled from performance."[1]

Examining these practices is all the more important because when workers who are losing their jobs see the top executives at their firms walking away with huge severance packages, it creates the understandable impression that there is a double-standard in which top executives are rewarded for failure at the same time working families are forced to sacrifice. As Secretary Geithner said yesterday, "we should reexamine how well these golden parachutes and supplemental retirement packages are aligned with shareholder interests, whether they truly incentivize performance and whether they reward top executives even if their shareholders lose value."

5. **We should promote transparency and accountability in setting compensation**

Many of the excessive compensation practices in place during the financial crisis likely would have been discouraged or reexamined if they had been implemented by truly independent compensation committees and were transparent to a company's owners – its shareholders. Companies often hire compensation consultants who also provide the firm millions of dollars in other services – creating conflicts of interest. According to one Congressional investigation, the median CEO salary of Fortune 250 companies in 2006 that hired compensation consultants with the largest conflicts of interest was 67 percent higher than the median CEO salary of the companies that did not use consultants with such conflicts of interest.[2]

That is why we hope to work with Chairman Frank and this committee to pass "say on pay" legislation, requiring all public companies to hold a non-binding shareholder resolution to approve executive compensation packages. We believe that "say on pay" will place a greater check on boards to ensure that their compensation packages are aligned with the interest of shareholders. Indeed, in Britain, where "say on pay" was implemented in 2002, it has – according to a study by Professor Stephen Davis at Yale's Millstein Center for Corporate Governance and Performance – been associated with greater

[1] Quoted in Lucian Bebchuk and Robert J. Jackson, Jr., "Executive Pensions," *NBER Working Paper #11907*, December 2005.

[2] House Oversight Committee Majority Staff, "Executive Pay: Conflicts of Interest Among Compensation Consultants," Report Published December 2007.

communication between boards and shareholders, while a recent paper by Fabrizio Ferri and David Maber of Harvard Business School has found that say on pay made CEO compensation more sensitive to negative results.[3] As a result, the resolutions have gained more and more support, with 76 percent of Chartered Financial Analysts now in favor of say on pay.[4]

In addition, we want to work with this committee and the Congress to pass legislation directing the SEC to put in place independence rules for compensation committees analogous to those required for audit committees as part of the Sarbanes-Oxley Act. Our goal is to move compensation committees from being independent in name to being independent in fact. Under this proposal, not only would committee members be truly independent, but they would also be given the authority to appoint and retain compensation consultants and legal counsel, along with the funding necessary to do so. This legislation would also instruct the SEC to create standards for ensuring the independence of compensation consultants, providing shareholders with the confidence that the compensation committee is receiving objective, expert advice.

I am pleased today to be testifying here alongside my colleagues from the SEC and the Fed. We are encouraged by the efforts of the SEC to seek greater transparency and disclosure on compensation, and by the commitment of the Federal Reserve and other bank supervisors to ensure compensation practices are consistent with their fundamental duty to promote the safety and soundness of our financial system. As Secretary Geithner announced yesterday, we also hope to work further with other agencies on this issue by asking the President's Working Group on Financial Markets to provide an annual review of compensation practices to monitor whether they are creating excessive risks.

As we move to repair our financial system, get our economy growing again and pursue a broad agenda of regulatory reform, we must ensure that the compensation practices that contributed to this crisis no longer put our system and our economy at risk. I commend the committee for holding these hearings, and I look forward to approaching this difficult issue with a degree of seriousness, reflection and humility – seriousness over the harm excessive risk-taking has caused for so many innocent people; reflection over the lessons we have already learned; and humility in recognizing the complexity of this issue, its potential for unintended consequences, and the importance of testing each of our ideas against the most rigorous analysis.

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[3] Stephen Davis, "Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable," Millstein Center Policy Briefing No. 1, 2007; Fabrizio Ferri and David Maber, "Say on Pay and CEO Compensation: Evidence from the UK," Harvard Business School Working Paper, 2009.

[4] Keith L. Johnson and Daniel Summerfield, "Shareholder Say on Pay: Ten Points of Confusion," Briefing Prepared for Shareholder Forum Program on Reconsidering "Say on Pay" Proposals, October 2008.

United States House of Representatives

Committee on Financial Services

Hearing on Compensation Structure and Systemic Risk

June 11, 2009

2128 Rayburn House Office Building

Testimony of Lynn E. Turner

Thank you Chairman Frank and Ranking member Bauchus for the opportunity to provide you my views on compensation and risk management, both of which are somewhat intertwined. I applaud the leadership of the Committee and its members for soliciting input on these important issues which played a role in the financial crisis.

Compensation and risk management are certainly not new topics. People have always wanted to know if they were making as much or more than their peers, from the day they graduated and started working. Human behavior is such that people all too often judge one another, right or wrongly, by the size of their home, the car they drive, and the material wealth they have accumulated. Accordingly, it comes as no surprise that people have often been willing to take greater risks when greater rewards could be had. And when those rewards are large, and can come quick and fast and make one financially secure for life as often they do on Wall Street, people have been willing to engage in greater risks to the individual, the business and even the capital markets.

With that in mind, my views on compensation and risk are also based on past experience as:

- A chief financial officer in an international high technology manufacturing company where I was involved with establishing compensation arrangements and terms.
- A board member of both large and small public companies.
- As a trustee for two institutional investors who invest in public companies, including financial institutions. As a trustee I chair a board committee that oversees proxy voting on such issues as compensation committee members and compensation arrangements.
- The managing director of research for several years at the proxy and financial research advisory firm, Glass Lewis.
- Chief accountant for the Securities and Exchange Commission.
- A former partner in an international accounting firm where I did audits of financial institutions, and advised businesses on compensation arrangements and Wall Street firms on new financial products.

Currently I am a senior advisor and managing director for LECG, a global expert services and consulting firm, with more than 750 experts and professionals in 31 offices around the world, providing independent expert testimony, original authoritative studies, and strategic advisory and financial advisory services. However, the views I express today represent my own personal perspective on the issues and do not necessarily represent those of the other organizations I am associated with.

Background

The U.S capital markets have been an important contributor to the growth of the American economy and business. They serve to gather available capital from retail and institutional investors who are looking for investment returns greater than they can

achieve otherwise, and allocate this capital to companies. Companies receiving this capital in turn use it to invest in research, jobs, plant and equipment in a way that will provide investors with the returns they seek.

