EXECUTIVE COMPENSATION OVERSIGHT AFTER THE DODD–FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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FRIDAY, SEPTEMBER 24, 2010

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EXECUTIVE COMPENSATION OVERSIGHT AFTER THE DODD–FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

Friday, September 24, 2010

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

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

Members present: Representatives Frank, Watt, Moore of Kansas, Green, Hodes, Ellison; Bachus, McHenry, Posey, and Lance.

The CHAIRMAN. The hearing will come to order. I apologize, I lost track of the time, and I am sorry. We will begin with the gentleman from Texas, Mr. Green, for an opening statement for 3 minutes.

Mr. GREEN. I thank you, Mr. Chairman, and I thank the witnesses for appearing today. I am honored, Mr. Chairman, that you called this hearing and I thank you for doing so.

I would like to mention very briefly a few pieces of statistical information that I think are exceedingly important. Currently, we have in this country a poverty rate that consumes about 43.6 million Americans. And this poverty rate is juxtaposed to persons who are making inordinate amounts of money and paying a capital gains tax. The numbers speak for themselves.

We had in 2007 a person who made $69.7 million working for one of our leading firms. And by the way, I salute people who make large amounts of money. I want people to make as much as they can honestly earn. But it is interesting to note that $7.25 cents an hour, what this person has made in 1 year would take a minimum-wage worker 4,878 years to make. That person who made the $69.7 million is making about $9.3 per second. And, of course, this person has reason to envy the hedge fund manager who in 2007 made $3 billion, which would take a minimum-wage worker about 198,000 years to make, as the person making the $3 billion makes roughly $400 per second.

Finally, I had mentioned the hedge fund manager who made $4 billion in 2009 which would take a minimum-wage worker 265,252 years to make, the hedge fund manager making about $534 per second.

I mention these not because I begrudge the persons who make these sums of money. I mention it because we have people in this country who work very hard, who make minimum wage, and it is very unfortunate that the people who support the maximum-wage earners, the persons who can make these hundreds of dollars per second, $400 per second, $534 per second, support the maximum-wage earners but would eliminate the minimum wage. Support the maximum-wage earners paying a capital gains tax of 15 percent, but would eliminate the minimum wage. The minimum-wage workers deserve as much consideration as the maximum-wage workers. I stand for helping both, and I will not allow the minimum-wage workers to be left behind.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from Florida is recognized for how much time—

Mr. POSEY. I thank you, Mr. Chairman. And I want to thank you for calling this hearing.

The CHAIRMAN. Three minutes for the gentleman from Florida.

Mr. POSEY. I want to thank you for calling this hearing, Mr. Chairman. This is a subject which has long interested me. When we had the major bank CEOs here, one of the members asked them for their compensation and they said what it was. And then they were asked what it was the year before as the ship was sinking and, to be sure, they included bonuses, and they went from I think about $12 million to $60 million, something like that. I wouldn't want to be held to that. And it left you to wonder, obviously, if one of them had gone down in a plane crash, if in fact their stockholders would have been hurt to the tune of $12 billion, $20 billion, $60 billion in their absence.

So the question that begs for an answer, of course, is what relationship there is between the people on these compensation committees and the people they compensate? I hope you will address that in your remarks today and we will discuss it in questions: How much transparency is there now? How much transparency is opposed? Have there ever been any findings or prosecutions for an improper relationship for which the citizens, the stockholders, suffered?

Those are some of the interests that I have and that I hope you will address today. And I want to thank the chairman again for holding this hearing.

The CHAIRMAN. Any other requests for time on our side? If not, I will just take a few minutes to say that the genesis of this hearing, frankly, was an article in the New York Times by Robert Shiller with whom we have had good conversations, in which he wrote that he thought executive compensation had to be addressed, and I noted that we had in fact done that. He wrote about the Squam Lake Group which consisted, as I recall, of economic officials from the second Bush Administration, I believe, and the Clinton Administration not currently involved.

And we noted that we had done some things, and I invited them to come and testify. We have given the regulators authority and we would like them to talk about how they are going to use it. One thing we should be clear on: At no point did any of our legislation, either on say-on-pay, which applies to all corporations or the more specifically financial ones here, have we addressed the dollar amount. That is not our job and we do not try to fix the amounts.

We did, in the say-on-pay, try to empower the shareholders. In this, the financial area, the problem is not the level but the incentive. There is a widespread view among many analysts and subscribed, it seemed to be, by all the regulators including those appointed by the Bush Administration and the Obama Administration, that the incentive structure was the problem. That a problem of heads I win, tails I break even, did not appropriately incentivize people.

So what the legislation does is not in any way to set dollar amounts or authorize anybody to set dollar amounts but to deal with the question of the incentive structure and try to empower the regulators and to mandate them to so structure the rules so that people are not incentivized to take risks excessively, by which we mean assist, whereby people take a risk and if it pays off, they do well; and if they take a risk and it does not do well at all, they break even. That is not a rational incentive structure.

And so we are pleased to have with us a couple of economists who have been—one of the economists who has been involved in this and also someone from the industry. And that is the genesis of this hearing, it did come from an article by Professor Shiller and a representative of the group, the Squam Lake Group, will be here.

We have given the authority to the regulators and we want to talk about how it should be used.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. General Counsel Alvarez and Directors Cross and Steckel, I am not sure how you were assigned the job to draft these rules, but I suppose you are going to use your real names on the draft; is that right? I guess it is a thankless job and it is a difficult job, but it could be more difficult if you were charged with looking into the pay of athletes or entertainers. So there is probably some silver liner there.

Obviously, this is a subject that is very popular and almost everything has been said about it that can be said, but at least this hearing, the scope of this hearing is limited to executive compensation oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act, so this hearing is limited, and I think maybe something newsworthy will come out of the hearing.

We look forward to your testimony, but I know you have a difficult job and there are literally thousands of different opinions on what you ought to do. And it is a difficult subject. I thank you.

The CHAIRMAN. Any further requests for time? If not, we will begin with our witnesses and we appreciate their testifying. We should note that when we originally called this hearing, the assumption was the House would be in session. It is not, and therefore you have fewer members, but that may or may not distress you.

I remember touring a Hollywood studio in 1981 in my first year, because I was on the Judiciary Committee and dealing with copyrights and they were giving me a tour of the studio. They were making a movie with Nastassja Kinski, and I forget who else, and it involves people who turned themselves into panthers or who were turned into panthers by some other force. And when we toured the site, the people from the studio apologized to me because the panthers weren't there. I said I wanted to be very clear.

As far as I was concerned, no one ever had to apologize to me for not putting me in the presence of panthers.

And so maybe, that is the way the witnesses feel; no apology is needed for the fact that there are fewer panthers here than there might otherwise be. But in any case, we do appreciate their coming, and we will begin with Scott Alvarez and your statement, Mr. Alvarez.

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

Mr. ALVAREZ. Thank you very much, Chairman Frank, Ranking Member Bachus, and all the members of the committee. I appreciate the opportunity to discuss the oversight of incentive compensation practices, an area in which the Federal Reserve has undertaken significant initiatives.

Incentive compensation is an important and useful tool for attracting and motivating employees to perform at their best. At the same time, poorly designed or implemented compensation arrangements can provide executives and other employees with incentives to take imprudent risks that are not consistent with the long-term health of the financial organization. To help address these problems, the Federal Reserve led the development of interagency guidance on incentive compensation that was adopted by the Federal banking agencies last June.

We are also close to completing a horizontal review of incentive comp practices at large complex banking organizations. Section 956 of the Dodd-Frank Act provides important support to these efforts by requiring that the Federal banking agencies, the SEC, the NCUA, and the Federal Housing Finance Agency prescribe joint standards governing incentive compensation.

The guidance adopted by the Federal banking agencies is based on three key principles:

First, incentive comp arrangements should provide employees with incentives that are appropriately balanced so they do not encourage employees to expose their organizations to imprudent risk.

Second, these arrangements should be compatible with effective controls and risk management.

And third, these arrangements should be supported by strong corporate governance, including active oversight by the organization's board of directors.

The guidance applies to senior executives. It also applies to non-executive employees who either individually or as a group have the ability to expose the banking organization to material amounts of risk. The guidance recognizes that activities and risks may vary significantly across banking organizations and across employees within a particular banking organization. As a result, one approach to balancing risk and reward will certainly not work for all.

Moreover, the guidance includes several provisions designed to reduce burdens on smaller banking organizations. At the same time, in order to help ensure that large banking organizations move rapidly to bring their arrangements into compliance with the principles of safety and soundness, last fall the Federal Reserve initiated a special horizontal review of incentive comp practices at a number of large complex banking organizations. We are currently reviewing a substantial amount of information collected in this horizontal review and expect to provide each firm with individualized feedback this fall.

After the assessments are completed, implementation of the incentive comp plans will become part of the supervisory expectations in normal supervisory process for each of these organizations. Firms have put forth significant effort to find constructive solutions to the issues we and they have identified.

In addition, over the course of the horizontal review, we have observed and encouraged real, positive change in incentive compensation practices. While significant improvements have been achieved, it should not be surprising that time will be required to implement all the improvements that are needed, given firms' relatively unsophisticated approach to risk incentives before the crisis, the complexity of compensation issues, and the large number of employees who receive incentive comp at large banks.

Importantly, the Federal Reserve expects large complex banking firms to make significant progress to improve the risk sensitivity of their comp for the 2010 performance year. After 2010, the Federal Reserve will prepare and make public a report on trends and developments and incentive comp practices at banking organizations in order to encourage improvements throughout the industry.

Section 956 of the Dodd-Frank Act supports these efforts and improves the ability of Federal regulators to collect information about incentive compensation arrangements at a wide range of financial firms.

The Dodd-Frank Act also empowers the appropriate Federal agencies to prohibit any type or feature of incentive comp payment arrangements that encourage inappropriate risks by a covered financial institution. By expanding the scope of coverage to include many large nonbanking firms, as well as supporting the Federal banking agencies' efforts, the Dodd-Frank Act helps level the playing field and reduces the potential for sound practices at banking firms to be undermined by arrangements at other financial competitors.

I appreciate the opportunity to describe the Federal Reserve's efforts in this area and I am happy to answer any questions.

[The prepared statement of Mr. Alvarez can be found on page 36 of the appendix.]

The CHAIRMAN. Our next witness is Meredith Cross, who is the Director of the Division of Corporation Finance at the SEC.

STATEMENT OF MEREDITH B. CROSS, DIRECTOR, DIVISION OF CORPORATION FINANCE, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. CROSS. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee. My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. I am pleased to testify on behalf of the Commission today on the topic of executive compensation oversight.

The Commission's role in this important area has traditionally been to require timely, comprehensive, and accurate disclosure to investors about a company's executive compensation practices and procedures. One challenge the Commission faces is that compensation practices continually evolve and become increasingly complex. The Commission has revised its disclosure rules to address these changes, including most recently in 2006 and 2009.

Currently, we are focused on implementing the requirements in the Dodd-Frank Act which address an array of compensation issues. I will briefly summarize those provisions and our plans to implement them.

Section 951 requires a shareholder advisory say-on-pay vote at all companies subject to our proxy rules at least once every 3 years, and a separate advisory vote on the frequency of say-on-pay votes at least once every 6 years. This section also calls for new merger proxy disclosure about, and a shareholder advisory vote on Golden Parachute arrangements. Although no rulemaking deadline is specified, the Commission's goal is to adopt final rules in time for the 2011 proxy season, since the say-on-pay and say-on-frequency advisory votes apply to shareholder meetings beginning January 21, 2011.

Section 957 requires the national securities exchanges to amend their rules to prohibit brokers from voting uninstructed shares on certain matters including executive compensation. On September 9, 2010, the Commission approved changes to the New York Stock Exchange rules that implement this mandate, and the Commission expects to approve corresponding changes to the rules of the other exchanges soon.

Section 952 requires the Commission to mandate new listing standards concerning compensation committee independence and compensation consultant conflicts of interest, and to adopt related disclosure requirements. These rules generally must be prescribed by July 16, 2011, and the Commission anticipates proposing these rules soon.

Sections 953 and 955 direct the Commission to amend our rules to require three new disclosures concerning executive compensation:

First, the relationship between executive compensation actually paid and the financial performance of the company.

Second, total annual compensation of the CEO, the median total annual compensation of all other employees, and the ratio between these amounts.

And third, whether employees or directors are permitted to engage in certain hedging transactions against the downside risk of company equity securities.

Section 954 requires the Commission to adopt rules mandating changes to listing standards so that listed companies will have to adopt and disclose clawback policies for recovering compensation from current and former officers in certain circumstances.

The Act does not specify deadlines for rulemaking under Sections 953, 954, or 955, but the Commission's goal is to publish proposals by July 2011.

Finally, Section 956 requires the Commission and other Federal regulators to jointly prescribe regulations or guidelines applicable to covered financial institutions, including, from the SEC's perspective, registered broker-dealers and investment advisers with assets of a billion dollars or more.

The regulations or guidelines, which must be prescribed no later than April 21, 2011, will require disclosure to the appropriate Federal regulators of the structures of incentive-based compensation and prohibit incentive-based payment arrangements that the regulators determine encourage inappropriate risks.

We are working with our fellow regulators to develop these regulations or guidelines within this timeframe. The SEC's Web site has a series of e-mail boxes to which the public can send comments before the various Dodd-Frank implementation rules are proposed and the official comment begins.

So far, comments on the executive compensation provisions range from those expressing general concern about compensation practices, to others providing detailed suggestions for implementation of specific provisions of the Act.

The Commission is committed to ensuring that our disclosure rules provide investors the information they need to make informed voting and investment decisions and to implementing the provisions of the Dodd-Frank Act, addressing compensation issues as required by the Act.

Further, we are committed to working with our fellow regulators to prescribe regulations or guidelines for covered financial institutions to prohibit incentive-based payment arrangements that encourage inappropriate risk, as mandated by the Act.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

[The prepared statement of Ms. Cross can be found on page 60 of the appendix.]

The CHAIRMAN. And finally, Mr. Marc Steckel, who is the Associate Director of the Division of Insurance and Research at the FDIC.

STATEMENT OF MARC STECKEL, ASSOCIATE DIRECTOR, DIVISION OF INSURANCE AND RESEARCH, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. STECKEL. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee. I appreciate the opportunity to testify on behalf of the FDIC at this hearing on the oversight of executive compensation after passage of the Dodd-Frank Act.

The structure of employee incentive compensation programs can affect banks' risk profiles and long-term performance. Without question, compensation programs that rewarded short-term profitability without accounting for risk were one in a series of factors that contributed to the recent financial crisis.

As deposit insurer, the FDIC brings a unique perspective to the regulation of incentive compensation practices. When a bank's compensation programs encourage the poorly managed risk-taking that precedes many bank failures, the Deposit Insurance Fund pays for the consequences of that excess.

Prior to the passage of the Dodd-Frank Act, the FDIC began to increase its efforts to curb the risky compensation practices that helped precipitate the financial crisis. As early as November 2008, the FDIC and other Federal banking agencies issued a statement addressing the need to rein in risky compensation practices in an interagency statement on meeting the needs of creditworthy borrowers.

In January of this year, the FDIC issued an advance notice of proposed rulemaking to examine whether the FDIC's risk-based assessment system should be updated to consider the risks presented by poorly designed incentive compensation programs. The ANPR solicited public comment on whether the deposit insurance assessment system could be used to complement supervisory standards—to incentivize banks to use compensation programs that are even less risky than those allowed under safety and soundness guidance and regulations.

Using the deposit insurance pricing system in such a way would be consistent with existing features of the system, which, for example, provides a comparative advantage to banks that choose to operate with capital levels greater than those mandated by supervisory standards.

The FDIC has reviewed the comments received in response to the ANPR and continues to work with the proposal. While our work isn't done yet, I can share that the Federal Deposit Insurance Corporation does not seek to limit the amount of compensation that employees can earn. Our view is that addressing the structure of compensation programs would be a more effective approach.

Moreover, we do not believe that a one-size-fits-all approach is the best policy either. Our view is that employee incentive compensation programs that are balanced and aligned with the long-term interest of all the banks' stakeholders present lower risk to the Deposit Insurance Fund.

Based on the comments received from the public, academics, and others, and our own research, FDIC staff has identified certain features of incentive compensation programs that we believe can help protect the Deposit Insurance Fund.

First, boards of directors and senior managers of financial institutions must take primary responsibility for ensuring incentive compensation programs effectively align employees' motivations with the long-term interests of the institution.

Second, portions of employees' incentive compensation should be deferred and subject to meaningful lookback mechanisms that allow awards to be reduced or rescinded if the original justification or the award proves over time to be invalid. Employees who have a portion of their incentive compensation deferred have less incentive to engage in risky behavior and, furthermore, must be concerned with the long-term health of their employer to ensure that they will receive the award at a later date.

In early 2010, the FDIC joined the Federal Reserve to review compensation practices used by large banking companies. Later, in June of this year, the FDIC joined the other Federal banking agencies in issuing the interagency Guidance on Sound Incentive Compensation Policies.

Turning to the implementation of the compensation provisions of the Dodd-Frank Act, I would note that Section 956 is the provision that most involves the FDIC. This section will strengthen the authority of the FDIC and other regulators over incentive compensation practices at covered financial institutions.

The FDIC has begun discussions with other regulators on how to implement the requirements of Section 956. The FDIC will continue to work with our fellow regulators and continue to seek ways to bring our unique perspective and capacity as deposit insurer to bear on this important issue.

I appreciate the opportunity to testify and will be happy to answer any of your questions.

[The prepared statement of Mr. Steckel can be found on page 70 of the appendix.]

The CHAIRMAN. I thank all of you.

First of all, let me ask—we did try to work with you— the provisions of the bill that you all work with, my impression is that those are generally consistent with the direction you were going in on your own.

Are there any things in the bill that could be a problem for you and that need to be fixed? We don't think so, but my sense is that we were basically empowering you and encouraging you to do what you wanted to do anyway.

Mr. Alvarez?

Mr. ALVAREZ. I agree with you, Mr. Chairman. We think this has been very helpful. If there is anything that comes up as we get further into this process, we will certainly come talk with you.

The CHAIRMAN. Anybody else?

Ms. CROSS. We agree.

The CHAIRMAN. The question, then, is what we are told of course, is nice try, but all those smart business people will outwit all those bureaucrats and they will come up with some new ways. I think we anticipated that by giving you general authority not to circumscribe.

But let me ask you, do you believe—first of all, you have obviously begun talking to and have been talking to some of the people you variously supervise. What is your sense of their approach? My own view is that, frankly, if this is done uniformly, a number of companies would welcome it; that is, we have control for the competitive advantage, that if everybody is under a set of fair rules, they appreciate that because you don't have a kind of a competitive effect and the reaction you are getting from the various institutions under your jurisdiction.

Mr. Steckel, let's start with you.

Mr. STECKEL. Thank you. We got comments on the Advance Notice of Proposed Rulemaking that we issued earlier this year. We got over 15,000 responses and most of them—in fact predominantly, they were in favor of us pursuing some approach. The minority of the comments we got were not supportive, and a lot of those were sort of on technical matters, and there were a few that were just philosophically opposed to the government having any role in compensation.

The CHAIRMAN. Of course the FDIC had moved—the Federal Reserve, before we acted, but I take it the statute is in general consult with the direction were you moving in.

Mr. STECKEL. That is right. I think the statute is supportive of the approach that we were pursuing.

The CHAIRMAN. Let me ask you the final question I have, which is the argument, yes, but all those smart people in the financial institutions will outsmart all you stodgy bureaucrats and all of us benighted politicians and find ways around all this.

A two-part question. Is there any indication that they are trying to do that? And if there is, do we need to give you more authority in case they do? Let's start with Mr. Alvarez.

Mr. ALVAREZ. I think one of the things that is helpful here is that the banking institutions at least understand the problem as well and accept the problem as well. So we don't sense the motivation to get around what we are trying to do. We find the institutions are really embracing the opportunity to limit risk in incentive compensation.

I think your first two points, though, were very key to this; we are not trying to limit the level of compensation. We are not putting caps on salaries, so there is less incentive to try to get around that. We are trying to align incentives and aligning incentives is what the industry wants to do as well. And also by having this broadly based across all banking and financial firms, we remove the disincentive. I think firms were very worried that if they were the first one to move, the first one to limit this compensation, they would lose the best people, and we are taking that away.

The CHAIRMAN. I think that was one of the things we had in mind, which is as you were doing this through your various agencies, unless you could have all done it in total lockstep, which is hard to do, there would have been a complaint about institutional advantage versus another.

Ms. Cross?

Ms. CROSS. I would first note this will be a new role for the SEC as it relates to the broker-dealer and investment adviser compensation oversight. So my fellow regulators have a head start, but we are learning from them and working with them to get there. I think there are a few points worth noting that should make this successful. I think first off is that it is a principle-based approach as opposed to caps and so it is hard to find—avoid a principle, the principle being that you are not supposed to structure your compensation to create inappropriate risks.

Another aspect that I think makes this successful is that the compensation committee is responsible for oversight of compensation, at least as to higher paid executives, and they are subject to fiduciary duties and they will be accountable; and there will be the say-on-pay vote so there are enough different pieces of this to make it have a lot of sunshine and a lot of shareholder input.

And then lastly we have—the SEC adopted disclosure requirements last year that would require disclosure if you have risks that expose you—have compensation programs that expose you to inappropriate risks. So I think that combination of factors suits us well and it should be successful.

The CHAIRMAN. Thank you. Mr. Steckel, do you have anything you want to add?

Mr. STECKEL. Yes, I do. There are two points, I think. The FDIC has pursued a lot of thinking around the idea of deferral. Large bonuses can be awarded and in many cases are earned and deserved. We don't have an argument about that, but in some cases they have been paid out but later the risks that were assumed blow up and cause problems for an awful lot of people and sometimes the public interest. We think meaningful lookback mechanisms are an important part of this.

Also we have explored the topic of aligning employees' interests, incenting employees to consider all of the banks' stakeholders. We think current practice currently aligns employees' interest with those of shareholders pretty well, probably to the detriment of some other stakeholders.

The CHAIRMAN. Thank you.

Not as a question, but as to procedure, we are going to be going to the second panel, which includes Mr. Baily who is, again, a representative of the Squam Lake Group. So I would hope that either you or some of your staff could stay behind. We thought that was a very thoughtful, bipartisan cross-Administration approach, and we hope you would able to listen to what they say and work with them as well.

Mr. Bachus?

Mr. BACHUS. Thank you, Chairman Frank. In my opening statement I mentioned entertainers and athletes. But the distinction that I would argue and I think is correct is athletes and entertainers don't lose billions of dollars of the assets of their corporations, and therefore there is no negative impact on the shareholders and on the broader economy. And certainly in the run-up to the Wall Street crash, we had numerous instances of traders or employees who took what I would call bad-tail risk, what you all—if that is the proper word for it—which actually resulted in insolvency for those institutions, to the shareholders, and taxpayers and the general economy suffered. So there are obviously—I think to address this and financial reform was the proper thing, and I want to make that clear.

Incentive compensation packages, I think all Republicans would agree with our members in the majority, a need to be consistent with safety and soundness practices, particularly if you have a Federal backstop or Federal safety net.

As we found with systemic risk, our large corporations I think it is essential, because of the interconnectivity of the economy, as we have all learned.

I do think with bad-tail risk, that is something I would assume you are all going to focus on, because we found out that really one employee, or one or two employees can bring down the largest insurance company in America. I think bad-tail risk, you have defined it, or the regulators or the industry, as a low probability of occurring, but if it does occur, a very high risk of threatening the insolvency of the institution. So I would say that is something that you really need to focus on.

I don't know with smaller companies where there is not a Federal backstop, not a systemic risk if the role is not a little bit different. But let me say this; your testimony was very thoughtful, every one of you.

Let me conclude with a question. I usually ask questions. That was a statement. But I do want to make it clear to Chairman Frank and to the public that there is widespread consensus not only among the public, but I think within the financial industry and within the Federal regulators and all of us, that compensation practices can threaten the safety and soundness of institutions and that there has to be some governance and oversight of that.

My question is, Nell Minow testified last year and she said, "I have a low confidence in politicians and bureaucrats." So she actually addressed us in the least favorable terms, but I will change that to Members of Congress and government officials, that she has very little confidence in them being able to review incentive compensation plans at financial institutions not to micromanage. She's afraid, and I think that is a fear we all have, that there will be too much micromanagement. How will your agency embark on this joint rulemaking and supervision without micromanaging compensation?

I will just ask, do you see that as a problem or could it be a problem?

Mr. ALVAREZ. So the approach that we have taken is, first, we are not trying to set the level of salary of individual employees, we agree we are not good at that; that is up to the corporation to deal with itself. So we have been focusing on structure and process. We are making sure the board of directors is involved in the decisionmaking. We are making sure that the management can explain why it awards bonuses in one situation and not in other situations.

We think that in order to deal with things like tail risk, the corporation should take into account deferral practices and clawback practices and a variety of other practices that are being developed by the industry, by academics, by HR professionals, risk management professionals, and bringing that to bear so the risks that come about from incentive compensation are not unintended and don't encourage greater risk to the organization.

So we are not about micromanaging the actual pay for individuals. We are about making sure the incentive structure and process leads to a good result.

Mr. BACHUS. And if I could get the other two to answer?

Ms. CROSS. Although we are at the beginning of this, from the SEC's perspective, we have the same approach in mind. And I don't think we have any interest in micromanaging the pay. We want to make sure we do what Congress directed us to do, which is to work with our fellow regulators to come up with standards that should decrease the risk of incentives that are dangerous.

Mr. BACHUS. Okay, thank you.

Mr. STECKEL. The FDIC has taken a fairly slow approach to this, because as you study this and you try to do good policy, it does become apparent that it is difficult and we want to avoid unintended consequences. I agree with the others in that we do not want to micromanage. We will not be setting pay levels. But I think conceptually we do have an interest in the structure of compensation and that large discretionary awards in many cases should at least in part be deferred to see if the tail risk does come up and cause a problem later.

We have spent a lot of time talking to industry professionals over the past year to help us form our views, and we are familiar with the work of the Squam Lake Group which has influenced our thinking somewhat.

Mr. BACHUS. Thank you very much. I appreciate it. I think your written testimony is going to be very helpful to us and I think, too, to the industry and to the public.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. I think I will pass. I was hoping to try to get to hear the second panel's testimony before I left, so I am going to try to expedite that. This testimony is very clear. So, Mr. Chairman, I am passing.

The CHAIRMAN. The gentleman from Florida, I guess, was here first by Republican rules.

Mr. POSEY. Thank you, Mr. Chairman.

The CHAIRMAN. We will get to you.

Mr. POSEY. I kind of want to echo the comments made by the gentleman from Alabama. Your intent and your advice is thoughtful and well-intended and I hope will be very effective. But if we tend ever to use a cannon to kill a sparrow, it causes a little bit more collateral damage than we intend sometimes. And I just want to express that I think the more complex you make the regulations, as the chairman said, the more wiggle room you are going to have and the more plans to circumvent it or take away the intent of what you are doing.

I think probably the absolute best accountability that we can have is the absolute best possible transparency, and I am not sure how all the compensation was arrived at. I am sure much of it was made in contractual deals downstream that said, if you do this you are going to get this. And so it may not have been decisions made after the fact at all, and may not in the future be made after the fact. It may be a predetermined set of guidelines that you may or may not have any control over.

I think with the transparency goes responsibility to have strict enforcement and prompt prosecution for violations. As we know, at the SEC we don't have a long history of that. And the FDIC activities that I have seen most recently in my district with the bank regulators gives me less confidence than ever in that agency. I think they are—just as I mentioned in some discussion yesterday—going off in a wrong direction out of fear or self-protection or whatever.

But I would appreciate during whatever time is left if you could explain briefly the difference between a typical—and I don't mean everyone would fit in that category—but a typical executive compensation and the relationship between the compensation committee and the chairman, or whoever they are compensating, and the difference between that relationship in the future as you foresee it under your guidelines.

Thank you, Mr. Chairman.

The CHAIRMAN. Was there a need for comment?

Mr. POSEY. I would like a comment briefly from each of them, if you don't mind.

The CHAIRMAN. I am sorry, go ahead.

Mr. STECKEL. The FDIC, as a policy goal, I think our focus is on material risk-takers. We are not interested in targeting many, many bank employees who may get small referral bonuses or small end-of-year performance bonuses that in no way could influence them to affect the overall health of an institution. But some higher paid employees can take those sorts of risks and can get paid an awful lot of money for that. I think we would tend to focus on those employees. There is really not a problem to fix with lower paid employees, I don't think.

Ms. CROSS. I will mention a couple points. Under the Act, there will now be a requirement for listed companies that the compensation committee be comprised solely of independent directors, and there will be enhanced disclosures about compensation committee independence. So I think that might get at part of your concern.

On the who will do this work and what is their relationship to the people that they are overseeing, boards of directors in general are responsible for risk oversight at companies. Sometimes they delegate that to a committee like a risk committee.

At companies these days, what has been happening is the compensation committee stays responsible for the executive compensation and so including, for example, the CEO pay, and there would be the requirement for independence in the future. And then the risk oversight would be from the board overall and that would be for the broader employee programs.

So I think there will be several different checks and balances within the board, and particularly strengthened by what you did in the Act.

Mr. ALVAREZ. I agree with the previous two about the involvement of the board of directors, and independent compensation committee in particular, in reviewing the CEO salary as you raised.

The point I would add is that for the most senior executives, I think we place particular emphasis on deferral of incentive compensation awards with adjustment of those awards as the risks mature and show up in an organization, so that CEOs in particular have their incentive compensation adjusted for the health of the company and the risks that show up in the company in the future. Not all risks show up immediately, so they need some time for those to mature and we would like those to be reflected in the incentive compensation award.

Mr. POSEY. Can I ask a follow-up question, Mr. Chairman? Thank you.

But suppose that I am the person in charge of hiring a CEO for my big bank, and I go to you and I say, look, I am going to pay you the average salary, $800,000 a year, and I am going to pay you a bonus based on, hypothetically, let's say 1 percent of the net profits. And he performs. I got what I wanted, he gets what he wanted; it will be $4 trillion under those circumstances. But he wrecked us in the meantime. What are you going to do?

Mr. ALVAREZ. The expectation is that the incentive compensation award would have a way of reducing—deferring that payment. So that 1 percent that you spoke of, the bonus wouldn't be paid immediately; it would be deferred over some period of time to allow the company to realize whether it has been wrecked. And if losses do indeed show up, then that award would be reduced. And what that does is, that removes the incentive for the CEO to take big risks immediately because they know those will show up in a reduction in their incentive compensation at a future time.

Mr. POSEY. I think that would be—one more question, since we don't have very many people.

The CHAIRMAN. We are already 2 minutes over.

Mr. POSEY. Okay.

The CHAIRMAN. The gentleman from Texas, thanks to the generosity of the gentleman from Kansas.

Mr. GREEN. Thank you, Mr. Chairman. Again, I thank you and the witness as well. I would like to just briefly explain why in my opinion it is very important to talk about the amount of the compensation. If we don't talk about the amount—and I am not begging the witnesses to do so—but it is important for us to do so. If we don't talk about the amount of the compensation, we don't really get an understanding as to why people would assume the types of risks that they assume, why they have this incentive to do these things.

And systemic risk is not created by persons who make minimum wage, not created by persons who are making $50,000, $60,000, or $70,000 a year, generally speaking. This systemic risk is created by persons who make hundreds of dollars per second. I mentioned the CEO who made $534 per second, which in about 28 seconds allows him to make what a minimum worker makes all year. This is the kind of compensation what we are talking about.

And I applaud the bill, I applaud Chairman Frank, and Chairman Dodd. I applaud you for indicating that we are not going to micromanage the pay of individuals; that is not what it is about. It is about making sure that the pay doesn't produce systemic risk, that is what it is about. But people in the American public have to understand what the pay is, so that they can see why people assume this type of risk and why they will do these kinds of things. It is huge. The amounts of money are escalating, they are not deescalating. The amount of executive compensation has been consistently going up, while creating this gap between low-income workers and maximum-income earners. We are doing the right thing by putting into place regulations that will curtail the taking of systemic risk, which, in my opinion, helped to create the crisis that we had to contend with.

And finally I will say this, as I am about to make my exit. I have spoken longer than I actually intended to, but I do want to say something about the athletes, if I may, and whether they bring down a team. If they don't perform, the tickets don't sell. If the tickets don't sell, the stockholders do lose money. But that is besides the point.

The point that I really would make in terms of making a distinction between the athletes and some of these persons who make $500 a second is that the athletes pay ordinary income taxes, the hedge fund manager pays capital gains tax, 15 percent ordinary income; it could be 36 to 40 percent depending on how you count it.

But it is not about athletes, it is about systemic risk, and it is about the inordinate amounts of moneys that I salute people for making because they have a talent to make, but that in some way can create liability for others when systemic risk is produced.

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

The CHAIRMAN. The gentleman from New Jersey.

Mr. LANCE. Thank you, Mr. Chairman.

Good morning to you all. I think this is a very important discussion. The bill states regarding incentive-based compensation that the regulation community will decide what is inappropriate.

Could each of you briefly give me your thoughts as to where you might be headed, as to what you might consider to be inappropriate. And I know it is a very broad question, but your initial thoughts as to that.

Mr. STECKEL. I think one thing that comes to mind is an exorbitantly large guaranteed bonus that gets paid regardless of the performance of the institution.

Mr. LANCE. And would you likely place an amount as to what is exorbitantly large?

Mr. STECKEL. No, I don't think we are prepared to do that, and I am reluctant to.

Mr. LANCE. So "inappropriate" would be translated as exorbitantly large.

Mr. STECKEL. I think we need to have some policy discussion.

Mr. LANCE. Yes. Ms. Cross?

Ms. CROSS. I would describe it in a more principle-based fashion as pay where the risks to the institution outweigh the rewards to the institution. So you would need to consider, looking at the type of pay structure, whether it has that impact. And if it does, it is inappropriate. You shouldn't be paying people more to expose the company to more risk than the company would be rewarded if it worked out well.

Mr. LANCE. Thank you. Mr. Alvarez?

Mr. ALVAREZ. I agree with Ms. Cross. It is very nuanced, there is no number, there is no automatic piece. It is about the risk that is incented by the compensation and whether that is something the company can handle.

Mr. LANCE. Thank you. I am sure we will be reviewing it with you as the process continues. Shareholders, of course, will have the right on say-on-pay. I think the bill may be somewhat ambiguous as to whether it should be an advisory or binding vote.

Does the panel have a position on that? I think that is particularly directed at Ms. Cross.