Capital markets attract capital when investors believe they can trust them with their money. The markets must demonstrate with confidence that they can be trusted by investors. Critical to establishing trust and confidence among investors is:

- A market perceived as being **fair** to all, with no particular participant receiving an upper hand or ability to wrongly manipulate the market to their advantage, at cost to others. Independence and avoidance of financial conflicts which would influence one's behavior is important in ensuring a market is perceived by investors as being fair.

- **Transparency** in the market such that investors receive the necessary financial information about the markets operations including execution and pricing, the companies with whom capital is being invested, the existence of any potential conflicts and the regulators who are assigned the task of protecting investors and consumers. High quality financial information that is considered to be the life blood of any capital market. Investors must have the financial information necessary to make an informed decision as to where they will allocate their capital so as to maximize their investment returns. If misleading, incomplete or untimely information is provided, investors will likely make misinformed decisions, allocating capital to where returns will be sub-optimal, and ultimately leading investors to seek other markets where higher returns can be achieved. Since there is only a finite amount of capital available, when through manipulation or deception companies get capital, they in turn deny access to that capital by deserving companies.

- To provide investors with confidence that the information they receive is full and fair disclosure, and not unbalanced, as well as to assist market participants in complying with laws and regulations, the markets require **independent** and unbiased gatekeepers such as independent auditors who verify numbers and disclosures, credit rating agencies who can unlock access to capital markets for companies and analysts who provide investment analysis. The markets and participants also require professionals such as attorneys who assist, prepare and/or review corporate filings in their capacity as experts to ensure compliance with laws and regulations.

- There needs to be **accountability** for those who take the public's money, and those responsible for ensuring the integrity of the market. This includes company executives whose companies receive and put the investors money to use, corporate boards who as the elected representatives of investors oversee management, those responsibility for performing due diligence on the transactions on behalf of the investors including determining if the investment is suitable for them, and gatekeepers such as accountants and credit rating agencies.

- **Regulators** who fulfill their responsibility to act as investor's advocate, and legislators who give them the tools they need to do so. This includes laws and regulations that are written to ensure orderly and fair, transparent markets and in doing so, provide the necessary protections to all market participants including investors.

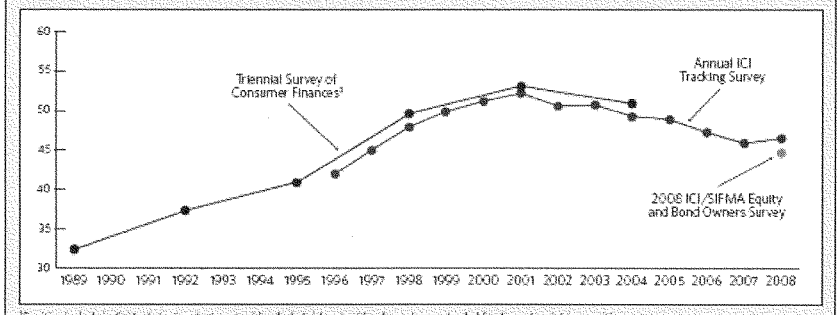
- Effective and timely **enforcement** of the laws, rules and regulations. Without strict enforcement, those who are law abiding capital market participants are disadvantaged by those who are not, and the laws, rules and regulations become meaningless. Investors then begin to lose their trust and confidence in the markets and look for safer things to invest in.

Currently today, there are approximately 90 million Americans, in 47 percent of the American households invested in the capital markets.[1] The number of Americans, and extent to which they invest, ramped up significantly during the 1990's as the chart below illustrates. This was driven by Americans setting aside money for their future retirement in self-directed pension plans, such as 401-K defined contribution accounts.

FIGURE 1.2

EQUITIES ARE THE DRIVING FORCE IN OVERALL OWNERSHIP RATES

OWNERSHIP OF EQUITIES[1] ACROSS THREE SURVEYS: PERCENTAGE OF U.S. HOUSEHOLDS



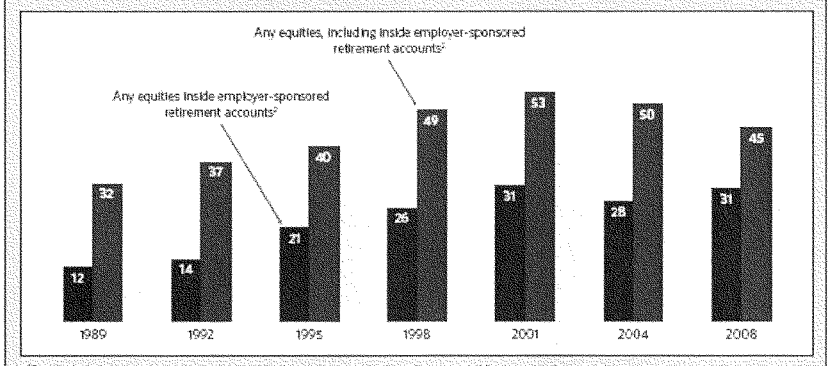
[1]Equities include individual stocks, stock mutual funds, hybrid mutual funds, exchange-traded funds, and variable annuities.
[2]Note that the fraction of households owning equities in the 2004 SCF is reported in this figure, even though the overall bond and equity ownership rate is not reported for 2004 in Figure 1.1. This is because the SCF questionnaire was changed between 2001 and 2004, and it is no longer possible to discern bond owners from households owning interest-bearing assets.
Sources: Investment Company Institute Annual Mutual Fund Shareholder Tracking Surveys, 2008 ICI/SIFMA Equity and Bond Owners Survey, and Federal Reserve Board Survey of Consumer Finances

[1] Equity and Bond Ownership in America, 2008. Investment Company Institute and Securities Industry and Financial Markets Association.

FIGURE 1.4

EQUITY OWNERSHIP THROUGH RETIREMENT ACCOUNTS FUELED OVERALL GROWTH BETWEEN 1989 AND 2008

OWNERSHIP OF EQUITIES[1]: PERCENTAGE OF U.S. HOUSEHOLDS



[1]Equities include individual stocks, stock mutual funds, hybrid mutual funds, exchange-traded funds, and variable annuities.
[2]Employer-sponsored retirement plans include DC plans (such as 401(k), 403(b), or 457 plans) and employer-sponsored IRAs (SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs).
Sources: ICI tabulations of Federal Reserve Board Survey of Consumer Finances 1989–2004 and 2008 ICI/SIFMA Equity and Bond Owners Survey

However, the trends in investing were negatively impacted during this decade, when corporate scandals such Enron and World Com, the Wall Street analyst scandal, and mutual fund improprieties such as market timing and late trading were exposed. Each of these scandals contributed to investors' loss of trust and confidence in the markets. However, the Dow Jones Industrial Average was able to climb from a low of 7,938.79 on October 1, 2002 in the midst of the corporate scandals to over 14,000 in 2007. Some attribute this change and rise to in part, the enactment of the Sarbanes-Oxley Act of 2002 and the restored confidence it gave some investors.

Nonetheless, with that loss of trust from one scandal after another this decade, the percentage of American households investing in the equity markets began to ebb and decline as the chart below illustrates. Unfortunately, when the supply of capital diminishes, it can drive up the cost of available capital, and make it more difficult for businesses to access the capital they need for research, jobs and investments. When combined with system-wide deleveraging and tightening of credit, the economic impact is potentially devastating.

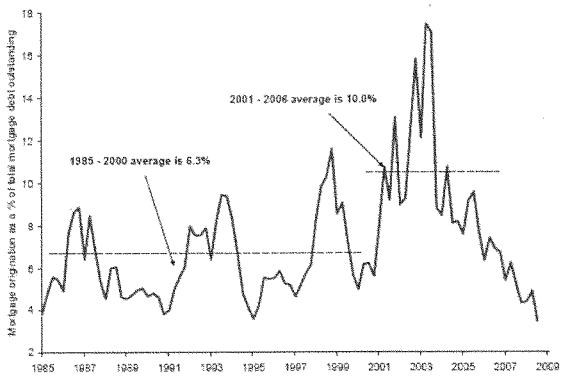
A February 2009 Harris Poll in February found that those surveyed believed Wall Street provided more benefit than harm as it provides the money needed by business. (Actually much of the money comes from American investors, not Wall Street.) However, those surveyed expressed a great distrust of Wall Street. The survey found "Those who think "most people on Wall Street would be willing to break the law if they believed that they could make a lot of money and get away with it" are up to 71%. The highest number previously was 64% in 1996." Those who believe that "in general people on Wall Street are as honest and moral as other people" have fallen to 26% from 41% last year. The

previous low was 35% in 2000, 2002 and 2003 during the dot.com market bust and corporate and Wall Street analyst scandals. And finally, "Those surveyed also indicated that those who believe that "most successful people on Wall Street deserve to make the kind of money they earn" have fallen to 30%, compared to 40% last year. The lowest number previously was 36% in 2002."

Compensation for Undue Risks

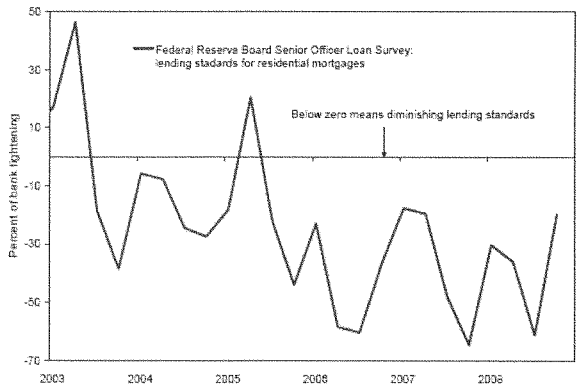
The blame for the financial crisis rests first and foremost with those who originated unsound loans, including mortgage brokers, mortgage lenders and bankers. The individuals and institutions involved, originated loans that were predatory in nature and not likely to be repaid in ever increasing numbers in the late 1990's and the 2000's. Sub prime loans were made by the millions, including loans that have often been referred to as No Doc loans, Liar's Loans, or Ninja (no income, no job, no assets) loans. Despite Congress having provided banking regulators authority to set lending standards for banks, as well as standards for what quality of assets they can hold the banking regulators failed to act. The chart below illustrates how as home owners took on ever increasing amounts of debt, risks to retail and institutional investors in these loans, the capital markets, the financial system and ultimately taxpayers and American workers rose quickly.

Exhibit 11: Mortgage origination surged – mortgage origination as a percentage of total mortgage debt outstanding



Source: Mortgage Bankers Association, Federal Reserve Board, Goldman Sachs Global Investment Research.

Exhibit 12: The surge in capital inflows eroded lending standards

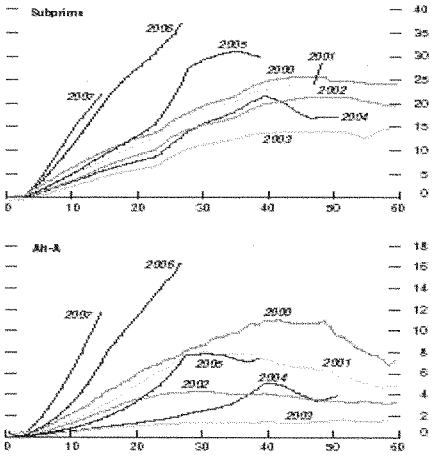


Source: Federal Reserve Board, Goldman Sachs Global Investment Research.

Securitizations of loans, including sub prime loans was also on the rise.

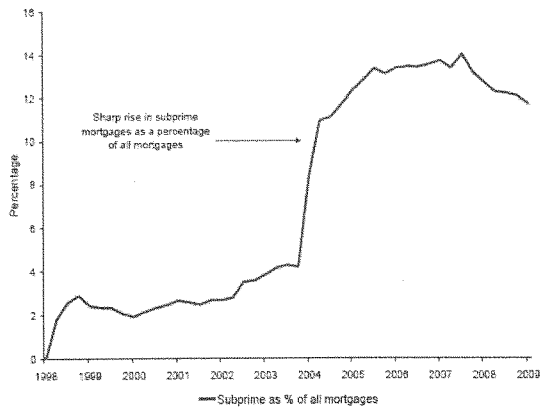
By 2006, the mortgage lending markets had become a train wreck waiting to happen. As noted in the charts below from the International Monetary Fund (IMF), loans originated in 2006 went into default almost as quickly as they were being made.

Figure 1.8. U.S. Mortgage Delinquencies by Vintage Year
(60+ day delinquencies, in percent of original balance)



As the volume of questionable mortgage loans increased, both in terms of loan amount and number of loans, housing advocates and others warned that many of the loans were unsustainable and would lead to as significant rise in foreclosure rates. The bank managements, boards of directors, and regulators ignored these earnings and failed to act on the increasing risks these loans introduced into the financial system. The mortgage loans, including home equity loans, significantly increased the levels of debt taken on by home owners. And the problems with the most problematic loans – the sub prime loans – rose exponentially.