Ms. CROSS. I am happy to address that. I think the bill is actually clear that it is nonbinding as it relates to both say-on-pay and say-on-frequency.

Mr. LANCE. Yes.

Ms. CROSS. There is some ambiguity as to whether the frequency vote is nonbinding, but our view is, reading the entire provision, that the part at the end that says it is a nonbinding vote applies to the whole Section, so—

The CHAIRMAN. If the gentleman would yield, that is certainly our intent, and if ever they felt we needed to clarify it, we would I am sure be able to do that quickly. But the intent was and, I think, in fact it is nonbinding.

Mr. LANCE. Thank you. That is clarifying. And I am pleased that the SEC is of that opinion, and I certainly defer to the Chair. Thank you, Mr. Chairman. I yield back the balance of my time.

The CHAIRMAN. Let me say, by the way, if I can have a minute of unanimous consent. One reason that has to be nonbinding is that if it was binding, you couldn't pay them anything. It is just a practical thing. And the English experience which we have looked to is that nonbinding is pretty influential.

The gentleman from Kansas. And I appreciate his deferring to our colleague from Texas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. One of the major concerns that continues to be raised by my friends across the aisle and the business community is a lack of certainty when it comes to the new rules businesses face. But given the near collapse of our financial system, I don't know how anyone can responsibly argue that a complete overhaul of our financial rules, as we did with the Dodd-Frank Act, was not warranted. And while businesses want certainty, they also want well-thought-out rules that are not hastily written, creating unintended consequences.

Given this strain between speed and quality rulemaking, what steps are your agencies taking to implement the new rules quickly, while also performing due diligence to improve executive compensation rulemaking?

Mr. ALVAREZ. The banking agencies have already issued guidance. We sought public comment from the industry and from consumer advocates and others about the policies. And we have already begun, actually, our horizontal review or examination of the practices at large organizations, which involves a dialogue with them about how best to improve their systems, the philosophy they bring to incentive compensation, and then the principles that we are trying to get them to adopt.

Mr. MOORE OF KANSAS. Thank you. Ms. Cross?

Ms. CROSS. With regard to the SEC's rulemaking initiatives, both for the executive compensation matters and all the other matters under Dodd-Frank where we have rulemaking, we set up public e-mail boxes where people can send in their comments even before we start with public rulemaking, so that we are able to take those into account as we get the rules ready for the public; and then, as always, will benefit from the public comment that comes in.

We are also meeting with many interest groups and posting the agendas from those meetings on the Web site so the people can see the topics that are under consideration. We agree it is very important that we have all the due diligence we can have so that these rules work well.

Mr. MOORE OF KANSAS. Thank you. Any comments, Mr. Steckel?

Mr. STECKEL. Yes. Chairman Bair has made this issue a priority, before and after passage of Dodd-Frank. We think Dodd-Frank helps us to our end and we are going to continue to pursue this vigorously.

Mr. MOORE OF KANSAS. Thank you. And I have one more question. We have all focused on what went wrong in the financial crisis and I think it is very appropriate, but I think it is equally as important to learn from the responsible actors and build on their successes.

So last month the oversight committee I chair held a field hearing in Kansas to learn from responsible Midwest banks and credit unions who were not the cause of the financial crisis.

And my question is, with respect to the new executive compensation rules that your agencies are drafting and implementing, what will it mean for community banks and credit unions? And in the rulemaking, are you avoiding one-size-fits-all approaches that may unfairly discriminate against smaller firms?

Mr. ALVAREZ. Sir, we have been quite clear in our guidance that we expect the types of adjustments on incentive compensation to vary based on the complexity, size, and use of incentive compensation by firms. So smaller banking organizations tend to not use incentive compensation very much, and they also have short, flatter organizations, much easier to police, and understand the risks that are associated with incentive compensation. So we haven't seen a problem coming up with smaller organizations. So our guidance makes allowance for that.

Mr. MOORE OF KANSAS. Thank you.

Ms. Cross?

Ms. CROSS. I will cover your question as it relates to the other executive compensation rulemakings since the banks are really for my fellow regulators.

There are numerous provisions in the Dodd-Frank Act that tell us to consider the impact on small business as we implement the rules, and we will carefully, carefully do so and request comment so that we can calibrate the rules appropriately, so that we don't unduly burden small business.

Mr. MOORE OF KANSAS. Thank you.

Mr. Steckel?

Mr. STECKEL. Yes. I think you are right. There are an awful lot of small banks that use limited, if any, amounts of incentive compensation as part of their business model, and we will specifically not target them. I don't think they are the problem that we are trying to address here.

Mr. MOORE OF KANSAS. Thank you very much to the witnesses.

Mr. Chairman, my time is nearly up. I yield back.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MCHENRY. Thank you, Mr. Chairman.

I certainly appreciate your testimony. I wasn't here for your verbal testimony, but I have read your testimony.

How do you plan to deal with multinationals? Section 953 has been cited by some as a logistical nightmare. How do you intend to deal with an individual's compensation to the overall firm's earnings and income that is not simply a domestic bank but a multinational?

Ms. CROSS. I think that one is for me. We are just beginning the rulemaking process, and we expect to propose the rules under 953 next summer. It doesn't have the same deadline, so we will have the opportunity as we prepare the rules to get input from everyone about how we should address those concerns.

We have heard that there are worries about the logistics of figuring out the pay in a multinational firm. So we are looking through those provisions now, working with all the interested parties, and we will put together a rule proposal we think can best implement it in a way that is workable.

Mr. MCHENRY. Okay. So, generally speaking, you are going to do what you normally do, which is you are going to input and make a rule; that is basically what you are telling me?

Ms. CROSS. The Act directs us to adopt a rule to implement that provision. So we are doing what we are tasked to do under the Act.

If we run into problems, we will let you know, and we will come back if it is something that isn't workable, but we would first like to try to see if the rule can be implemented in a way that results in implementing what we have been tasked to do in a way that is workable.

Mr. MCHENRY. Okay. Yes.

Mr. ALVAREZ. One thing I would add, in the banking area, there is an awareness worldwide that incentive compensation practices need to change, and we have been working with some of our foreign counterparts, especially through the Financial Stability Board, to develop standards that are being used on an international basis. Our guidance is very much in tune with the international direction of the FSB. So we are actually heartened that the other parts of the world are seeing the importance of all of us moving down this road together.

Mr. MCHENRY. How important do you think that is with basically foreign standards that are similar to ours?

Mr. ALVAREZ. I think it is very important because of the incentives that are created. We don't want to lose our best talent to foreign competitors or have businesses move offshore in order to avoid incentive compensation rules. So it is important that this be an international work.

Mr. MCHENRY. Certainly.

Now, Ms. Cross, you mentioned to my colleague from New Jersey that weighing the balance of pay, an individual's pay, whether that—the potential gain outweighs the systemic risk, that is basically what you are—similar to what you said; isn't that right?

Ms. CROSS. That is right.

Mr. MCHENRY. Isn't that in many respects in the eye of the beholder?

Ms. CROSS. Again, I think that I would like to emphasize that we don't envision micromanaging the pay of any particular individual. It is much more of a structural question. So, as you develop guidelines or regulations that set forth standards for how the pay is to be structured, limitations really on the structure of pay that would present those risks, as in the guidance that has already been issued, you would look in terms of, what risk does it pose for the company, and are they appropriately calibrated? Yes, it is in the eye of the beholder, but the compensation experts have significant input and have, I think, reflected in the guidance that you can calibrate it to appropriately reflect risk.

Mr. MCHENRY. So, therefore, a trader and a CEO can have different rules?

Ms. CROSS. I think that is right. I think there would be different structures that would be appropriate for a trader versus a CEO.

Mr. MCHENRY. Okay. But even in the case of some similar failed institutions that the Federal Government has a significant ownership interest in currently, in different sections, different divisions of the company, you have people compensated in very similar ways. One lost billions of dollars for the institution; the other made hundreds of billions of dollars for the institution. So even with basically the same incentive packages, you are going to have widely variant outcomes and widely different systemic risk based on the nature of their business; is that fair to say?

Ms. CROSS. I think that has historically been the case. And I don't want to speak for the folks who have already done this, but the horizontal review they have been going through to find out what are the compensation practices throughout these organizations should help us as regulators develop guidelines that would be appropriate so that is more appropriately calibrated throughout the organizations.

The CHAIRMAN. If the gentleman would yield, I would acknowledge when I called this hearing I was thinking frankly about the provisions that we initiated, which was the say-on-pay and executive piece. The Senate added that other piece, and I share some of the questions about that. I think it was imprecisely worded. It is not clear.

It seems to me if you look at the wording literally, an inappropriately large number of people are involved in the comparison, and obviously if that can be worked out, okay. But we are very much open to try to fix that legislatively because that was the Senate piece, and you are right. It is appropriately on the table.

Mr. MCHENRY. And let's understand that truly the debate is not between Democrats and Republicans. The true enemy is the Senate.

The CHAIRMAN. In this case, there is the House-Senate difference.

Mr. BACHUS. Could you further yield? And I appreciated those questions. I thought they were insightful.

One of the things that I know in the written testimony that you address, similar to that last question, is that compensation doesn't vest immediately, and therefore, although a trade may have a short-term positive, it may be a long-term disaster. And we talked about the bad-tail risk, and even if you have one trader who makes a half billion dollars, you have another trader who gets wiped out for $2 billion—which we have seen, a very large amount. So the fact that one could make and one could lose, if the one that loses bankrupts a corporation, that is a serious risk.

But the other thing is, that often you can maximize short-term profits at the sacrifice of long-term profits.

The CHAIRMAN. If the gentleman would yield. I think we all agree that is why we haven't tried to be too rigid but have given discretion to the regulators, precisely on that compensation.

The gentleman from Minnesota.

Mr. ELLISON. Thank you, Mr. Chairman, and thanks for pulling this hearing together. I only have a few questions.

My first question is, in light of the passage of the Frank-Dodd bill, the provisions on compensation, have you seen adjustments within the industry? Have you witnessed any sort of a self-correcting conduct that would sort of align compensation with proper incentives for the company?

Mr. ALVAREZ. We have been doing a horizontal review where we are actually looking at the practices, and we are finding that institutions are taking steps on their own. They have identified some of the very same problems that we had identified in the guidance. They want very much to remove incentives to folks to increase risk behind the backs, as it were, of the control systems these organizations have put together. So we are finding good cooperation. There are still a lot of uncertainties. There is still a lot of work that needs to be done.

One of the things, for example, that is difficult is getting good metrics for risk. Some areas are easier to identify risks than others. You may be able to identify, for example, mortgage loans and the loss rates on mortgages, but it is not always easy to identify if a certain strategic move is going to work out. So it takes some time for those things to develop.

So we continue to work with organizations to find good metrics and to use judgment that is well informed when there are not good metrics, but as a general matter, we think the institutions are willing and interested in making change.

Ms. CROSS. I would note that the concept of finding out whether pay creates inappropriate risk is a relatively new idea that people are just learning about, and so, for example, particularly at the nonbanks, the sort of rank-and-file public companies, they are in the process now of doing inventories of their incentive programs and figuring out, do these create inappropriate risks for the companies? And it has been a very good exercise I think for boards to hear what kind of programs there are and what kind of risks they may pose, and then the companies over time can revise those programs. So I think this is not just at the financial institutions. I think it is throughout our capital markets, which is a very healthy thing.

Mr. STECKEL. I would add that we see banks paying a lot more attention to this recently than say a few years ago. Both the passage of Dodd-Frank and also a lot of bad press that was out there about these companies pushed them in that direction. We also think that the rulemaking that is required under Dodd-Frank is also necessary to make sure we don't, over time, backslide to some of the bad practices that occurred years ago.

Mr. ELLISON. Can you all report on what you are seeing about these rules and the legislation and the application of the rules that are being promulgated on people who work below the top executive level? So many decisions are not made at the top executive level, and I think it is important we pay attention to those incentives as well.

Just a very quick story. I met with a group of people who worked in a bank, and they were told they couldn't hand back over overdraft fees that they were urged to push people to open up new accounts, and these are people on the bank level working with customers. Their incentives were to have people open up more accounts so they would generate more fees, have, you know—not push back overdraft stuff, and there is just a lot of pressure on these line employees. I don't think this will work—do you see that this bill could affect the way they are compensated? Do you see it traveling down that far?

Mr. ALVAREZ. Our guidance specifically provides that it must. We don't deal just with senior executives. We deal with any employee or group of employees who can increase materially the risk to the organization.

And what we had in mind, another example, are mortgage originators. Mortgage originators may not make very much money themselves individually. On the other hand, it is important that a firm understand the incentives it creates when it gives bonuses to those folks. Is it encouraging them to just increase volume without regard to risk or increase the volume without regard to compliance with the law? There are lots of things incentive compensation practices in the mid-2000's did that I think we all regret now.

So one of the things we have been trying to do—and this is an area where I think there needs to be a little more work by banking organizations—is to identify those groups who are lower paid employees but who do receive incentive compensation and do, as a group, add risk to the organization.

Mr. ELLISON. Are you in a position to hear from some of those employees? Because I can tell you that some of them are a little nervous about talking to me. I had to promise not to identify their company. They told me about a lot of pressure tactics they were under. Is this something you have been able to do is to hear directly from them?

Mr. ALVAREZ. We do hear directly from some employees through a variety of ways. We also are getting the actual incentive compensation policies that apply to them so we have a chance to look at the actual document.

The CHAIRMAN. If the gentleman will yield, that is a very important point. We will work with our colleague to make sure that we have channels whereby that kind of information can be sent along in a way that would protect the individuals. We will work with you. The time has expired. I thank the panel. This has been useful. We have a work in progress here.

I will say there are some of these things initiated in the House, some in the Senate. My own view, as was indicated by the questions from my colleague from North Carolina, is that the House pieces were somewhat better organized than the Senate piece and that more work will have to be done on that, and we will be working with you on it. We don't rule out the possibility that it will have to be further amended.

I thank the panel.

I now call up Martin Baily and Darla Stuckey. Thank you.

And we will begin with the testimony from Martin Baily, who is a senior fellow at the Brookings Institution, and was part of the Squam Lake bipartisan group of economists who had significant government service who met to discuss this, and Mr. Baily is a former chairman of the Council of Economic Advisers.

Would someone please close the door, as you will never know who will wander in here?

Mr. Baily?

STATEMENT OF MARTIN NEIL BAILY, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. BAILY. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. It is a great privilege to be here.

In a sense, I guess, I am representing the Squam Lake group. I do want to mention that I think they see themselves primarily as a group of finance academics. There are a few of us who have served in government. I was in the Clinton Administration, as you mentioned. Fred Mishkin was at the Federal Reserve. Matt Slaughter was in the Bush Administration. But most of the group are actually finance academics, and they got together in an attempt to see if there is anything from finance theory and practice that could contribute to financial sector reform.

It is also, as you said, a range of views. Sometimes, we have had to be sort of dragged together to form a consensus, and I do want to say one or two of the things that I will say today may not represent the views of the whole group.

Let me get started then. I think the Dodd-Frank Act made substantial steps forward towards improving regulations but, obviously, left a fair amount to be done by the regulators. So I think it is very appropriate. I applaud you for holding meetings such as this.

Some of this, as was mentioned earlier, has to be done at the international level, and historically, the international level hasn't been a great forum. The Basel process has not been either timely or effective. There is some sense, I think, that the financial crisis lit a fire under them, and they are doing a better job now, but that is something certainly we have to monitor.

Now, the two recommendations from the Squam Lake group that relate to compensation are, first, to discourage any regulation of the level of the compensation, and we have had already quite a bit of discussion of that, and that is in line with the Dodd-Frank Act. So I don't know I need to say a lot about it.

I think if I were to make one comment it is that we do indeed have a very wide and widening income distribution in our economy, but it is a much more fundamental problem than just the financial sector. It has to do with, are we providing the right skills to people; do we have the right tax system, and so on. So I don't think that was a matter for financial regulation. I agree with you, the decision you have made about the level.

Our recommendation is that the regulators should look at the structure of compensation to make sure that it is aligned with the interests, not only of shareholders in the institution but also of taxpayers who may get called upon to bail out this institution, and I know we have put in place various steps so that we should not have to bail out financial institutions, but we don't know what is going to happen in the future, and I think it is an important tool in the arsenal to make sure that we have the right compensation structure to reduce that possibility.

We want to make sure that when executives are making decisions about the risks they are taking in their own institutions, they are not sort of in the back of their minds thinking, if things go wrong, I can get supported by the taxpayer, either in the form of the FDIC or somewhat in the way that happened, unfortunately, in the crisis.

A major goal of capital market reform should be to force financial firms to bear the full cost of their own actions, and as I said, we propose several mechanisms and there are such in the Dodd-Frank Act to do that, but compensation is a useful tool.

Systemically important financial institutions should withhold a significant share of each senior manager's total annual compensation for several years. The withheld compensation should not take the form of stock or stock options. Rather, each holdback should be for a fixed dollar amount, and employees would forfeit their holdbacks if the government goes bankrupt—excuse me, if the firm goes bankrupt or receives extraordinary government assistance. So we want to make a very direct link between taxpayer interest and incentive on the senior managers of the company. We want to hold them accountable for the possible failure of their company.

Now, I talk in my written testimony a little bit about what is currently in the Dodd-Frank Act versus our proposal. I talk a little bit about what regulators are doing. We have heard about that already here. I talk a little bit about what has been proposed in the U.K. financial services authority because, as was noted earlier, it is a good idea to have harmonization, and obviously, London is the other main financial center. This should be more broad than London, but that is obviously the biggest alternative to New York as a financial sector.

So let me just draw my conclusions. I am running out of time already. Here I will express my one concern about whether the Squam Lake—

The CHAIRMAN. We understand. Take another couple of minutes. We have only a few people. So take another couple of minutes.

Mr. BAILY. You shouldn't encourage me to blab on, but I will finish quickly.

My only concern with the Squam Lake recommendation is whether or not it goes quite far enough, deep enough down the organization. If you have a large organization and an international organization and you are a trader and you see the benefits to you in terms of your bonus of taking on certain kinds of risks, I think the notion of worrying about taxpayers or if the firm might actually go broke and have to be put in receivership with the FDIC or something, that may seem a little bit too remote.

So the way in which I myself would go a bit further—and it is along the lines of the testimony that was given earlier—is that each company should work with its regulator, the Federal Reserve or the FDIC or the SEC, to describe what their compensation structure is, how it lines up with their own internal risk management structure, and that they are, in fact, providing the right holdbacks for traders and for other folks within the company to make sure that we don't go to the edge of the precipice; in other words, that we build in incentives for traders that might take big, risky bets but that wouldn't necessarily drive the company into bankruptcy but would pose additional risks on the system.

But I do stress that not everyone at Squam Lake agrees with that. There was a good bit of concern among members of the Squam Lake group that we don't want to overregulate this. And I agree with that. We want to maintain incentives for performance, for innovation, all the things which help this be a dynamic sector.

I will stop there. Thank you, Mr. Chairman.

[The prepared statement of Mr. Baily can be found on page 49 of the appendix.]

The CHAIRMAN. Thank you.

Next is Darla Stuckey, who is the senior vice president for policy & advocacy for the Society of Corporate Secretaries and Governance Professionals.

Ms. Stuckey.

STATEMENT OF DARLA C. STUCKEY, SENIOR VICE PRESIDENT, POLICY & ADVOCACY, SOCIETY OF CORPORATE SECRETARIES AND GOVERNANCE PROFESSIONALS

Ms. STUCKEY. Thank you, Chairman Frank, and Ranking Member Bachus.

I am here today on behalf of the Society of Corporate Secretaries & Governance Professionals. Our members include corporate secretaries, securities lawyers, compliance officers, and even some executive compensation plan administrators. They work in companies of every size and every State and in every industry. I would love to talk more about us, but if you would like to know more, please go to governanceprofessionals.org.

You have asked for our views on the effects of the implementation of the compensation-related provisions of Dodd-Frank, particularly as they affect risk taking and particularly in the financial services area. Without taking a position on the impact of the Act specific to financial services companies only, since all companies are covered by Dodd-Frank, we do believe that the governance changes under Dodd-Frank, along with the SEC rules implemented since the crisis of 2008, generally will help companies manage and oversee risk and further corporate accountability.

Our members who are financial services companies simply request that the SEC, the Fed, and the FSA coordinate their compensation rulemaking and do so soon.

You also asked for our views on what the Federal regulators should consider, so I now turn to three of the executive comp provisions, and I apologize if you have spoken about these in the first panel at length, but I will talk about say-on-pay, a little bit on pay ratio, and clawbacks, as well as I would like to talk—

The CHAIRMAN. No apology. We want your opinion. The fact that the other people talked about it makes your opinion even more important. So, please, go ahead.

Ms. STUCKEY. Okay. Thank you. I also would like your indulgence to talk a minute or two about the whistleblower provision in Dodd-Frank, which is not specifically executive comp related, but is very important.

First, say-on-pay and say-when-on-pay. You know what say-on-pay is, the shareholder vote on executive comp. It is effective for meetings after January 21, 2011. Our only concern with this is that the SEC's schedule as submitted may be too late. We urge the SEC to propose these rules soon in October, so the rules will be out in early January so we can hit the January 2011 target. Given the short timeframe that we have, we suggest they implement rules similar to the TARP companies. They have had it for the last 2 years. Our members would use that as a model and get that done.

The Act also requires companies to give shareholders a vote on how frequently—this is what we call—how frequently they should get say-on-pay, we call say-when-on-pay. I guess the SEC calls it say-on-pay frequency.

With respect to say-when-on-pay, SEC rulemaking should provide boards a choice this year whether to offer a resolution with their own single recommendation, for example, 2 years; or to give a multiple choice resolution where the shareholders could pick: A, B or C; 1, 2 or 3 years. We believe that this has to be driven by boards and managements. They are in the best position to recommend the frequency to ensure that the timing of the vote is aligned with respect to compensation programs, many of which are driven in 3-year increments. The shareholders will be able to express their views.

Finally, on this one, the SEC should clarify that a shareholder proposal seeking an alternative 1-, 2-, or 3-year scheme would be excluded from a proxy statement. This would avoid unnecessary uncertainty or a conflict with the company's resolution, and we don't think it was your intent to have say-when-on-pay votes every year in the 6-year period.

Pay-ratio disclosure, I heard some of the colloquy. As you know, it does, by construction, apply to all employees. We would hope that all employees becomes all U.S. employees for U.S. companies and all U.S. full-time employees. We realize this rule won't be implemented until next summer or looked at until next summer, but we think that we need technical clarifications during this time, and we believe that the clarifications should be driven by intent and practical reality, which you have already heard. We don't believe that it was Congress' intent to include workers all over the globe to compare to U.S. CEO's, and in addition, it is quite, quite burdensome.

One other thing that would help immensely with this and that we believe the statute should be clarified to provide is that total comp means total direct comp. That is cash: that is base salary, cash bonuses, equity comp, but not pension accruals, 401(k) matches, and other noncash items.

Clawbacks: The Act also requires companies to implement policies to recapture incentive comp that would not otherwise have been received in the event of a restatement. This clawback provision is mandatory, provides no board discretion, covers all present and former executive officers, does not require misconduct, and has a 3-year look back; it goes well beyond existing law and practice today. Our biggest concern with this is that boards must have some discretion in this area to implement a clawback. At the least, it must be allowed to determine if recoupment would cost more than the expected recovery amount is worth; that is, whether you have to pursue litigation to get it back, the likelihood of recovery, whether it violates any employment contract, and there are also some State law concerns, that it would violate State law provisions.

Surely Congress didn't intend to require clawbacks even where the recovery is less than the cost to recover it. For this reason alone, it is very simple: Boards must be given some discretion. So we urge the SEC to do that in its rulemaking, and at this point, I would recommend to you there is a letter from the Center on Executive Compensation attached to my testimony.

The CHAIRMAN. Letter from whom?

Ms. STUCKEY. The Center on Executive Compensation. It is attached to my written testimony.

The CHAIRMAN. Center for?

Ms. STUCKEY. Executive Compensation.

Finally, I will turn now to the whistleblower bounty provision, and I appreciate your indulgence.

It is in every company's best interest to have a robust compliance program, but the SEC and the U.S. Sentencing Commission strongly support effective in-house compliance programs that can prevent and detect criminal conduct or other wrongdoing.

Section 922 of Dodd-Frank states that the SEC shall pay an award to whistleblowers in cash between 10 and 30 percent of any money they receive over $1 million that either they collect, the U.S. Attorney collects, any other SRO or any State Attorney General, as a result of the whistleblower's assistance. Importantly, the bounty depends on whether the informant provides original information to the SEC. That is, if an employee is aware of a potential violation and wants to report an issue, he now has to choose whether to raise it to the company or with the SEC.

Employees have long been trained to raise issues first with their superior, alternatively with an ombuds or an ethics hotline or even to the chair of the company's audit committee.

Under the new whistleblower provisions, an employee will now have a significant financial incentive to bypass raising the issue with the company at all for fear of losing the bounty, because if he raises to the company first, the company might beat him or her to the SEC.

And if you believe the New York Post, the threat is real. Yesterday, the Post reported that when the new movie, "Wall Street: Money Never Sleeps" opens Friday, today, moviegoers will see an advertisement prior to the movie recruiting whistleblowers who know of misconduct at their companies. The ad will inform people of the potential riches that can come with being a whistleblower, letting them know that they can make money and also do a good thing. The ads also tell people that they can remain anonymous, and it also provides them with the address of the new whistleblower Web site, SECsnitch.com.

We don't believe this was the intended result of this provision, having employees bypass their companies. It is contrary to long-established public policy, and it also undercuts the well-established internal compliance programs put in place after SOX that companies have spent so much money on.

We suggest that the statute grant bounties but not on the condition that the whistleblower bypasses the company.

Finally, we believe the SEC should refer to the defense and health care industries, which have long had to deal with false claims cases and have experience in this area.

I encourage you to review my written testimony, and I think my time is up. I thank you.

[The prepared statement of Ms. Stuckey can be found on page 86 of the appendix.]

The CHAIRMAN. I thank both of the witnesses for their testimony.

Let me say to Ms. Stuckey, as I did when the gentleman from North Carolina raised it, the provisions about all compensation, the comparisons, did originate in the Senate. We have some questions about it. I guess it would seem clearly there would be a consensus that it shouldn't be every single employee. Now, I don't know whether it was drafted with enough flexibility to allow that, but if necessary, we would have to step in. I think that is clearly the case, and that was not one of the issues that we thought most important.

So that would be our general sense would be to—we will be urging the SEC to narrow that, if possible, and if not, then we would do it statutorily if we have to, which clearly is necessary in that regard.

Mr. Baily, you did note that with regard to how deep into the company we get, you had your own views they were not universally shared by the Squam Lake group. One question, is the Squam Lake group a one-time group? Are you guys going to hang out some more, or what can we expect from Squam Lake?

Mr. BAILY. We are going to hang out more. There is some new stuff that is going on to look at, the GSEs, Fannie Mae and Freddie Mac and a couple of other things. One or two members of the group have made a graceful exit, but we are still in business.

The CHAIRMAN. With regard to the GSEs, I would advise you not to waste your time to advise us on the post-GSE regime. There will be no more GSE's. I think that is fairly clear. We will obviously be open to what would be replacing them, and that will be very important. The gentleman from Alabama.

Mr. BACHUS. Thank you, and Mr. Chairman, I want to associate myself with Ms. Stuckey's remarks about the SEC getting their rules on say-on-pay out as soon as they can because businesses need to make decisions, and it would be very helpful. It would give certainty, which is always, I think, a good thing.

Let me go back to the question of Ms. Stuckey, for purposes of the median pay ratio disclosure, you said that it ought to apply only with U.S.-based full-time employees, and I tend to agree with you on that, but because this covers all—I am not sure anybody said this. This is not just financial companies; 953 applies to all public companies, which in itself, we have talked about financial companies getting in trouble and the safety net. But would you go ahead and just explain for the record why you believe only U.S. employees.

Ms. STUCKEY. Sure, I would be happy to. I don't believe—it sort of caught our group by surprise and I understand that there is some appeal and there have been statistics quoted by the media in the past about average worker pay to CEO pay, and I am not sure how correct those are. So I can understand why someone would want to know what the average worker makes.

We don't really think that institutional shareholders particularly care about this number, but companies are willing to implement Congress' intent, and it could be hugely burdensome. And without sounding like I am whining, if you are a multinational company and you have 100,00 employees in 20 or 30 or 40 countries, there are lots of pitfalls. There are cross-border issues, like exchange rates. There are privacy laws in France, for example, that might not even allow you to do this, all kinds of things. So if you are willing to work to make this only U.S. employees, a lot of corporate secretaries and human resource professionals will breathe easier. So this is a situation where we don't think the cost would outweigh the benefit of what the number is.

And the reason why we don't think that the pension number should be included is the pension number certainly is known for the CEO and the top five folks, but in order to find the median employee, it is very different than finding an average. You have to do an actuarial pension calculation for each of your 8,000 people, say, in the pension plan, and that is for a medium-sized energy company in the Midwest that I spoke to.

To do a pension calculation for 8,000 people and line them up in a row and pick the middle guy or gal, that is a huge burden. So we would urge you not to include that at all, but even if you wanted to include that, to allow the calculation to be done without that, find the middle person, then add the pension back in and then do the ratio, if you understand what I mean.

Mr. BACHUS. I do and let me say this. I agree with you that this would be a very burdensome problem.

Mr. Baily, do you have any comment on it?

Mr. BAILY. I am quite concerned about the level of poverty in the United States. I am quite concerned about the fact that ordinary workers have not done very well in the last few years. I don't see how publishing that ratio helps anybody very much. So I am not a big fan of that.

The CHAIRMAN. If the gentleman would yield, I would note again, that was a Senate provision, and I think our inclination is to see to what extent it can be lessened as a burden, and if not, we would be able to work to try and change that next year.

Mr. BACHUS. I think that is very helpful, and I think there is somewhat of a consensus building.

Ms. Stuckey, what are some of the other potential hurdles or pitfalls to public companies complying with the Dodd-Frank compensation provision?

Ms. STUCKEY. I can mention one that I cut out in the interest of time, and that would be the pay versus performance disclosure. There is a new provision that the SEC provide rules on this, and I think companies are anxious about this because they want the rule to be written flexibly enough to explain, whether it be in draft form or not, how compensation actually paid is tied to performance.

The current compensation structure of the current chart is not easy to understand. And they want to be able to tell—boards and comp committees want to be able to tell their story, to explain which point in time relates to which compensation, and that some compensation may be granted in year one. It may be a reward for a past year's performance. It may be incentive for a future year's performance. Some compensation is based on just 3-year straight line performance pay based on net income.

But they want to be able to show that at the bottom level, and you may not want to hear this, but at the bottom level, they want to be able to show that their executives are vested, just like the shareholders, and when the share price falls, they hurt, too. So their options become underwater, and the comp number that maybe the media reports isn't really what they got. So we want the SEC to write rules flexibly enough so that companies can tell that story.

Mr. BACHUS. Okay. Thank you.

Mr. Baily, do you have any comment on that?

Mr. BAILY. No, I don't have any further comment on it.

Mr. BACHUS. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I would note again that the provision just being discussed is another United States Senate provision. So we will be approaching with some—we will take a fresh look at it.

The gentleman from Florida.

Mr. POSEY. Thank you, Mr. Chairman.

Mr. Baily, did I hear you correctly that before employing employees who should or could be subject to executive compensation requirements, that they should work with the FDIC, the SEC or whoever ahead of time before they make arrangements to employ these people, that they should work with them, they should go to a bureaucrat and get their plans approved or get some kind of warm and fuzzy from them?

Mr. BAILY. Maybe I misstated or maybe I am misunderstanding your question. I think there is a process going on now where the regulators that are approving the risk-management structures within companies so that they are meeting risk-management standards are asking them to explain what their policy is on compensation.

It is not that I want them to say, this is the amount going to each employee and we are going to approve that going to each employee. No, I don't think that is a good idea at all, but what is their policy and does it meet the requirements for risk management, both in terms of their own desire to reduce risk within their institution and to make sure that they are not putting taxpayers in risk should something happen to the company?

Mr. POSEY. Did I understand correctly—and I will look at the transcript—but you suggested they should go to the FDIC, the SEC or someone beforehand to make sure that their plans are going to be compliant in advance, like there is some latitude given to the bureaucrat to make this judgment call, and they would have some type of influence on the committee who is setting the compensation outside of clear and unambiguous rules that apply to everyone that should be easily understood by the sector of this country that provides jobs and produces and gives us a GDP that we enjoy, that regulates a lifestyle that we had, that we are going to have those people go to a bureaucrat and get an opinion or try and get some kind of feel good signal in advance before they cut a deal?

I hope that is not what you said and that is not what the transcript will say because I find that appalling. I find that is probably the quickest way to destroy the economic system we are trying to get to recover, but that would probably do more damage than anything else when you have that kind of intrusion, unclear, very ambiguous, could be arbitrary, could be capricious, affecting private companies', public companies', opportunity to do business.

I would think that you would say, here are the rules, if you don't go outside that box, you are okay. If you go outside that box, you are in trouble. Or maybe that you will establish, instead of a zillion different rules, say here's the new fiduciary standard, you have this fiduciary standard to your stockholders, and it would be a jury in question whether or not you break that fiduciary standard, and if you do break it, the consequences are severe.

Thank you, Mr. Chairman.

Mr. BAILY. I certainly did not wish to create arbitrary and capricious rules or to create a system in which you have to have necessarily warm-and-fuzzy relationships with bureaucrats. So I, too, will look back at the transcript and make sure that I was saying something that I want to stand by.

I do understand very much the need to have incentives and opportunities and that businesses be allowed to run their operations, as long as the policies they are following—and there should be clear rules about this, I agree with you again on that—so that within the rules, they are not imposing excessive risk on taxpayers.

Mr. POSEY. The biggest disincentive in the world is for you to have to clear your decisions with a government bureaucrat on any level. I just think the suggestion that you need some kind of government approval after you have made your decision, inside the box of the guidelines that are established, that should be clear, unambiguous is just staggering to the imagination.

Mr. BAILY. I take your point.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MCHENRY. Thank you, Mr. Chairman, and I certainly appreciate the testimony.

And Mr. Baily, your discussion began with, I think, a key point, which is income distribution deals with a lot larger set of issues like skills, education, training, the ramifications of the Tax Code, really the provisional incentives the Tax Code puts in place, and I appreciate you mentioning that at the beginning, because I think the one key thing that we can do as a matter of governmental policy is make sure that there is a skill base out there so that we can have a very diverse, very active economy, and appreciate you starting with that, and that is something that is of issue to me and my constituents at home.