Exhibit 13: The percentage of subprime mortgages soared to record levels



Source: Mortgage Bankers Association, Goldman Sachs Global Investment Research.

Unfortunately, the financial system lacked the transparency, risk management or financial incentives necessary to ensure there would be self discipline in the capital markets with respect to lending activities. Despite a request from the SEC to the accounting standard setters in 1998, the standard setters had failed to pass new standards providing greater transparency with respect to loans which are almost always the largest asset on the balance sheets of banks. In 2000, The Working Group on Public Disclosure, established in April of 2000 by the Board of Governors of the Federal Reserve System, issued a report to banking and securities regulators that largely went unheeded. That report recommended banks and other financial institutions disclose market risks on a quarterly basis including current credit exposures and risks based on internal credit ratings, insight into key concentrations of risks such as sub prime loans, and how well market risk models actually performed.

A Failure to Properly Manage Risks

Risk management was also lax or nonexistent both within financial institutions and at the federal regulatory agencies. It was clearly the responsibility of the federal financial market regulators to identify risks and take responsible actions within their authority to manage and mitigate those risks. As a former SEC senior official, I think a federal regulator who said their job did not involve identifying and addressing risks is a regulator who should be fired.

The SEC's risk management office established by Chairman Donaldson in the wake of the mutual fund scandals, had largely been dismantled in subsequent years with only one remaining employee by February of 2008. The Office of the Comptroller of the Currency (OCC) had two risk offices, that were combined into one in 2006. Although the OCC, Federal Reserve, Office of Thrift Supervision (OTS), and Federal Depository Insurance Corporation (FDIC) all had field examiners in banks they regulated, the banking regulators failed to identify and/or failed to manage the risks that were growing with each passing day. And certainly the regulator of Fannie and Freddie was very cognizant of the risks those two institutions were engaging in as they greatly expanded their portfolios and exposure to risks, and yet failed to take responsible actions to stem the risks.

When Merrill Lynch removed their CEO in 2007, they announced they would be hiring a risk officer for what was one of the largest financial institutions in the world. The lack of an effective risk officer in this institution with adequate authority was emblematic of problems throughout the industry. In Merrill's case it was later found to contribute to losses that first forced the company to find a buyer and ultimately, caused the buyer to need government aid as a result of those losses.

By the end of 2007, the sub prime crisis had exploded. Merrill Lynch and other firms took billions in write downs. Merrill's CEO would leave in October of 2007 followed by the Citigroup CEO the following month. CEO's of AIG and Wachovia would also be pushed out. All of these institutions would take tens of billions in writedowns and ultimately need billions in investment from the U.S. taxpayer to survive.

Pay for Nonperformance – The Wrong Financial Incentives

A key problem with compensation among executives is that the compensation is not negotiated directly between management and the investors. Rather an intermediary, the board compensation committee, who often has close ties to management but not investors, negotiates the pay package on behalf of investors. Too often that results in compensation based on what other executives are paid. It is not linked to the actual performance of the company versus its competitors, nor to the total shareholder returns that are generated.

This process is exacerbated among Wall Street firms that have tended to pay lower base salaries and very large bonuses. The annual large bonuses have resulted from volume selling of products that were very damaging to the markets and investors without consideration to the long term impact they could have on corporate profits. As a result, bonuses were often paid in profitable years for business activities that in later years destroyed some of these firms. Unfortunately, there needs to be much closer alignment between compensation and long term performance, through the reduced percentage of pay that is given through annual bonuses, greater use of restricted stock, and the ability to claw back excessive compensation when it has been earned through deceptive or fraudulent means.

The public does properly perceive compensation among financial firms to be excessive. Merrill's CEO retained more than $161 million after he was ousted on top of the $70 million he took home during his four-year tenure. The bulk of the exit pay was linked to previously earned benefits and stock since his departure was deemed a retirement; he did not receive any severance pay. Citigroup's CEO collected $110 million while presiding over the evaporation of roughly $64 billion in market value. He left with an exit package worth $68 million, including $29.5 million in accumulated stock, a $1.7 million pension, an office and assistant, and a car and a driver. Citigroup's board also awarded him a cash bonus for 2007 worth about $10 million, largely based on his performance in 2006 when the bank's results were better. Mr. Mozilo, the CEO of Countrywide Financial which was forced into a sale to Bank of America (BofA), took home more than $410 million since becoming chief executive in 1999, including several stock sales made under an automatic plan while the company was buying back shares.[2] Unfortunately, the boards of these companies were either unable or unwilling to clawback this compensation as a result of

[2] Chiefs' Pay Under Fire at Capital. New York Times, March 8, 2008. Jenny Anderson.

the destruction of these companies and the huge losses suffered by their investors due to a lack of performance.

According to the Wall Street Journal on May 2, 2009, "From 2006 through 2008, the 10 largest financial companies in the U.S. awarded their chief executives a cumulative total of more than $560 million in cash, stock and options. Those firms -- some of which are no longer among the 10 biggest -- have lost a total of nearly $1 trillion in market value since the end of 2006."[3] That means CEO's of companies who stock performance was miserable were taking out over half a billion in compensation. No wonder investors and the American public are livid with them.

On January 17, 2007, Bloomberg reported that Wall Street's five biggest firms paid a record $39 billion in bonuses for 2007. In that year the firms shed 25 percent of their equity value, said they were eliminating at least 6,200 jobs and three of the companies suffered the worst quarterly losses in their history and shareholders lost more than $80 billion.

Goldman Sachs Group Inc., Morgan Stanley, Merrill Lynch & Co., Lehman Brothers Holdings Inc. and Bear Stearns Cos. together awarded $65.6 billion in compensation and benefits last year to 186,000 employees. The year-end bonuses, at 60 percent of the total, exceeded the *$36 billion* distributed in 2006 when the industry reported all-time high profits. The industry's bonuses were larger than the gross domestic products of Sri Lanka, Lebanon or Bulgaria, and the average bonus of $219,198 was more than four times higher than the median U.S. household income in 2006, according to data compiled by the U.S. Census Bureau.[4] And these bonuses were paid out in part due to earnings made from sub prime lending, securitizations and derivative products that would prove to be the "financial weapons of mass destruction" Warren Buffet had forewarned of.