The question here today, the reason why we are even having this discussion is really at the heart, and I know the chairman has had this interest in executive comp for long before the financial meltdown. But the reason why we are talking about systemic risk and executive comp, well, compensation structures, is largely because of the Federal Government's actions to prevent a complete and utter meltdown of the financial marketplace. Is that basically your view, Mr. Baily?

Mr. BAILY. I am sorry, could you just repeat the last sentence?

Mr. MCHENRY. Basically, the reason why systemic risk is the discussion is because the Federal Government had to bail out firms, right?

Mr. BAILY. Yes.

Mr. MCHENRY. Then you look at the overall structure, and you said, of course, you got paid millions if you did "X," if you failed, and you got paid billions if you succeeded, so of course, the incentive is to not worry about failure; somebody else will pay for it.

My concern is this: We write a regulation, and to Ms. Stuckey's point, you have three or four different regulators, they write three or four similar regulations but just dissimilar enough, that you can't really please everyone, and then they stay on the books. And in the end, the marketplace figures out a way, with the force of money and the power of money and the power of ideas in order to make more money as individuals, and they get around it. So basically, it is great. Congress feels good. We have stuck it to these folks that were making all this money, and we feel good, and in the end, it nets out with nothing. Is that a concern that you have, Mr. Baily?

Mr. BAILY. Yes, it is a concern.

Now, as we discussed a little bit in the earlier panel, one response to that is that many of these companies, and I think maybe that is a little also in answer to the earlier question, a lot of these companies are themselves reforming their own compensation structures, so they are not saying, oh, no, we don't want to do that. Some of them actually did it before the crisis. Some of the better companies and more enlightened companies had pretty good compensation structures, and they did withhold bonuses over several years, and in most cases, those companies fared better over this crisis than the ones that did not.

So I don't think we are pushing this down the throats of most companies. We are trying to do things that, by and large, they are doing on their own.

The only thing that we added I think in the Squam Lake Report was to make sure we don't just end up with systems that kind of align the employees with the shareholders, meanwhile forgetting that taxpayers could be on the hook. And so we want to make sure that at the level of incentive, particularly to the CEO, but to senior management, that they know that some of their pay is on the line if taxpayers have to get involved and so we can help avoid some of these bailouts that we had.

Mr. MCHENRY. Would you agree that the best way for this to actually happen is not through a government regulation but through a corporation's reform within?

Mr. BAILY. I think there is an interest in—we do have supervision and regulation of our financial institutions. So I don't think we can just leave it to the companies themselves to do it. I think we have to make sure that it is being done in a way that protects us as taxpayers rather than just leaving it to—

Mr. MCHENRY. Beyond financial firms.

Mr. BAILY. Oh, beyond financial firms?

Mr. MCHENRY. I think that is an answer.

Mr. BAILY. I can certainly come back with a response, but if these are not companies that are going to get bailed out or receive government interest, by and large, they should do their own thing without the interference of the government.

Mr. MCHENRY. Okay. And certainly it would be in the shareholders' interests to ensure, such as say-on-pay, can have their say-so and take their capital away from firms that don't have the right incentive structure where the CEO and the executives aren't truly aligned with the interests of shareholders, and the marketplace can make that choice. And that is what many of us are saying. It is not that we certainly support certain compensation amounts. It is that we believe in the individual ownership of that company rather than government regulation.

And finally, Mr. Chairman, I appreciate your indulgence, but to Ms. Stuckey's point about total direct compensation versus an individual who has worked for a company for 30 or 40 years and started at the retail, checking people out, has worked their way up and is number two in line to the CEO and, after 40 years, has a lot of deferred compensation, and it appears that he has a lot more direct compensation from the firm than he truly does. And I appreciate your interest, and I have folks in my district who have that very issue that it certainly overstates what they believe is really worthwhile to disclose.

Ms. STUCKEY. I would agree, and I just, if you have 1 minute, I can give you a couple of other things, questions that have actually been raised by people attempting to gather the information: What do we do with 401(k) matches? What about mid-year employees or part-timers? People who have come on with an acquisition? What about severance? What about people who are downsizing, given their huge severance package because they have been there 30 years and maybe you have accelerated their vesting, what do we do about that? What do you do about overtime and shift differential payments of hourly workers? And then, of course, there is the overseas currency, nonmonetary components, like apparently in overseas countries, many people get cars. Sometimes they even get food. There are a lot of things that might have to be valued. So that is the sort of nuts and bolts stuff that we are concerned about.

Mr. MCHENRY. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the witnesses. This will be an ongoing process, and this has been useful, and we will continue to work on it. The hearing is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

A P P E N D I X

September 24, 2010

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Testimony

by

Scott G. Alvarez

General Counsel

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

September 24, 2010

Chairman Frank, Ranking Member Bachus, and other members of the Committee, thank you for the opportunity to discuss the oversight of incentive compensation practices in banking and financial services, an area in which the Federal Reserve has undertaken significant initiatives. Incentive compensation is an important and useful tool for attracting and motivating employees to perform at their best. At the same time, poorly designed or implemented compensation arrangements can provide executives and other employees with incentives to take imprudent risks that are not consistent with the long-term health of financial organizations. For example, offering large payments to managers or employees to produce sizable increases in short-term revenue or profit--without regard for the potentially substantial short- or long-term risks associated with that revenue or profit--can encourage managers or employees to take risks that are beyond the capability of the financial institution to manage and control. It is clear that flawed incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007.

To help address these problems, the Federal Reserve led the development of interagency guidance on incentive compensation adopted by the federal banking agencies in June 2010. We also are close to completing a horizontal review of incentive compensation practices at large complex banking organizations (LCBOs). Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) provides an important support to these efforts by requiring that the federal banking agencies, the Securities and Exchange Commission (SEC), the National Credit Union Administration Board (NCUAB), and the Federal Housing Finance Agency (FHFA) prescribe joint regulations or guidelines on incentive compensation.

In my testimony, I will describe the guidance on sound incentive compensation policies issued by the Federal Reserve and the other federal banking agencies earlier this year. In addition, I will provide an update on the horizontal review of incentive compensation practices at large banking organizations initiated in the fall of 2009. I will also review the incentive compensation provisions of the Dodd-Frank Act and provide some preliminary thoughts on these provisions and their implementation. The Federal Reserve remains committed to helping move the industry forward in developing and implementing incentive compensation practices that are consistent with prudent risk management and safety and soundness.

Final Guidance on Sound Incentive Compensation Policies

In February of this year, I testified before this committee about the guidance on incentive compensation proposed by the Federal Reserve in October 2009 and on the related supervisory initiatives we had commenced to help ensure that incentive compensation programs at banking organizations do not encourage excessive risk-taking.[1] I am pleased to report today that final guidance was adopted in June.[2] Importantly, the other federal banking agencies--the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation--joined the Federal Reserve in adopting the guidance, ensuring that the principles embedded in the guidance will apply to all banking organizations regardless of the identity of their federal supervisor.

The guidance adopted by the federal banking agencies is based on three key principles. These principles are: (1) incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk; (2) these arrangements should be compatible with effective controls and risk management; and (3) these

[1] See Scott G. Alvarez (2010), "Incentive Compensation," statement before the Committee on Financial Services, U.S. House of Representatives, February 25, www.federalreserve.gov/newsevents/testimony/alvarez20100225a.htm.
[2] See Board of Governors of the Federal Reserve System (2010), "Federal Reserve, OCC, OTS, FDIC Issue Final Guidance on Incentive Compensation," press release, June 21, 2010, www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm.

arrangements should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

Because compensation arrangements for executive *and* non-executive employees alike may pose safety and soundness risks if not properly structured, the guidance applies to senior executives as well as other employees who, either individually or as part of a group, have the ability to expose the banking organization to material amounts of risk. Importantly, in identifying employees covered by the guidance, banking organizations are directed to consider the full range of inherent risks associated with an employee's activities, rather than just the level or type of risks that may remain after application of the organization's risk controls. While strong and effective risk-management and internal control functions are critical to the safety and soundness of banking organizations, poorly designed or implemented incentive compensation arrangements can themselves be a source of risk to banking organizations and undermine the controls in place. For example, unbalanced incentive compensation arrangements can place substantial strain on the risk-management and internal control functions of even well-managed organizations. Accordingly, the guidance emphasizes that organizations should have both balanced incentive compensation arrangements and effective risk management and internal controls.

The guidance outlines four currently available methods that banking organizations can--and often do--use to make compensation more sensitive to risk: (1) risk-adjusting compensation awards for measurements of risk, (2) deferring payment of awards so that the payments may be adjusted as risks are realized or become better known, (3) using longer performance periods, and (4) reducing the sensitivity of awards to measures of short-term performance. Each method has advantages and disadvantages. Accordingly, a banking organization may need to use more than one method to ensure that an incentive compensation arrangement does not encourage excessive risk-taking.

In addition, activities and risks may vary significantly across banking organizations and across employees within a particular banking organization. For this reason, the methods used to achieve appropriately risk-sensitive compensation arrangements likely will differ across and within firms, and use of a single, formulaic approach likely will provide at least some employees with incentives to take excessive risks. For example, incentive compensation arrangements for senior executives at large complex organizations are likely to be better balanced if the arrangements involve deferral of a substantial portion of the executives' incentive compensation over a multiyear period, with payment made in the form of stock or other equity-based instruments and with the number of instruments ultimately received dependent on the performance of the firm during the deferral period. Deferral, however, may not be effective in constraining the incentives of employees who may have the ability to expose the firm to long-term or "bad tail" risks, as these risks are unlikely to be realized during a reasonable deferral period.[3] Similarly, the use of equity-based incentive compensation may not be effective in balancing the incentives of mid- and lower-level employees because these employees may view the outcomes of their decisions as unlikely to have much effect on the firm or its stock price.

These differences highlight the need for flexibility in approaches by financial institutions. As in many areas, one size certainly does not fit all. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization. Methods for achieving balanced compensation arrangements at one organization may not be effective at another organization, in part because of the importance

[3] *Bad tail risks* are risks that have a low probability of being realized but would have highly adverse effects on the organization if they were to be realized. These risks warrant special attention from a safety-and-soundness perspective given the threat they pose to a banking organization's solvency and the federal safety net.

of integrating incentive compensation arrangements with the firm's own risk-management systems.

While the guidance highlights the best current thinking on incentive compensation, it also recognizes that much theoretical and practical study is being done on new methods for constructing effective incentive compensation arrangements. The guidance urges large banking organizations to actively monitor industry, academic, and regulatory developments in incentive compensation practices and theory and be prepared to incorporate into their incentive compensation systems new or emerging methods that are likely to improve the organization's long-term financial well-being and safety and soundness.

The guidance reflects the expectation that large banking organizations will have robust procedures for collecting information about the effects of their incentive compensation programs on employee risk-taking, as well as systems and processes for adjusting compensation arrangements to eliminate or reduce unintended incentives for risk-taking. Smaller banking organizations, however, typically make less use of incentive compensation arrangements than larger banking organizations, and because smaller organizations are less complex, they are more able to readily adjust compensation as risks emerge. Accordingly, the guidance includes several provisions designed to reduce burdens on smaller banking organizations and reflect the real differences between the scope and complexity of the activities, as well as the incentive compensation practices, at large and smaller banking organizations. The Federal Reserve's supervisory approach to incentive compensation also reflects this two-tiered approach. While the Federal Reserve intends to integrate reviews of incentive compensation arrangements at both large and small banking organizations into our examination process going forward, experience suggests that incentive compensation arrangements at small banks are not nearly as complex or prevalent as those at larger institutions. As a result, reviews of incentive compensation practices at smaller firms are more easily integrated into the normal examination process. For the largest banking organizations, we have undertaken a special horizontal review of incentive compensation practices at the largest banking organizations, a topic to which I will now turn.

Horizontal Review of Incentive Compensation Practices

While firms of all sizes should manage the risks created by their incentive compensation arrangements, LCBOs warrant special supervisory attention because the adverse effects of flawed approaches at these institutions are more likely to have adverse effects on the broader financial system. To help ensure that LCBOs moved rapidly to bring their arrangements into compliance with the principles of safety and soundness, last fall the Federal Reserve initiated a special "horizontal" review of incentive compensation practices at the LCBOs under the Federal Reserve's supervision.[4] Overall, a multidisciplinary team of more than 150 staff members from the Federal Reserve System, including supervisors, economists, and legal professionals, have participated in these reviews to date. Although the initiative is being led by the Federal Reserve, representatives of each of the other federal banking agencies have been involved in the horizontal process in order to promote full and consistent coverage of U.S. banking organizations.

Supervisory teams have collected substantial information--through questionnaires, documentary requests, and interviews with key executives and managers--from each LCBO concerning the firm's existing incentive compensation practices and related risk-management and corporate governance processes. To supplement this information and to evaluate specifically how incentive compensation practices were used at the line-of-business level, teams conducted

[4] Horizontal examinations, which the Federal Reserve has used for many years, involve a coordinated review of particular risks or activities across a group of banking organizations.

"deep dive" examinations of incentive compensation practices in trading and mortgage-origination business lines at a number of LCBOs.

Importantly, early this year, each LCBO was required to submit a detailed self-assessment of shortcomings and gaps in its existing practices relative to the principles contained in the proposed guidance, as well as plans--including timetables--for addressing any weaknesses in the firm's incentive compensation arrangements and related risk-management and corporate governance practices. These initial internal assessments and plans were carefully reviewed by the multidisciplinary and interagency examination teams over a span of several weeks. The reviews focused on the adequacy of each firm's assessment of its current practices and plans for improving those practices, as well as areas where additional information was needed to permit a full review of the organizations practices and plans. Firms were required to address all substantive or informational deficiencies and then to submit revised assessments, plans, and timetables by midsummer.

The federal banking agencies are currently reviewing these revised plans with the finalized guidance in hand. The results of the deep-dive examinations are also being used to inform these reviews. We expect to provide each LCBO with individualized feedback on its revised plans and timetables this fall. After the assessments are completed, implementation of the revised plans will become part of the supervisory expectations for the banking organizations, and future reviews of incentive compensation at LCBOs will be integrated into the normal supervision process.

During the horizontal review, firms have largely been responsive to these Federal Reserve-led efforts and have put forth significant effort to find constructive solutions to the issues identified. In addition, over the course of the horizontal review, we have observed and encouraged real, positive change in incentive compensation practices at LCBOs. For example, many firms are developing enhanced and comprehensive methodologies to systematically identify employees whose activities, either individually or as a similarly compensated group, may expose the organization to material risk; the firms are also completing fresh assessments of the types of risks to which these employees may expose the organization. These first steps are critical in identifying employees whose incentive compensation arrangements may expose the organization to material risk.

Many LCBOs also are revising their performance measurement processes in order to adequately capture activities that expose the firm to a wide range of risks by, for example, developing performance assessment processes that incorporate risks that are difficult to measure and include input from risk management and control functions. For many firms, these changes have necessitated significant investments to improve their performance management and incentive compensation infrastructures. Notably, many LCBOs are developing innovative solutions for common areas of weakness. For example, many firms lacked incentive compensation arrangements for midlevel managers that were appropriately sensitive to the risks posed by those managers' activities. The firms have developed varying techniques to appropriately balance incentive compensation for those managers, including in some cases using appropriate risk adjustment techniques, deferral of payouts, or some combination of the two. In many cases, the methods chosen have been tailored to the particular business line of the manager and to the operating context of the organization.

Many LCBOs also are enhancing their deferral arrangements, especially for senior executives, to ensure that information about risk-taking activities that becomes available over time affects incentive compensation payouts. Finally, LCBOs are continuing to find ways to appropriately involve risk-management and other control personnel into the design, implementation, and oversight of incentive compensation arrangements and to improve the corporate governance structure over these arrangements, for example, by developing line-of-business compensation committees involving risk-management personnel.

While significant improvements have been achieved, it should not be surprising that time will be required to implement all the improvements that are needed, given firms' relatively unsophisticated approach to risk incentives before the crisis, the unavoidable complexity of compensation issues, and the large numbers of employees who receive incentive compensation at large banks. Each LCBO is expected to ensure that the organization's plans are adequate to achieve incentive compensation arrangements that are consistent with safety and soundness. The Federal Reserve also expects that the organization's plans will be appropriately revised to address all weaknesses at that organization identified as part of the horizontal process and fully implemented in an expeditious manner. Importantly, the Federal Reserve expects LCBOs to make significant progress to improve the risk sensitivity of their incentive compensation for the 2010 performance year. The implementation of these plans will be monitored through the ongoing supervisory process.

The Federal Reserve intends to actively monitor the actions being taken by banking organizations with respect to incentive compensation arrangements and will review the final guidance in light of the work being done to implement the Dodd-Frank Act incentive compensation provisions and in cooperation with the other federal banking agencies, as appropriate, to incorporate best practices that emerge. After 2010, the Federal Reserve will prepare and make public a report, in consultation with the other federal banking agencies, on trends and developments in incentive compensation practices at banking organizations in order to encourage improvements throughout the industry.