Chief executives at the nation's largest corporations earned less in total compensation in 2008 than in 2007, according to an analysis of the pay data of companies in the Standard & Poor's 500 index. The analysis is based on 2009 proxy statements filed through March 31. Average total compensation for the CEOs declined 6 percent from $11.07 million in 2007 to $10.4 million in 2008. Similarly, median income for these CEOs declined from $8.6 million in 2007 to $7.7 million in 2008.[5] This compares to the median pay for the full-time workers who have kept their jobs rose 4 percent to $37,544 in 2008, from $36,140 the previous year, according to the federal Bureau of Labor Statistics.[6]

But even as the economy slumped and 5.1 million Americans lost their jobs, the median salary for CEOs of 200 large companies increased 4.5 percent to $1.08 million, according

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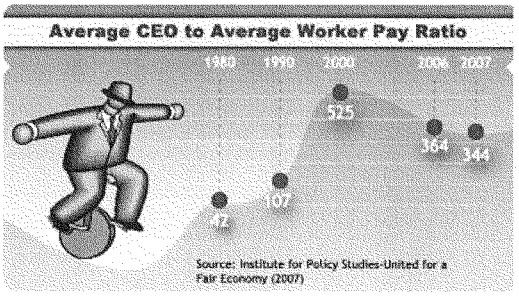
[3] CEOs Need to Bring Investors Along for the Ride with Them. Wall Street Journal, May 2, 2009.
[4] Wall Street Bonuses Hit Record $39 Billion for 2007. Bloomberg News, January 17, 2008, Christine Harper. See http://www.bloomberg.com/apps/news?pid=20601087&sid=aPXU4y.z8E9o&refer=home
[5] Preliminary data from The Corporate Library is based on 218 proxy statements filed through March 31, 2009.
[6] "Who Moved My Bonus? Executive Pay Makes a U-Turn," The New York Times, April 5, 2009.

to a survey by The Wall Street Journal.[7] And despite the public outcry over private jets and other executive perks, companies kept plying executives with generous freebies. CEO perks went up, on average, 12.5 percent in 2008 to $336,248—or nine times the median salary of a full-time worker.[8]



"When push comes to shove, companies didn't make as many changes to these programs last year as shareholders would like," according to David Wise, a senior consultant at the Hay Group, which compiled the survey for The Wall Street Journal.[9]

That is not to say all executives are overpaid. I have seen many executives who provided their investors with above average returns in exchange for reasonable compensation. And some executives such as Lloyd Blankfein at Goldman Sachs and Jeffrey Immelt at GE have advocated very beneficial changes in compensation schemes that members of Congress and the business community should give due consideration to. Care should be taken to ensure not all business executives are painted with the same broad brush.

In foreign countries such as the United Kingdom, the Netherlands and Australia, the owners of public companies – the investors – are given a right to vote on executive compensation. But it is a basic fundamental right that shareholders here in the United States have been denied during a period in which executive compensation, especially as compared to the compensation of Main Street Americans, has risen exponentially.

Unaccountable Boards of Directors

With Americans increasing their investment in stocks of public companies, they have become increasingly dependent on their elected representatives to oversee the management of companies working on their behalf. This includes being dependent upon the compensation committees of boards of directors for establishing reasonable levels of compensation based on the performance of the management team and the company given full consideration to the environment that company operates in. Yet the corporate governance system in the U.S. currently only allows investors to vote for a director, or

[7] "CEO Pay Sinks Along With Profits," The Wall Street Journal, April 3, 2009.
[8] Preliminary data from The Corporate Library is based on 218 proxy statements filed through March 31, 2009.
[9] "CEO Pay Sinks Along With Profits," The Wall Street Journal, April 3, 2009.

abstain from voting. Investors are not given the opportunity to vote against investors. Investors in countries such as the U.K., Canada, Australia, Germany, Japan, South Africa, Finland, Indonesia, Russia, Italy and India all provide investors some form of nominating directors when they hold a sufficient ownership in the company ranging from a nominal amount to up to 10%.

"Proxy Access" is a term used to describe a procedure by which directors nominated by shareholders would be identified in proxy statements published by corporations and listed on the corporation's proxy card for election by the shareholders.

The process by which directors at U.S. corporations are elected long has been criticized by investors both here and abroad. Incumbent directors, by controlling the nomination process and deciding who to place on the corporation's ballot for consideration by the shareholders, essentially have maintained control over corporate boards and have been resistant to meaningful change in the boardroom. In addition, because the nomination process has been controlled by incumbent directors, director candidates largely have been viewed as being more responsive to their fellow directors, upon whom they depend for appointment to the board, than to the shareholders who they are supposed to represent.

Under the existing regime, shareholders have no meaningful ability to influence the nomination process by corporate boards, and financing an independent solicitation for the election of an alternative candidate or slate of candidates can be prohibitively expensive. Indeed, the expense of proxy solicitation generally dissuades investors from financing independent campaigns for directors unless part of a larger goal to acquire control over the company. Thus, the existing regime prevents shareholders from directly influencing the board of directors through the election of independent candidates.

"Proxy access" long has been considered the "holy grail" for shareholders. If implemented, it would provide shareholders with a low-cost method of nominating director candidates and the expense of soliciting proxies for such candidates would be shared by all shareholders. As a result, shareholders have been advocating for "proxy access" for decades. In 1976, the SEC considered adopting a mandatory "proxy access" rule, but declined to do so.

Even in the absence of an SEC rule requiring "proxy access," corporations are not legally precluded from voluntarily adopting proxy access policies, and can have bylaws making proxy access a requirement at a particular corporation. Thus, beginning in the mid-1980's, shareholders began to submit proposals to specific corporations urging the adoption of "proxy access" policies and/or bylaws. Initially, the SEC's Division of Corporation Finance permitted such proposals to be submitted to shareholders. In approximately 1998, however, the Division began permitting companies to exclude such proposals under the "election exclusion" of SEC Rule 14a-8(i)(8). Between 1998 and 2002, the SEC generally barred "proxy access" proposals. Also during this period, activist shareholders increased their use of the shareholder proposal mechanism of Rule 14a-8, and sought to introduce proxy access proposals with increasing frequency. In 2002, the SEC proposed the adoption of a formal rule that would have made proxy access

mandatory for all publicly traded corporations. In response to intense lobbying efforts by corporate interests, the SEC did not take any action on the proposed rule.