Section 956 of the Dodd-Frank Act

Having seen the consequences of poorly structured compensation arrangements, the Congress also included provisions in the Dodd-Frank Act to strengthen the ability of regulators to identify and correct problems before they threaten a financial institution or the financial system. Section 956 of the act improves the ability of federal regulators to collect information about incentive compensation arrangements at a wide range of firms, including publicly traded nonbanking firms and the housing-related government-sponsored enterprises (GSEs), as well as banking organizations already subject to the guidance. The Dodd-Frank Act also empowers the appropriate federal regulators to prohibit any type of incentive-based payment arrangement, or any feature of such an arrangement, that the regulators determine encourages inappropriate risks by a covered financial institution, either by providing excessive compensation, fees, or benefits or by potentially leading to material financial losses to the institution. Section 956 requires the federal banking agencies, the SEC, the NCUAB, and the FHFA to jointly develop, no later than April 21, 2011, regulations or guidelines implementing these disclosures and prohibitions concerning incentive-based compensation at "covered financial institutions" with at least $1 billion in assets. For this purpose, a "covered financial institution" means a depository institution, registered broker-dealer, credit union, investment adviser, Freddie Mac, Fannie Mae, and any other financial institution that the regulators determine should be covered. By expanding the scope of coverage to include many large nonbanking firms as well as supporting the federal banking agencies' efforts, the Dodd-Frank Act helps level the playing field by reducing the potential for sound practices at banking firms to be undermined by arrangements at nonbank competitors.

The Federal Reserve is working with the other appropriate federal regulators to develop the regulations or guidelines required by section 956 of the Dodd-Frank Act. We can already see substantial interest and commitment of resources on the part of all agencies. Most, if not all, of the regulators have experience in writing regulations or guidance dealing with compensation issues. The SEC, for example, has implemented disclosure requirements for the compensation of senior executives at publicly traded companies, and for other employees where the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on companies. Building on these efforts, the Dodd-Frank Act also requires the SEC to take a number of additional actions to improve disclosures to shareholders at publicly traded financial firms, the independence of compensation committees at these firms, and the role of shareholders in reviewing compensation of senior executives at these firms.

As discussed earlier, the federal banking agencies have issued guidance on sound incentive compensation arrangements. And section 956 requires the appropriate federal regulators--the banking agencies along with the SEC, the NCUAB, and the FHFA--to ensure that any compensation standards established pursuant to that section are comparable to those applicable to insured depository institutions under the Federal Deposit Insurance Act (12 U.S.C. § 1831p-1). Together, these agencies are determining together how best to take account of their individual expertise, mission, and supervisory approach as we work together to develop joint regulations or guidelines.

A number of interpretive and operational issues are being addressed in meeting the requirements of section 956. Perhaps most importantly, the provision allows the regulators to issue regulations or guidelines, and choices will have to be made in that regard. The regulators may ultimately make different choices on this issue for the different parts of section 956. For example, the disclosure provision may be particularly amenable to implementation by regulation. For the prohibition provision, regulations may be more appropriate if and to the extent regulators can craft effective standards regarding particular prohibited practices and determine how best to apply those standards across the universe of institutions and employees.

The Federal Reserve recognizes that international coordination in this area is important both to promote competitive balance and to ensure that internationally active organizations are subject to consistent requirements. For this reason, the Federal Reserve will continue to work closely with its domestic and international counterparts to foster sound compensation practices across the financial services industry. Importantly, the guidance adopted by the federal banking agencies is consistent with both the *Principles for Sound Compensation Practices* and the related *Implementation Standards* adopted by the Financial Stability Board in 2009.[5] We expect these principles to be influential in the implementation of section 956 as well.

Conclusion

I appreciate the opportunity to describe the Federal Reserve's continuing efforts to improve incentive compensation practices and am happy to answer any questions.

[5] See Financial Stability Forum (2009), *FSF Principles for Sound Compensation Practices* (Basel, Switzerland: FSF, April), www.fsforum.org/publications/r_0904b.pdf?noframes=1; and Financial Stability Board (2009), *FSB Principles for Sound Compensation Practices: Implementation Standards* (Basel, Switzerland: FSB, September), www.financialstabilityboard.org/publications/r_090925c.pdf.

Testimony Prepared for the Hearing:

Executive Compensation Oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act

United States House of Representatives
Committee on Financial Services

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By

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Chairman Frank, Ranking Member Bachus and Members of the Committee, it is a privilege to testify to this committee on the topic of the oversight of compensation in financial services companies.

Key Points in this Testimony

- The Dodd-Frank bill has provided a new (and in my judgment very valuable) framework for regulation of financial institutions, however, it leaves to regulators many tasks of implementation.
- The Act gives regulators the authority to set rules for compensation of senior employees of financial institutions.
- The level of pay for executives and other risk-takers (traders, loan officers, investment bankers, brokers and so on) should not be regulated; Dodd-Frank does not mandate regulation of pay levels for executives; regulators should not either.
- Financial regulators have a legitimate interest in setting compensation rules because the *structure* of compensation can have an impact on the level of risk-taking. Decisions made within individual institutions may be excessively risky because executives are counting on government support should the company lose its risky bets.
- To offset this incentive to take excessive risk, a significant part of the pay of executives and other risk takers should be delayed and paid out over several years.
- The Squam Lake proposal is that a portion of each executive's compensation be withheld at the time it is earned and invested in cash-equivalents. This would be paid out to the executive over five years provided the company does not require extraordinary assistance from the government or become bankrupt.
- Imposing claw-back provisions is a mistake because they are unworkable.
- My own view is that regulation of compensation should extend to traders and others within regulated financial institution that can take large financial bets. Regulators should not be involved in setting detailed compensation plans, but senior executives should be expected to explain to regulators how their compensation structure matches their overall risk management strategy. Other members of the Squam Lake Group do not support this position.

Introduction

In the wake of the financial crisis and the bail outs of many financial institutions, the American people became outraged at the very high salaries and bonuses being paid to financial executives and traders. It is understandable that taxpayers do not want government funds be used to pay such bonuses to executives who have contributed to the failure of their companies and the need for taxpayer funds, and Congress and the President responded to the situation by putting in place compensation restrictions administered by a special master.

While the Dodd-Frank Act made important steps forward in improving financial regulation a lot remains to be done during implementation. This is understandable, because the House and Senate are not the right place for detailed rule making and, of course, some important issues, such as capital and liquidity requirements, have to be worked out internationally to ensure a level playing field for US financial institutions. The Basel process has not been either timely or effective in past years, but there are indications now that it is moving more quickly and constructively to develop harmonized standards.

The financial crisis is not over yet; its effects still linger and the recession that it caused is very much still with us, but the subject of this hearing is welcome: to review the supervision of compensation structures within financial institutions. There were many causes of the crisis but one of the contributory factors was that traders and CEOs were often rewarded on the basis of short term profits, encouraging them to take excessive risks that paid off handsomely in the short run but that caused large losses over a longer period. One element of a more stable financial system involves compensation structures for those in financial institutions that do not incent excessive risk taking.

In the fall of 2008 when the financial crisis was in full flight a group of financial economists met for a weekend at a retreat center on Squam Lake New Hampshire to look at longer term issues in policymaking. The aspiration was to help guide the evolving reform of capital markets—their structure, function and regulation. It was a diverse group with a range of academic, private sector and public policy experience. The resulting work of the group was published this year in a book, *The Squam Lake Report: Fixing the Financial System,* by Princeton University Press. In this testimony I will lay out the recommendations made by the Squam Lakers concerning compensation, and comment on the relation between these and the provisions of the Dodd-Frank bill.

I will then also provide a discussion of proposals that have been made elsewhere. US regulators are iterating with private sector institutions to set up improved internal risk management structures and to rely on deferred compensation. The Financial Services Authority in London issued in 2009 its recommendations on compensation.

I then draw my own final conclusion and assessment of the proposals on regulation of compensation.

The Squam Lake Recommendations on Compensation in Financial Services Companies

There are two recommendations from the Squam Lake Report that relate to compensation in financial services companies. The first is to discourage any regulation of the *level* of pay. There has been no convincing evidence that high levels of compensation create an inherent or fundamental risk for these companies or the larger economy. In fact, the report argues that these executives contribute mightily to the success of their employers—even a small difference in talent can translate into tremendous returns given the size and complications present in this business.

Even among those with similar professional qualifications, there are tangible differences in the skills of financial employees, and even a small difference in skill can have an enormous impact on the profits of a financial firm. An extra 1 percent return on a $10 billion investment portfolio adds $100 million to a firm's earnings. An investment banker who structures a transaction incorrectly can quickly transform a large acquisition from a brilliant idea to a $200 billion albatross.

In addition, it is relatively easy for financial executives to move from one firm to another because they rarely rely on firm-specific inputs such as particular machines, patented processes, or other unique forms of capital. When there are synergies within a group of workers, such as an investment-banking team, the whole group can move from employer to employer. This mobility gives employees great bargaining power when negotiating their compensation.

Limits on the level of compensation in the financial services industry are also likely to trigger unintended and undesirable consequences. Pay caps imposed on a subset of firms, for example, could push their most talented bankers, traders, and other key professionals to unregulated firms. Broader limits on the compensation of financial executives may even drive parts of this highly mobile industry to more receptive countries.

Past efforts to cap executive compensation have often created unexpected problems including, in some cases, an increase in the pay of those whose wages were meant to be constrained. A 1982 law aimed at limiting golden-parachute payments in the United States paradoxically extended their use to new firms and new situations. In particular, firms discovered they could circumvent the new taxes on golden-parachute payments by extending the payments to all terminations without cause, not just those associated with a change in control. Similarly, a 1993 American law aimed at limiting the tax deductibility of executive salaries sparked the proliferation of riskier option-based compensation.[i] Today the difficulty remains the same: regulating the level of compensation for financial executives could do more harm than good, both to the firms being regulated and to the overall economy.

Our recommendation that governments should avoid regulating the level of compensation is not a rejection of proposals intended to improve corporate governance, such as say-on-pay votes and tighter standards of independence for compensation committee members. Such proposals may make corporations more productive by increasing management's incentives to act in the long-term interest of shareholders. However, changes that reduce the conflict between management and shareholders can magnify the conflict between financial institutions and society. This is an example of the more general point that regulations can easily have costly unintended consequences.

Although regulators should generally not set the level of compensation for financial executives, the possibility that governments will bail out financial firms during a crisis implies that stakeholders in financial firms—executives, creditors, and shareholders—do not face the full cost of their failure. As a result, these institutions have an incentive to take more risks than they would if they bore all the costs of failure. This, in turn, increases the likelihood of bank failures, the potential for systemic risk, and expected taxpayer costs. These market concerns lead us to recommend regulatory guidelines for the *structure* of compensation in financial institutions.

A major goal of capital-market reform should be to force financial firms to bear the full cost of their actions. In the Squam Lake Report, we propose several mechanisms to help achieve this goal and executive compensation is one such approach for inducing financial firms to internalize the costs of their actions. Specifically, if a significant portion of senior management's compensation is deferred and contingent on the firm surviving without extraordinary government assistance, managers will be less inclined to pursue risky strategies.

Our recommendation is that systemically important financial institutions should withhold a significant share of each senior manager's total annual compensation for several years. The withheld compensation should not take the form of stock or stock options. Rather, each holdback should be for a fixed dollar amount, and employees would forfeit their holdbacks if the firm goes bankrupt or receives extraordinary government assistance.

In effect, holdbacks hold employees directly accountable if their firm fails. They are essentially providing insurance against failure, and like any other insurance provider, they earn a fixed amount (akin to an insurance premium) if the firm does well, and bear a loss if the firm does poorly. As a result, this deferred compensation partially offsets management's incentive to pursue risky strategies that might result in government bailouts. Similarly, rather than wait for a bailout during a financial crisis, the management of a troubled firm would have a powerful incentive to find a private solution, perhaps by boosting the firm's liquidity to prevent a run, raising new capital, or facilitating a takeover by another firm. Because taxpayer losses trigger executive losses, holdbacks better align the personal incentives of managers with the fiscal and systemic goals of taxpayers.

More familiar forms of deferred compensation, such as stock awards and options, do little to reduce the conflict between systemically important financial institutions and society. Managers who receive stock become more aligned with stockholders, but this does not align them with taxpayers. Managers and stockholders both capture the upside when things go well, and transfer at least some of the losses to taxpayers when things go badly. Stock options give managers even more incentive to take risk because they pay off only if the stock price moves up. Thus, compensation that is deferred to satisfy this regulatory obligation should be for a fixed monetary amount. For example, firms might be required to withhold 20 percent of the estimated dollar value of each executive's annual compensation, including cash, stock, and option grants, for five years. At the end of this period, employees would receive the fixed dollar amount of their deferred compensation if the firm has not declared bankruptcy or received extraordinary government support.

Regulators need to specify clearly what events would trigger the loss of holdbacks. The triggers should include capital injections like those of the Troubled Asset Relief Program. Another should be unusual guarantees by the government of a firm's debt. We do not think triggering events should include less extreme events like borrowing from the Federal Reserve discount window.

Resignation from the firm should not accelerate the payment of an employee's holdbacks. Accelerating payment for employees who quit would weaken their concern about the long-term consequences of their actions. Moreover, it could create an incentive to quit, particularly if the employee discovers the firm may be in trouble. In the same spirit, managers should not be rewarded for taking their firm into bankruptcy. If a firm declares bankruptcy, its managers should receive their holdbacks only after its other creditors have been made whole.

This positioning of managers' claims means that a firm's obligation to pay deferred compensation does not affect its payments to other creditors in bankruptcy. Moreover, managers have no reason to push their firm into bankruptcy in an effort to collect compensation holdbacks. Thus, commitments to pay accumulated holdbacks do not put the financial institution or its other creditors at risk. Assets the firm holds to pay these obligations are capital that is available to pay other debts. Large firms that implement aggressive holdbacks can boost by billions of dollars the capital they have available to buffer against a major shock.

Compensation holdbacks are not a panacea. No single tool can perfectly align the incentives of stakeholders in financial companies with society's desire to avoid systemic financial distress. However, transparent compensation holdbacks with clearly specified trigger mechanisms would help reduce the chances of another crisis.

Compensation Oversight in the Dodd-Frank Bill in Relation to Squam Lake[1]

The portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act that addresses executive compensation adheres to our first recommendation. The Act avoids rigid limits on the level of executive compensation at financial institutions and public companies of the kind that were part of the TARP legislation. In regard to our second recommendation, the act articulated principles for executive compensation but, understandably, left the specific provisions to be jointly enumerated by various government regulators.

The major components of this portion of the Act deal with financial institutions but also other public companies. They specify heightened disclosure of information related to executive compensation, rules to maintain the independence of compensation committees, a greater say for company shareholders, and a claw-back provision. For example, the law calls for the SEC to issue disclosure rules for the relationship between compensation and company performance as well as the ratio between the median

[1] Since reading legal documents is not my strongpoint, I have relied in part on detailed summaries of the bill, notably the summary provided by Davis Polk.

employee and CEO compensation. The claw-back provision enables the recovery of excess incentive-based compensation following a restatement of company earnings.

For shareholder issues, broker discretionary votes are eliminated for certain matters and shareholders are now required to have non-binding votes on executive compensation and golden parachutes. This may further align shareholder and management interests, but as mentioned above, this is not the same as alignment with taxpayer interests.

In terms of executive pay at financial institutions, the Act calls on federal regulators to jointly prescribe regulations for 1) disclosure of all incentive-based compensation structures at covered institutions and 2) prohibiting pay arrangements that incentivize inappropriate risk-taking by employees, directors or principal shareholders that could lead to material financial loss to the covered financial institution.[2]

Federal regulators charged with enforcing these provisions include the SEC, the Federal Reserve, the OCC, the FDIC, OTC, the National Credit Union Administration Board and FHFA. The principle for establishing these standards, as discussed in the Act, is the Federal Deposit Insurance Act.

As it stands, therefore, the Dodd-Frank bill does not include explicit provisions for deferred compensation that would be forfeit in the event that a financial institution were to fail or obtain material assistance from the government. However, the fact that the Act prohibits pay arrangements that incentivize inappropriate risk taking allows regulators to promulgate rules that would accomplish this goal.

Proposals Formulated by US Regulators

In October 2009 the Federal Reserve requested comment on "Proposed Guidance on Sound Incentive Compensation Policies." After reviewing 34 comments, the Fed--along with the OCC, OTS, and FDIC—released final guidance on compensation structure on June 21, 2010. These 3 principles are:

- Incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk.
- These arrangements should be compatible with effective controls and risk-management.
- These arrangements should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

[2] Covered financial institutions include depository institutions and depository institution holding companies, broker dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac, and any other financial institution determined by the appropriate federal regulators. Covered financial institutions with assets of less than $1 billion are excluded.

According to the press release, "The Federal Reserve, in cooperation with the other banking agencies, has completed a first round of in-depth analysis of incentive compensation practices at large, complex banking organizations as part of a so-called horizontal review, a coordinated examination of practices across multiple firms. Last month, the Federal Reserve delivered assessments to the firms that included analysis of current compensation practices and areas requiring prompt attention. Firms are submitting plans to the Federal Reserve outlining steps and timelines for addressing outstanding issues to ensure that incentive compensation plans do not encourage excessive risk-taking.

"During the next stage, the banking agencies will be conducting additional cross-firm, horizontal reviews of incentive compensation practices at the large, complex banking organizations for employees in certain business lines, such as mortgage originators. The agencies will also be following up on specific areas that were found to be deficient at many firms, such as:

- Many firms need better ways to identify which employees, either individually or as a group, can expose banking organizations to material risk.
- While many firms are using or are considering various methods to make incentive compensation more risk sensitive, many are not fully capturing the risks involved and are not applying such methods to enough employees.
- Many firms are using deferral arrangements to adjust for risk, but they are taking a "one-size-fits-all" approach and are not tailoring these deferral arrangements according to the type or duration of risk.
- Many firms do not have adequate mechanisms to evaluate whether established practices are successful in balancing risk.

"In addition to the work with the large, complex banking organizations, the agencies are also working to incorporate oversight of incentive compensation arrangements into the regular examination process for smaller firms. These reviews are being tailored to take account of the size, complexity, and other characteristics of these banking organizations." (This quotation is taken from:
http://www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm)

The approach being used by the Federal Reserve and other financial regulators is to iterate with financial companies and other interested parties in order to determine what approach to compensation regulation will be workable, reduce risk and avoid undermining the incentives for real performance. This is a good approach to use, although with the caveat that the approach to risk management must adequately take into account the interests of taxpayers and not just align employee and shareholder interests.

Private Companies are Changing their Compensation Practices.

The idea of withholding some fraction of employee compensation for a period of time is not a new one, indeed several banks already had in place such plans. My Brookings colleague Douglas Elliott has written about executive compensation based on his experience at JP Morgan Chase, where he was an investment banker. JP Morgan has had in place a plan for several years where bonuses are paid out over time.[3]

On October 20, 2009 the Swiss bank Credit Suisse announced new rules for how it would pay its top employees. First, a higher portion of total compensation will come in the form of fixed monthly salary. Second, a higher proportion of variable compensation (bonus pay) will be deferred. Third, deferred variable compensation will be more closely tied to performance as measured by share price, return on equity, and the profit/loss of the employee's unit.

These provisions may not dramatically alter or even lower the level of compensation for executives, the goal is to align better pay practices with long-term employee and shareholder interests.

The reforms being introduced in private companies, including some practices that were in place prior to the crisis, indicate that enlightened financial institutions can see that it is in their own interests to follow risk-reducing policies. Their policies are designed to align employee incentives more closely with shareholder incentives and the longer run stability of their companies.

Compensation Principles Proposed by the UK's Financial Services Authority

The UK suffered in the financial crisis at least as badly as did the United States. The FSA is widely considered to have failed in its mission to supervise and regulate financial institutions based in the UK prior to the crisis, and the apparent lack of communication between the FSA and the Bank of England contributed to the severity of the crisis. Despite these historical shortcomings, there are good reasons to look at developments in the regulation of compensation of financial companies in the UK. London has been and will continue to be one of two large global financial centers, together with New York, and an important competitor to it. New York and London should compete for financial business, but they should have compatible policies in dealing the problem of excessive risk-taking. Moreover, the FSA did not have a monopoly on making mistakes in the period leading up to the crisis.

In March 2009 the FSA released a Consultation Paper on remuneration practices in financial institutions.[4] The paper states that it is not concerned about the absolute level of compensation (in line with the Squam Lake position), but that it is concerned about "remuneration practices which may pose risks to the firm and be inconsistent with effective risk management."

The paper proposes a rule, which states: "A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote

[3] His work can be found at http://www.brookings.edu/papers/2010/0111_wall_street_elliott.aspx

[4] Financial Services Authority, *Consultation Paper 09/10, Reforming remuneration practices in financial services,* March 2009.

effective risk management." In accordance with the traditional approach to regulation in the UK, the FSA states that the way in which this rule is met will depend upon the nature of the individual financial institutions. However, it does propose a set of ten principles that it believes should govern compensation structures and the following four are of particular interest.

Principle 4 states that bonus pools for employees should be based on profits and the size of the pool should include an adjustment for current and future risk, and take into account the cost of capital employed and the liquidity required. Principle 5 states that the performance-based portion of compensation should be based on longer term performance. Principle 6 states that performance assessment should be based significantly on non-financial metrics, including adherence to effective risk management and compliance with the regulatory system, including relevant overseas regulatory requirements. Principle 9 states that the majority of any significant bonus should be deferred with a minimum vesting period. In the guidance for this principle, the FSA states that at least two-thirds of the bonus be deferred. Principle 10 links the deferred elements of the compensation structure to the firm's future performance.

Conclusions on a Safer Compensation Structure for Financial Institutions

The financial crisis revealed failures in both financial markets and regulation. We cannot rely simply on market forces to prevent another crisis nor can we expect that regulators will be able to foresee and then forestall the next bubble or crisis. The best approach is to get market forces and regulatory rules and principles working together to reduce risk-taking while preserving competition and innovation. The Dodd-Frank act was an important step towards improving regulation and supervision but much of the work of implementation remains to be done. US regulators, together with the international process at Basel, will have to establish rules that are effective and efficient. This Committee has an important interest in following this process to make sure its intentions area followed.

The Squam Lake group identified a market failure in that individuals and particular financial institutions do not take into account the systemic risk that can be caused by their risk taking activities. This market failure is exacerbated by the fact that in the past policymakers have stepped in to rescue institutions that are in danger of bankruptcy and, despite the best of intentions, there is always the possibility that they will do so again in the future. At some point in the years ahead, traders or senior executives may make decisions without adequately taking into account the risks, counting on government support to bail them out in the event of disaster. Thereby, these institutions impose costs on taxpayers and the overall economy. In order to offset this problem, we proposed that a portion of bonuses be paid out over up to five years and that the amounts held in escrow are forfeit in the event that the institution receives substantial government assistance. The five year time frame is longer than in most other proposals. And another important element of the Squam Lake proposal is that the amount that is held in escrow would be in fixed income assets and not in shares or options of the company. In our judgment, having bonuses tied to the future value of the company's shares will increase the alignment between the incentives given to employees and those desired by shareholders, but comes at the expense of a more secure financial system and places greater risk on taxpayers. The best economic interest of shareholders will not be perfectly aligned with the best interest of the financial system and the economy. This argument puts our position at variance with many of other proposals described here that tie the eventual bonus to the performance of the company.

I do have concern that the Squam Lake proposal may not go far enough in giving the right incentives to traders or others that may make large bets on the market but are not part of the team of people managing the company. Tying individual compensation to overall company performance may make the trigger for forfeiture seem remote to employees in a large and international company. On the other hand, I do not want regulators determining the details of company compensation structures, which should be a managerial initiative. I believe that regulators should require top management to explain their compensation structure and how this structure is consistent with their own overall risk management procedures.

This was not the view agreed to by the whole group, where several members were concerned about too much interference by regulators. They noted that if the CEO and other very senior management have their own pay on the line in the event of a company failure, then they have an incentive to structure pay within their companies to avoid excessive risk-taking that would endanger the company and hence put taxpayers at risk.

I support the efforts now underway by the FED and other regulators to work in an iterative fashion with the significant financial institutions to work out compensation rules that support stability while allowing the companies to attract the talent they need to compete. These regulators must make sure that systemic risk is adequately considered and that it is not enough to align employee and shareholder interests.

One of the great challenges of this crisis is to ensure that the rules of the game be set to reduce the risk of another devastating crisis, but at the same time maintain the incentives for risk taking that are the essence of a dynamic and growing economy. In the boom, risks were taken that threatened the collapse of the whole financial system. Risk premia were too low. Right now, risk premia are very high. There are massive amounts of cash being held in companies or by banks in the form of excess reserves, while the economy stagnates. Regulatory rulemaking going forward should not discourage all risk taking, but rather should work with financial institutions themselves to figure out the specific structure that will incent effort and good judgment while protecting taxpayers and the economy.

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[i]. Kevin J. Murphy discusses these examples in his testimony, "Compensation Structure and Systemic Risk," before the U.S. House of Representatives Committee on Financial Services, June 11, 2009.

Testimony Concerning Executive Compensation Oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act

by Meredith B. Cross
Director, Division of Corporation Finance
United States Securities and Exchange Commission

Before the Committee on Financial Services of the United States House of Representatives

September 24, 2010

Introduction

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. I am pleased to testify on behalf of the Commission today on the topic of executive compensation oversight.

The Commission's role in this important area has traditionally been to promulgate and administer disclosure requirements concerning executive compensation. This has been the case throughout the Commission's long history, including in the very early days of the agency in the late 1930s.[1] The challenge the Commission has always faced in promulgating and administering its executive compensation disclosure rules is that compensation practices continually evolve. Over the years, the manner and types of

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1 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. *See* Securities Exchange Act Release No. 1823 (August 11, 1938).

compensation have become increasingly complex. As a consequence, the Commission has revised its disclosure rules as necessary to account for new developments in compensation practices.

The Commission's rules governing executive compensation disclosure are designed to elicit timely, comprehensive, and accurate information about a company's compensation practices and procedures. The Commission's focus has been on requiring companies to provide this information to investors. We believe that information about executive compensation must be straightforward and meaningful to facilitate investor access and use of that information.

As noted, a key component of the Commission's executive compensation disclosure rules is keeping pace with changing trends and developments in executive compensation practices. Accordingly, in 2006, the Commission amended its executive compensation disclosure rules to improve the quality and presentation of executive and director compensation disclosure.[2] Prior to adopting the rules, the Commission and its staff conducted an exhaustive reassessment of the agency's previous disclosure requirements.

Building on the previous disclosure requirement strengths, the 2006 amendments combined a broader-based tabular presentation with improved narrative disclosure designed to give investors information about how and why a company arrived at specific

2 SEC Release No. 33-8732A (August 29, 2006).

executive compensation decisions and policies. In the spring of 2007, the staff of the Commission's Division of Corporation Finance conducted a targeted review of 350 public companies in order to assess compliance with the revised rules and provide guidance to companies for future improvements to their disclosures. Executive compensation disclosure review remains a focal point of the Division's review program and the staff continues to comment on ways that companies can enhance their disclosure.

In 2009, the Commission sought to address investor information needs with its Proxy Disclosure Enhancements rulemaking,[3] which further amended its rules to require new disclosure concerning compensation and other corporate governance matters. These amendments were intended to enable investors to better analyze board performance, decision making processes and compensation practices.

An important component of the 2009 disclosure rules is a new requirement concerning the relationship of compensation and risk. In adopting this requirement, the Commission recognized that investors should have access to information about, and understand how, compensation structures and practices affect an executive or other employee's behavior and risk-taking. As noted by the Commission in proposing the new requirement, some had expressed concerns about incentive compensation policies that may have created inadvertent incentives for management or other employees to make decisions that

[3] SEC Release No. 33-9089 (December 16, 2009).

significantly, and inappropriately, increase the company's risk, without adequate recognition of the risks to the company.[4] Companies, and in turn investors, may be negatively impacted where the design or operation of their compensation programs creates incentives that drive behavior inconsistent with the overall goals and strategy of the company.

To address these concerns, the Commission adopted disclosure requirements in its 2009 rules concerning how companies reward and incentivize their employees to the extent these practices create risk to the company. More specifically, to the extent that risks arising from a company's compensation policies and practices are reasonably likely to have a material adverse effect on the company, companies must provide disclosure about those policies and practices. These disclosures apply with respect to compensation policies and practices for all employees – not just executives – if those policies create risks that are reasonably likely to have a material adverse effect on the company. In adopting this new requirement, the Commission used a materiality standard for this

[4] *See, e.g.*, Calvin H. Johnson, *The Disloyalty of Stock and Stock Option Compensation*, 11 CONN. INS. L.J. 133 (2004-2005); Michael C. Jensen, *et al.*, *Remuneration: Where we've been, how we got here, what are the problems, and how to fix them (2004)* (unpublished manuscript on file), available at www.ssrn.com/abstract=561305. The relationship between compensation incentives and risk also has been recognized in the legislation authorizing the Troubled Asset Relief Program ("TARP"). Specifically, Section 111(b) of the Emergency Economic Stabilization Act of 2008, as amended by Section 7001 of the American Recovery and Reinvestment Act of 2009, requires the Secretary of the Treasury to require each TARP recipient to meet appropriate standards for executive compensation and corporate governance that shall include "limits on compensation that exclude incentives for senior executive officers of the TARP recipient to take unnecessary and excessive risks that threaten the value of such recipient during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding." *See* Pub. L. 111-5, §7001, 123 Stat. 115, 517 (2009).

disclosure in an effort to guard against disclosure overload. Even where disclosure may not be required, we think the process of determining whether disclosure is required is a useful exercise in and of itself for companies. In comments to companies issued this year, Commission staff asked companies to explain what process they went through in deciding whether their compensation programs posed these risks, which provided us with insight into how companies reached the disclosure decisions they did.

In 2009, the Commission also adopted amendments to the proxy rules to set out the requirements for a say-on-pay vote at companies that received financial assistance under the Troubled Asset Relief Program.[5] Under the Emergency Economic Stabilization Act, these companies are required to permit an annual advisory shareholder vote on executive compensation. Consistent with the EESA, the Commission's rules require public companies that are TARP recipients to provide a separate shareholder vote on executive compensation in proxy solicitations during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding. These rules are intended to clarify what is necessary under the Commission's proxy rules to comply with the EESA vote requirement and help to assure that TARP recipients provide useful information to shareholders about the nature of the required advisory vote on executive compensation.

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[5] SEC Release No. 34-60218 (July 1, 2009).

Currently, the Commission's and staff's efforts in the area of executive compensation are focused on implementing the provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[6] that address an array of compensation issues. Section 951 of the Act requires a shareholder advisory "say-on-pay" vote on executive compensation at all companies that are subject to the Commission's proxy rules – not only at TARP companies – at least once every 3 years, and a separate advisory vote at least once every 6 years on whether the say-on-pay resolution will be presented every one, two, or three years. In addition, in any proxy statement asking shareholders to approve a merger or similar transaction, the Act requires disclosure about – and a shareholder advisory vote to approve – compensation related to the transaction, unless the arrangements were already subject to the periodic say-on-pay vote. The Dodd-Frank Act also requires that every institutional investment manager subject to Exchange Act Section 13(f) report at least annually how it voted on any of the required votes. Although the Dodd-Frank Act does not specify a deadline for rulemaking, the Commission's goal is to adopt final rules in time to inform the 2011 proxy season. Proposing releases for rules addressing these provisions will be available on the SEC web site when approved by the Commission.

Section 957 of the Dodd-Frank Act also requires the rules of each national securities exchange to be amended to prohibit brokers from voting uninstructed shares on the

[6] *See* Sections 951 through 957, and 971 through 972 of the Dodd-Frank Act.

election of directors, executive compensation, or any other significant matter, as determined by the Commission by rule. The Commission previously approved changes to New York Stock Exchange ("NYSE") Rule 452 to prohibit broker voting of uninstructed shares in director elections,[7] and on September 9, 2010 approved further changes to the NYSE rules to prohibit broker voting on all executive compensation matters, which include the say-on-pay votes.[8]

Section 952 of the Dodd-Frank Act also requires the Commission to write rules mandating new listing standards relating to the independence of compensation committees and establishing new disclosure requirements and conflict of interest standards that boards must observe when retaining compensation consultants. These rules must be prescribed by the Commission within 360 days from the date of enactment of the Act, and the Commission anticipates proposing such rules soon.

In addition, Section 953 of the Act requires the Commission to amend our executive compensation disclosure requirements to require companies to disclose information showing the relationship between executive compensation actually paid and the financial performance of the company, as well as information about the total annual compensation

7 *See* New York Stock Exchange Rule 452.11(19) and Listed Company Manual Section 402.08(B)(19); SEC Release No. 34-60215 (July 1, 2009), 74 FR 33293 (July 10, 2009) (SR-NYSE-2006-92).

8 SEC Release No. 34-62874 (September 9, 2010). We anticipate that corresponding changes to the rules of other national securities exchanges will be considered by the Commission in the near future.

of the chief executive officer, the median annual total compensation of all other employees, and the ratio between these two amounts. Rule amendments are also mandated by Section 955 of the Dodd-Frank Act that will require companies to disclose in their annual meeting proxy materials whether any employee or director is permitted to purchase financial instruments designed to hedge any decrease in market value of equity securities granted as part of their compensation or held by the employee or director. Section 954 of the Dodd-Frank Act further requires the Commission to adopt rules mandating changes to listing standards requiring companies to implement and disclose "clawback" policies for recovering from current and former executive officers incentive-based compensation paid during any 3-year period preceding an accounting restatement due to material non-compliance with financial reporting requirements. The Dodd-Frank Act does not specify deadlines for rulemaking on these provisions, but the Commission's goal is to publish proposed requirements by July 2011.

Finally, the Commission and its staff are working to implement Section 956 of the Dodd-Frank Act, which requires the Commission and other federal regulators[9] to jointly prescribe regulations or guidelines applicable to "covered financial institutions," including, for the Commission, registered broker dealers and investment advisers with assets of $1 billion or more. The regulations or guidelines will require disclosure to the appropriate federal regulators of the structures of incentive-based compensation and

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9 The other entities specified in Section 956 are the Federal Reserve, Office of the Comptroller of the Currency, the FDIC, the Office of Thrift Supervision, the National Credit Union Administration Board, and the Federal Housing Financing Agency.

prohibit incentive-based payment arrangements that the regulators determine encourage inappropriate risks by covered financial institutions, and must be comparable to the standards applicable to insured depository institutions under the Federal Deposit Insurance Act. The rules or guidelines must be prescribed no later than nine months after the enactment of the Act. Commission staff is working with other federal financial regulators to develop appropriate regulations or guidelines within this timeframe.