In 2006, the United States Court of Appeals for the Second Circuit held that under the existing proxy solicitation rules, corporations were *not* permitted to exclude shareholder proposals advocating the adoption of bylaws that would install proxy access regimes at individual corporations. *AFSCME Employees Pension Plan v. American International Group*, 462 F.3d 121 (2nd Cir. 2006). In other words, the Second Circuit ruled that shareholders were empowered under the existing proxy rules to submit proposals advocating the adoption of proxy access bylaws, yet the SEC's Division of Corporation Finance had wrongfully been depriving shareholders of that right for nearly a decade. Although the SEC had declined to participate in that litigation, the SEC's response to the Second Circuit's decision was immediate – it promised to amend the proxy rules to "provide uniformity." In the summer of 2007, the SEC published two competing proposed rules. The first rule would have permitted shareholders to submit proxy access proposals provided such proposals had certain minimum characteristics (such as minimum shareholdings, etc). The second proposed rule, however, would amend Rule 14a-8(i)(8) to bar any proposals advocating proxy access regimes in their entirety. In the fall of 2007, again succumbing to intense lobbying efforts from business interests, the SEC adopted the latter rule.

The current SEC Chairman and Commission deserve much credit for again proposing new rules giving shareholders equal access to the proxy with management. However, the Chamber of Commerce has indicated it would consider taking legal action against the SEC if it did so. As a result, Congress should clarify and make certain the authority of the SEC to do this important rule making.

Although proxy access proposals no longer can be introduced by shareholders through the resolution process established in SEC Rule 14a-8, "proxy access" bylaws themselves remain legal. At least one corporation – Comverse Technology – has voluntarily adopted a proxy access bylaw, and UnitedHealth Group, Inc., has agreed to adopt a proxy access procedure as part of a settlement of a securities class action recently announced by the corporation.

Asset Managers Fail as Fiduciaries

For many years, including the past couple of years, investors of all types – mutual funds, public and corporate pension funds, labor funds and broker dealers have all continued to vote again and again for the members of the compensation committees of many of the institutions that have failed to perform and required government assistance to remain sustainable. This has included boards of such companies as AIG and Citigroup where investors have publicly voiced their concerns regarding excessive compensation. These investors also share part of the blame for the current financial crisis as they have quite frankly, reaped what they voted for.

A report issued earlier this year titled "Compensation Accomplices – Mutual Funds and the Overpaid American CEO" found that:

> "...mutual funds are increasingly supportive, as a group, of management positions on proposals dealing with executive pay, despite the current outrage over CEO pay amounts and disconnection from company performance. As a group, the 26 mutual fund families had the following voting patterns:
>
> • The average level of support for management proposals on compensation issues was 82% in 2007 and 84% in 2008, a steady increase from 75.8% in 2006.
>
> • The average level of support for the categories of compensation-related shareholder proposals we selected was 42% in 2007 and 40% in 2008. This represents a significant decrease from the 46.5% support found in 2006."

The report also found that some fund families including AllianceBernstein, Barclays and Ameriprise have "consistently ranked as "Pay Enablers"...T. Rowe Price was among the "Pay Constrainers" in 2006 as well as both years covered by this study, while Templeton has been a "Pay Constrainer" for a couple of years.

Many mutual fund and asset managers have an inherent conflict in that they strive to gather assets to manage, often soliciting corporate executives for the contracts to manage the pension fund assets of companies. They receive significant fees for such arrangements. At the same time, asset managers are voting the shares held by the funds in which investors have placed their money and may well be required to vote for or against management and board members at companies they are soliciting business from. This creates a very significant conflict. As noted in the survey cited above, it appears all to often fund and asset managers may be putting their own interests ahead of the best interest of those investors whose money they are managing.

The New Entrepreneurial and Destructive Financial Products

While sub prime loans were being made, Wall Street and banking financial institutions also created new financial products, some of which were derivatives of such products, which created further and in some cases, increased risks to the market. Various types of loans, including sub prime loans, were packaged by the banks and Wall Street into pools of loans, placed in trusts, and debt and equity investments in the trusts were sold to investors, often referred to as Collateralized Mortgage Obligations (CMO's) or Collateralized Debt Obligations (CDO's). By doing these transactions, often referred to as securitizations, the risk of not collecting on the loans was transferred to someone other than the person making the loan, leaving the person making the loan with "no skin in the game" and transferring the risk to the investor. As a result, the loan originator became was incented by the up front loan origination fees to do the highest volume of loans possible, without concern for collecting the loan, as that was no longer a risk to it.

And of course we have witnessed the explosion in the credit derivatives market which at one time was in excess of $60 trillion in dollars, much larger than the amount of debt underlying those derivatives. Unfortunately, Congress created a very serious gap in the regulation of such securities with the passage of the Commodities Modernization Act in 2000. That is a gap that must be filled by legislation requiring greater transparency of contracts and pricing, centralized clearly and trading, more timely settlement, and the ability of the CFTC and SEC to oversee, regulate and when necessary, enforcement capabilities in order to protect markets, investors and American taxpayers.

As the House has learned in earlier Committee Hearings, executives at companies such as AIG were compensated handsomely, and paid bonuses for engaging in devising these new financial products, some of which have had enormous destructive impact on financial markets. Yet the reward for creating and selling these products has proven to be much more lucrative for those who engaged in such activities than the risks they faced.

And certainly, the risk of reputational damage to individuals, senior executives and the firms they managed did not sway those at Wall Street and Banks who reaped the huge rewards previously outlined. In fact, reputational risks seldom do overcome the opportunity for a "fast buck" as we previously have seen during the corporate scandals of Enron and Worldcom, the Wall Street analysts' fiasco, the mutual fund late trading and market timing and now the current financial crisis.

Recommendations

Despite the shortcomings I have mentioned above, I would caution the government that compensation should be decided by and between compensation committees of boards of directors, with input and counsel from management, and independent consultants. More importantly, investors should and must have a voice on compensation and the negotiated terms, especially when directors and management fail in their fiduciary and agency obligations.

I strongly urge that the government not get involved in setting compensation, either directly, through taxation legislation, or by establishing government overseers of compensation. Past attempts at legislating compensation such as through limits on tax deductibility of pay have had negative impacts on companies and their stock values, and ultimately investors. I believe compensation should be determined by transparent free markets.

However, the free markets today do not provide the necessary transparency or accountability to operate effectively. To correct those serious deficiencies, I would urge the Committee, its leadership and members to consider and pass legislation and push for regulations addressing the following recommendations.

<u>Improving Transparency</u>

To improve transparency, the SEC should enhance its disclosure of compensation arrangements. Former Chairman Cox and the Commission made significant strides in enhancing disclosures to investors regarding compensation arrangements, provided investors actually took the time to read them. Yet the SEC did not require disclosure of perhaps the most significant data one uses in assessing compensation – that is the performance metrics a management team and board compensation committee uses when judging performance versus competitors including the nature, types and level of triggers for payment of bonuses. While many companies have voluntarily provided these performance metrics and triggers, many have not. The SEC should be requested to level the playing field for all and require all companies make these disclosures to their investors.

In addition, the SEC should require disclosure of the value of all equity grants in the year those grants are made by the board. At Glass Lewis, we found directors and investors used the value of the grants when they were made as a determining factor in assessing compensation. Yet the SEC, in a "late midnight" rule making changed their rules from requiring such disclosures, to one of requiring the amount of expense recorded in the financial statements to be disclosed. This error in rulemaking which was quite controversial at the time it was done without adequate and timely solicitation of investors input, should be reversed.

Investors have also asked for disclosure regarding consultants used by compensation committees and whether they are independent from management or not. Having served boards of directors of public companies and watched these consultants in action, I have all too often seen their lack of independence contribute to excessive compensation. All too often they have done peer comparisons on compensation which constantly raised the "average" pay, while ignoring whether or not performance among the peers was comparable. As such, I strongly support disclosures regarding the independence of compensation consultants and their fee arrangements, just as we do for independent auditors.

I believe all asset and investment fund managers, including corporate and public pension funds, should be required to publicly disclose their votes on proxy matters, including votes on boards of directors including compensation committee members as well as compensation arrangements. Such transparency is necessary if accountability is to be established in a free market system. Recently at the public pension fund I serve as a trustee for, we have adopted a policy of making such disclosures, even though there is no rule requiring it. Such a policy is in the best interests of our investors and members and is a positive step in establishing our accountability to them.

A requirement should also be established to require investment and asset fund managers to disclose the compensation arrangements under which they pay their portfolio managers. As was highlighted in the Conference Board Report of the Commission on Public Trust and Private Enterprise in 2003, a vast majority of such managers are paid for short term, not long term performance, including quarterly or annual bonuses. Whether or not a fund pays for long term results on behalf of its investors or continues to pay for

short term results which has included high levels of turnover in the portfolio's driving up costs to investors, should be made transparent to investors and the markets. It is critically important that investors quite investing on a short term quarterly to quarterly "what have you done for me lately" basis to a longer term view focused on long term shareholder value creation. All to often executives at financial firms have created products and a business model focused on short term profitability to the detriment of the long term sustainability and value of the company, as that is what some investors have wrongly and incorrectly pushed for.

I believe the SEC and/or the Financial Accounting Standards Board should adopt a requirement for greater disclosures of risks by all public companies including financial institutions. Current disclosure requirements are woefully inadequate, have missed the target, and have not provided investors with adequate information to assess whether compensation arrangements have been appropriately designed in light of risks the company is facing or has engaged in. Over two decades ago, the major international accounting firms urged the SEC to adopt a rule that would have placed all such risk disclosures in a single section of the reports of public companies. That recommendation and the recommendations of The Working Group on Public Disclosure were for the most part ignored in what has become a very expensive lesson with a great cost to investors and taxpayers. I would urge the committee to consider those recommendations and others that focus on the risks of changing business products and environments, increasing degrees of leverage, and how cash flows are affected by both short term and long term funding and liquidity needs and requirements.

Creating Accountability

Greater accountability for the oversight of compensation arrangements should be established by making corporate boards of directors more accountable to those who they are elected to represent. To establish that accountability, the following is required:

1. Requiring directors be elected by a majority of investors who vote.

2. Elimination of broker dealer votes as the SEC has taken steps to do so.

3. Giving investors an advisory vote on the compensation arrangements disclosed each year in the proxy. However, if a company had a majority of investors vote against such compensation scheme for two or more consecutive years, the vote would become binding. Also investors should be provided a vote on golden parachutes or other forms of severance, that had not been previously disclosed and voted on in connection with a proxy, provided it gave compensation to the executives that exceeded one year of compensation.

4. Giving investors a private right of action to claw back bonuses and other incentive or equity based compensation, or profits from sales of securities, when one of the top executives of a company have been found to have engaged in reckless or fraudulent conduct which has violated securities laws, and it can be demonstrated

that as a result of such misconduct, investors have suffered losses. This would of course include, but not be limited to misstatements of financial statements.

5. Giving investors the same access to the proxy that management has, for the purpose of nominating directors, provided an investor has held at least one percent of the stock of the company for a period of two years or more. This will give investors not only a greater ability to hold directors accountable by running alternative slates of directors, but also encourage them to take a longer term view with respect to holding their investments. Some say this will give special interests the ability to gain control of a company through an unduly influenced vote. That couldn't be further from the truth, and to date, no single shareholder has even come close to achieving that.

In addition, I fear shareholder votes cast by fund managers are often cast in the interest of those managers and their institutions and not in the best interests of those whose money they are managing. As such, proxy voting has and will continue to be ineffective in establishing accountability, even through say on pay or majority voting regulations unless those votes are cast in the interest of investors. To achieve that goal, the SEC should be given the power to require those voting proxies on behalf of investors - mutual funds, public and corporate pension funds, and other asset managers - to cast those votes solely in the best interests of the investors. In addition, these fund and pension managers should also be required to disclose to their investors if they have a financial conflict when casting such votes. As voting shares is critically important to a public company and investors, firms who provide proxy advice on voting such shares should be much more transparent and subject to regulation by the SEC.

Systemic Risk Regulation

This year former SEC Chairman Richard Breeden testified before the U.S. Senate on risk regulation and the concept of a risk regulator. I found his testimony to be most informative and thoughtful and would urge you to consider it.

I do believe that if the current federal regulators had done their jobs, much, but perhaps not all of the damage that has been done the capital markets and financial system in the U.S. and abroad could have been avoided. I think the first and most important step to creating a successful risk regulation system is to adequately oversee the current federal regulators to ensure they are doing their jobs. However, that requires greater transparency on the part of these federal regulators. To achieve that necessary transparency and accountability I would require that each of the regulators in their annual reports to Congress:

- Identify both currently existing and potential risks;

- The risks should include broader economic risks as well as industry or sector specific risks, and risks for specific entities for which it is more likely than not that the regulator would recommend governmental support;

- Discuss what steps are being taken to manage and mitigate those risks.

In addition, I would require the examination reports of the federal banking and securities regulators be made public when completed. A recent GAO report has cited shortcomings in such reports when they were allowed to remain out of the public eye. I have had the opportunity to read such reports, including during audits of troubled financial institutions. I believe such reports would be beneficial to investors and depositors and do not agree that they would result in "runs" on a bank. Rather I believe that with public disclosures of such reports, it is likely the management team of the financial institution would be much more proactive in preventing serious deficiencies in the management and operation of the institution.

There has been much discussion of whether or not a new government agency and systemic risk regulator should be created. I believe this is not necessary if the current federal and state regulators do their job and actively cooperate and communicate with one another. Where legislation is necessary to permit timely sharing and exchange of information, including between state and federal agencies, it should be passed by Congress.

Some have discussed and suggested a council of existing regulators. Unfortunately, this sounds all to much like yet another Presidents Working Group which failed to identify and mitigate the risks leading up to the current crisis.

If Congress were to decide yet another risk regulator is necessary, then I would recommend it consider creating an equivalent of the National Transportation Safety Board for the financial markets. Such an agency would:

- Have an independent agency chair, sufficient staff and knowledgeable independent board members with requisite expertise.
- Its board could include members of the other federal agencies.
- Be charged with responsibility for identifying systemic risks to the financial system and just as the NTSB does, issue reports to the public and responsible federal and state agencies with recommendations for managing and mitigating those risks. This would include identifying risks with respect to financial products being sold in the capital markets.
- Have the ability to investigate capital markets and their participants when a serious risk or problem exists on its own or in cooperation with other federal regulators and issue reports with their findings and recommendations.
- The rulemaking for corrective actions would remain with the respective federal financial or securities market regulator, provided corrective actions were taken within one year or a reasonable period of time. This is consistent with the relationship between the NTSB and FAA.
- The agency would have the ability to pay private sector wages so as to attract the breadth and depth of knowledge necessary to identify, clearly understand, and then make smart recommendations on how to manage and mitigate the risks.

- The agency would need to be transparent to the public with respect to its work, findings and recommendations.

Closing

In closing I would like to urge the committee to focus on the principles of transparency, accountability, independence, effective regulation and enforcement when it comes to designing regulatory reforms. I believe these principles apply to most if not all components of the capital markets including compensation as well as risk management. They are principles that history has demonstrated time and time again are necessary for efficient capital markets that fulfill their critical role for not only investors, but also business and American taxpayers.

I have worked with others to draft legislation that would accomplish many of the recommendations set forth above. If it would be of interest to the committee or any of its members, I would be happy to share it with you.

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Unintended Consequences of Executive Compensation Regulation Threatens to Worsen the Financial Crisis

J.W. Verret, Assistant Professor
George Mason University School of Law

Testimony before the House Committee on Financial Services
Full Committee Hearing on Compensation Structure and Systemic Risk

10 a.m. on Thursday, June 11, 2009
2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee, it is a privilege to testify in this forum today. My name is J.W. Verret, and I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to study of the intersection of state and federal authority in corporate governance.

Today I will discuss executive compensation proposals currently under consideration. I will also highlight a Wall Street norm of issuing, and feeling pressure to meet, quarterly earnings guidance, which is a central cause of short term tunnel vision for Wall Street executives.

There are seven executive compensation initiatives underway. Such a wide array of ideas from disparate corners risks repeating the lack of coordination that contributed to the present crisis.

The multitude of proposals threatens to override two SEC driven initiatives offering some promise in this area. Former SEC Chairman Cox completed an extensive overhaul of executive compensation disclosure in 2006, and Chairman Schapiro is promising further changes. Chairman Cox's reforms offer only two years of working history to assess. I recommend studying the effect of these disclosure changes before instituting proscriptive regulation that risks passing high costs onto investors.

Even with the best of intentions, compensation regulation risks unintended consequences. A glaring example are the 1993 tax code changes to limit the deductibility of non-performance based compensation, originally intended to limit the disparity in pay between executives and the average worker. The result was that executive compensation increased exponentially and the disparity immediately widened.

Pay restrictions will also limit banks in their competition for top talent, which risks exacerbating the banking crisis. Immediately following the announcement of compensation restrictions by the Obama Administration, Bank of America indicated that Deutsche Bank poached 12 of its highest performing executives and other reports indicated that UBS was hiring financial advisors from TARP firms with compensation increases as high as 200%. In a global environment, restrictions may place American banks at a competitive disadvantage.

Pay packages are of necessity complex. Compensation is intended to link pay to the executive's performance running the company, without rewarding or punishing executives for factors outside their control. It would make little sense, for instance, to reward or punish executives for the effect of Federal Reserve policy on a company's stock price. I am concerned that regulatory restrictions may limit a compensation committee's flexibility to achieve this goal.

Further, executive compensation's role in the current crisis is unclear.
Comparing the compensation at banks determined healthy enough to repay their TARP funds to compensation at banks likely to need additional injections of capital reveals little difference in their executive compensation approaches. It is logical to assume that if executive compensation were to blame for excessive risk taking, the differences between the two groups would be more apparent.

Short-term thinking is, however, a significant risk to the safety and soundness of the nation's banking system. But a focus on compensation approaches the issue indirectly and merely scratches at the surface.

Compensation is how executives can be motivated toward short term goals. The real question is why they are directed toward short-term goals in the first instance.

The widely accepted convention of quarterly earnings pressure in capital markets is the root of this short-termism. Companies feel pressured to make quarterly predictions about their earnings, and then cut corners to meet those predictions. Companies that abandon quarterly forecasting find analysts suddenly stop following their stock.

This is a reform issue with broad support among the spectrum of capital market participants. Pension funds, mutual funds, and company issuers all express dissatisfaction with the existing pressures of quarterly earnings guidance, but companies feel that voluntarily opting-out will be taken as a negative signal.

Before consideration of dramatic overhaul in executive compensation, I would urge this committee to wait until executive compensation disclosure reforms have time to bear fruit. I would also urge this committee to consider examining quarterly earnings pressure to get at the root of short term thinking on Wall Street, before making changes to executive compensation practices that may end up unintentionally doing more harm than good.

I thank you again for the opportunity to testify, and I look forward to answering your questions.

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