To maximize the opportunity for public comment and to provide greater transparency in the rulemaking process, the Commission has made available to the public a series of e-mail boxes to which interested parties can send preliminary comments before the various rules are proposed and the official comment periods begin.[10] These e-mail boxes are on the SEC website, organized by topic. Since July 27th, the public has been providing preliminary comments on 31 topics, including the executive compensation provisions of the Dodd-Frank Act. The comments we have received to date range from those expressing general concern regarding executive compensation practices at public companies to others providing detailed suggestions with regard to the Commission's implementation of specific provisions of the Dodd-Frank Act.

[10] SEC Chairman Schapiro Announces Open Process for Regulatory Reform Rulemaking, Press Release 2010-135 (July 27, 2010), http://www.sec.gov/news/press/2010/2010-135.htm.

Conclusion

As governance and compensation practices continue to evolve, the Commission will remain steadfast in its efforts to assure that our disclosure rules provide investors with the information they need to make informed investment decisions, including in our work to implement the provisions of the Dodd-Frank Act addressing compensation issues. Further, we are committed to working with our fellow regulators to prescribe the regulations or guidelines for covered financial institutions as mandated by the Dodd-Frank Act.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

STATEMENT OF

MARC STECKEL

ASSOCIATE DIRECTOR
DIVISION OF INSURANCE AND RESEARCH
FEDERAL DEPOSIT INSURANCE CORPORATION

on

EXECUTIVE COMPENSATION OVERSIGHT
AFTER THE DODD-FRANK WALL STREET REFORM
AND CONSUMER PROTECTION ACT OF 2010

before the

Committee on Financial Services
U.S. House of Representatives

September 24, 2010
2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the FDIC's oversight of the executive compensation practices of insured depository institutions (IDIs).

Compensation programs are critical tools that contribute to the successful management of financial institutions. Properly run compensation programs can aid in the attraction and retention of qualified staff and the alignment of employee performance with organizational objectives. Federal banking regulators, many academics, and others agree that the incentive compensation practices of financial firms were a contributing factor to the excessive build-up of risk that precipitated the recent global financial crisis.

As the economic crisis continued to unfold, the federal banking agencies took steps to curb the potentially risky compensation practices that were proliferating at financial institutions. In November 2008, the federal banking agencies issued the interagency *Statement on Meeting the Needs of Creditworthy Borrowers*. In addition to addressing credit availability, this guidance emphasized the importance of properly structuring compensation. In early 2010, the FDIC joined the Federal Reserve Board (FRB) in its initial review of the compensation practices among large IDIs. In June, we also joined with the FRB, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision in issuing guidance on compensation practices.

During the past year the FDIC has explored whether, as the deposit insurer, there is specific action we could take to price for risky incentive compensation practices in deposit insurance assessments. The FDIC believes that the structure of employee incentive compensation programs can affect the overall risk profile of financial institutions, including IDIs. This, in turn, can affect the long-term performance of these institutions. Thus, the FDIC, as both a primary federal regulator and deposit insurer, is concerned with how certain incentive compensation programs can influence the risk-taking behavior of an IDI's employees.

Our testimony provides general background on studies of incentives and compensation practices. We discuss our supervision of those practices and the requirements outlined in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Finally, we outline the FDIC's recent proposal to address certain incentive compensation practices through the risk-based assessment system.

Literature on Compensation that Influences Employee Risk-Taking

Our review of work by academics, consulting groups and others indicates that compensation structures influence incentives and can induce excessive and imprudent risk taking within financial organizations. FDIC staff also reviewed a selection of Material Loss Reviews issued by the Inspectors General for the FRB, the FDIC, and the Department of the Treasury, and found that a number of those reviews cited the compensation practices at the failed IDIs as a contributing factor in the institutions' failure.

The FDIC shares the view that incentive compensation practices influence the amount of risk undertaken by an institution and, in particular, that the composition of an executive's compensation will affect his or her willingness to engage a firm in risk-taking activity. Although not specific to the financial services industry, a 2005 study by Moody's Investors Service found that large unexplained bonus and option awards were predictive of default and large ratings downgrades in firms.[1]

With respect to IDIs, arguments by academics and others that these institutions are different from nonfinancial firms are well-known. Many believe that these differences influence the way economists and policymakers should think about corporate governance, executive compensation, and risk taking in banking.[2] In particular, IDIs are more highly leveraged than nonfinancial firms and because of deposit insurance, many IDI liability holders have weaker incentives to engage in risk-monitoring activities than holders of other types of debt.

Additionally, prior to the passage of the Dodd-Frank Act, arguments had been

[1] Moody's Investors Service, Special Comment: CEO Compensation and Credit Risk (July 2005) (available at http://www.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20pages/Credit%20Policy%20Research/documents/current/2003600000426617.pdf).

[2] See, for example, Macey, Jonathan R. and Maureen O'Hara. 2003. The Corporate Governance of Banks. *Economic Policy Revie,* Federal Reserve Bank of New York. April: 91-107. John, Kose, Anthony Saunders and Lemma W. Senbet. 2000. A Theory of Bank Regulation and Management Compensation. *The Review of Financial Studies* 13, no. 1: 95-125.

made that the likelihood the government would bail out large financial institutions lessened any incentive for uninsured depositors and other debt holders to monitor a large IDI's risk-taking activities (the "too-big-to-fail" problem). Such a possibility could also have made employees more willing to undertake excessive amounts of risk and for stockholders to allow excess risk to be taken. In a book published earlier this year, the Squam Lake Working Group on Financial Regulation (Squam Lake Group) noted that, "[b]ecause the owners and employees of financial firms do not bear the full cost of their failures, they have an incentive to take more risk than they otherwise would. This, in turn, increases the chance of bank failures, systemic risk, and taxpayer costs."[3]

The Squam Lake Group argued that a major goal of financial reform should be to force financial firms to bear the full cost of their actions. To this end, they suggested that regulators take steps to reduce employees' incentives to take excessive risk. Specifically, they recommended that systemically important financial firms should be required to hold back a significant share of each senior manager's annual compensation for a period of time. The authors also argued that such compensation should be for a fixed dollar amount—not stock or stock options. In this way, senior managers would become creditors of the firm and the deferred compensation they were owed would reduce any incentive they have to pursue risky strategies that might result in a government bailout. The Squam Lake Group argued that deferred compensation should be forfeited if the firm becomes bankrupt or receives extraordinary government assistance.

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[3] Squam Lake Working Group on Financial Regulation, 2010, Regulation of Executive Compensation in Financial Services. Council on Foreign Relations. Working Paper at 2.

A number of empirical studies have analyzed the relationship between executive compensation, risk taking, and the performance of IDIs. Most of these studies, however, have focused solely on the compensation of the chief executive officer (CEO). Earlier studies tend to find a more tenuous relationship between CEO compensation and firm performance. One early study found little evidence to support the claim that the structure of an IDI's CEO compensation provides incentives for risk taking.[4] Other studies attributed the strengthening of the relationship between CEO compensation and bank performance to the deregulation that occurred in the industry during the 1990s.[5] More recent studies, however, have found relationships between compensation and IDI performance and have also linked the use of option-based compensation to greater risk taking.[6]

A recent working paper by DeYoung, Peng and Yan investigates how the terms of CEO contracts at large commercial banks influenced or were influenced by the risk

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[4] See: Houston, Joel F. and Christoper James. 1995. CEO Compensation and Bank Risk: Is Compensation in Banking Structured to Promote Risk Taking? *Journal of Monetary Economics* 36: 405-431.

[5] See: Crawford, Anthony J., John R. Ezzell and James A. Miles. 1995. Bank CEO Pay-Performance Relations and the Effects of Deregulation. *The Journal of Business* 68, no. 2: 231-256. Hubbard, R. Glenn and Darius Palia. 1995. Exeuctive Pay and Performance: Evidence from the U.S. Banking Industry. *Journal of Finaricial Economics* 39: 105-130. Fields, L. Page and Donald R. Fraser. 1999. On the Compensation Implications of Commercial Bank Entry into Investment Banking. *Journal of Banking & Finance* 23: 1261-1276.

[6] Harjoto, Maretno A. and Donald J. Mullineaux. 2003. CEO Compensation and the Transformation of Banking. *The Journal of Financial Research* 26, no. 3: 351-354. John, Kose and Yiming Qian. 2003. Incentive Features in CEO Compensation in the Banking Industry. *Economic Policy Review* Federal Reserve Bank of New York. April: 109-121. Adams, Renee and Hamid Mehran. 2003. Is Corporate Governance Different for Bank Holding Companies? *Economic Policy Review* April: 123-142. Also see, Chen, Carl R., Thomas L. Steiner and Ann Marie Whyte. 2006. Does Stock Option-Based Executive Compensation Induce Risk-Taking? An Analysis of the Banking Industry. *Journal of Banking & Finance* 30: 916-945. DeYoung, Robert, Emma Y. Peng and Meng Yan. 2010. Executive Compensation and Business Policy Choices at U.S. Commercial Banks. The Federal Reserve Bank of Kansas City Research Working Papers RWP 10-02.

profiles of these firms. Using data from 1994 to 2006, the paper finds strong evidence that CEOs took on more risk in response to the risk-taking incentives of their compensation contracts. The paper also found that the sensitivity of CEO wealth to changes in the volatility of their IDI's stock returns increased dramatically during the period. CEOs with higher sensitivity to stock market volatility took on greater credit and market risks at their IDIs.

Although most compensation studies have focused on the relationship between compensation and the performance of CEOs or top-level executives, some literature examines compensation for lower-level employees and whether such compensation also contributed to excessive risk taking in the most recent financial crisis. In a 2009 paper, Aggarwal and Wang examine data on the compensation of small business loan officers from a major commercial bank. They find that switching compensation practices to incorporate incentive-based compensation for these loan officers resulted in riskier underwriting and poorer performance than a control group that received fixed compensation.[7]

The FDIC as Safety-and-Soundness Regulator

Section 39 of the Federal Deposit Insurance Act

After the economic downturn in the late 1980s, Congress took action to prescribe certain safety-and-soundness standards for financial institutions and revised Section 39 of

[7] Agarwal, Sumit and Faye H. Wang. 2009. Perverse Incentives at the Banks? Evidence from a Natural Experiment. Federal Reserve Bank of Chicago Working Paper 2009-08.

the Federal Deposit Insurance Act (FDI Act).[8] As revised, Section 39 requires each appropriate federal banking agency for all IDIs to, among other things, prescribe standards to prohibit, as an unsafe-and-unsound practice, employment contracts, compensation or benefit agreements, perquisites, stock option plans, post employment benefits, and other compensatory arrangements that would provide employees with "excessive compensation, fees, or benefits" or that "could lead to material financial loss to the institution."

In response to this mandate, the FDIC, along with the other federal banking regulators, issued *Interagency Guidelines Establishing Standards for Safety and Soundness.*[9] Among other things, these guidelines provide that "excessive compensation" and "compensation that could lead to a material financial loss to an insured institution" are prohibited as unsafe-and-unsound practices. The guidelines provide that compensation shall be considered "excessive" when amounts paid to the employee are unreasonable or disproportionate to the services actually performed, considering specified factors outlined within the guidelines.

[8] 12 U.S.C. § 1831p-1 was added by the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242, 105 Stat. 2236, and subsequently amended by the Housing and Community Development Act of 1992, Pub. L. 102-550, 106 Stat. 3895 (1992) and the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325, 108 Stat. 2160 (1994).

[9] 12 C.F.R. Part 364 Appendix A.

The FDIC and the other federal banking agencies also have the authority to restrict compensation when institutions' capital levels fall below certain thresholds under Section 38 of the FDI Act (Prompt Corrective Action).[10]

Golden Parachutes

In addition to the safety-and-soundness standards, Congress created restrictions on golden parachute payments through title XXV ("Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990") of the Crime Control Act of 1990.[11] Importantly, these restrictions apply to institutions that are in a "troubled" condition. The purpose of restricting golden parachute payments was to prevent officers and directors of IDIs, or their holding companies, from voting generous compensation for themselves at the expense of their troubled financial institutions.

The statute does not restrict golden parachute payments directly; rather, it authorizes the FDIC to "prohibit or limit, by regulation or order, any golden parachute payment or indemnification payment" and lists a number of factors for the FDIC to consider in restricting golden parachute payments to institution-affiliated parties ("IAPs").[12]

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[10] 12 U.S.C. § 1831o.

[11] Pub. L. No. 101-647, 2523, 104 Stat. 4789, 4867 (codified at 12 U.S.C. § 1828).

[12] 12 U.S.C. §1828(k)(1)-(2).

The FDIC's regulations address both entering into agreements to make golden parachute payments, as well as actually making such payments, when an institution is in a troubled condition. The regulations permit limited exceptions by application. As more banks are falling into the "troubled condition" category, thereby triggering the golden parachute restrictions, the FDIC is preparing new guidance on the regulation of golden parachutes. The guidance to the industry will highlight the golden parachute rules and clarify the application process for exceptions and the factors considered in the review of those applications. This proposed guidance will ensure that applications made on behalf of senior management of a troubled institution will continue to be subject to heightened scrutiny that will include an evaluation of the individual's performance as well as his or her influence and involvement over major corporate initiatives and policy decisions, especially any actions that may have facilitated high-risk banking strategies.

Recent FDIC Supervisory Actions

As noted above, as part of their response to the financial crisis, the federal banking agencies moved to strengthen regulation of compensation at financial institutions. In November 2008, the federal banking agencies issued the interagency *Statement on Meeting the Needs of Creditworthy Borrowers*. In addition to addressing credit availability, this guidance emphasized the importance of properly structuring compensation. The Statement warned that poorly designed management compensation policies can create perverse incentives that can ultimately jeopardize the health of a banking organization. In addition, such policies are to be supported by independent risk management and control functions.

The FDIC then began working with the FRB on compensation issues in early 2010 by participating in the FRB's horizontal review of incentive compensation practices at large banks. The interim results of these reviews revealed common incentive compensation weaknesses in the following areas: identifying covered employees, balancing risk and reward, designing and monitoring incentive compensation programs, assessing the compatibility of incentive compensation with risk management and control functions, and implementing effective corporate governance.

In June 2010, the FDIC joined with other federal banking agencies in issuing interagency *Guidance on Sound Incentive Compensation Policies.*[13] The guidance identifies three key principles. Compensation arrangements should:

- Provide employees with incentives that appropriately balance risk and reward;
- Be compatible with effective controls and risk-management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

As a follow-up to the interagency guidance, the FDIC is developing enhanced examination procedures to use in evaluating incentive compensation at our institutions during each safety and soundness examination and in connection with processing relevant institution applications. In the coming months, the FDIC and the other federal banking agencies will contribute to an FRB report on trends and developments in compensation.

[13] 75 FR 36395 (June 25, 2010)

The Dodd-Frank Act

The Dodd-Frank Act requires the federal banking agencies to prescribe joint regulations or guidelines to enhance reporting of incentive compensation structures and to prohibit certain compensation arrangements. Specifically, the act mandates that incentive-based compensation should be prohibited when it encourages inappropriate risks by providing employees with compensation that is "excessive" or "could lead to material financial loss." The FDIC has begun discussions with other financial regulators to implement the requirements of the Dodd-Frank Act. Implementation of these requirements will further strengthen the FDIC's and other federal banking regulators' authority over, and supervision of, compensation practices at IDIs and affiliated entities.

The FDIC as Deposit Insurer

The FDIC is also concerned about the incentive compensation practices of IDIs because of our unique role as deposit insurer. Among other things, the Federal Deposit Insurance Reform Act of 2005 gave the FDIC, through its rulemaking authority, the opportunity to better price deposit insurance for risk.[14] Poorly designed incentive compensation practices at IDIs can motivate employees to engage in imprudent and excessively risky activities on behalf of the institution that can ultimately pose potential risk and cost to the DIF. The FDIC is examining whether and, if so, how the risk-based

[14] Section 2109(a)(5) of the Federal Deposit Insurance Reform Act of 2005. Section 7(b) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)).

deposit insurance assessment system should price for such risks.

As a first step, the FDIC Board of Directors voted to issue an Advance Notice of Proposed Rulemaking (ANPR) in January of this year to explore what action it could take as deposit insurer that would complement the supervisory guidance and standards being developed domestically and internationally.[15] Supervision, by its nature, focuses on defining the minimum standards that all institutions must meet in order to continue operation. The FDIC, as deposit insurer, is also concerned with how differences in risks among institutions can contribute to their likelihood of failure. With this in mind, the FDIC sought comment on whether, in conjunction with the supervisory guidance and standards being developed, it should price the risk posed by poorly designed incentive compensation practices directly into the deposit insurance assessment system.

In issuing the ANPR, the FDIC made clear that it did not seek to limit the amount of employee compensation or to limit its concern only to executives of the IDI. Rather, our concern was whether IDI incentive compensation programs are structured so that employees have incentives that are aligned with the long-term interests of the IDI and that such programs reward employees for focusing on risk management. The ANPR included a preliminary model of how the FDIC might assess the potential risk to the DIF posed by an IDI's incentive compensation program.

The comments we received fell into two groups, those that stated the FDIC should

[15] 75 FR 2823 (Jan. 19, 2010)

pursue rulemaking and those that stated the FDIC should allow time for supervisory efforts to be finalized. A number of the comments addressed the specific questions in the ANPR and provided valuable suggestions regarding specific aspects of the proposal. Staff reviewed these comments and is undertaking a more in-depth study of how best to protect the DIF from the risk posed by poorly designed incentive compensation practices. As a part of this undertaking, staff is also studying whether risk-based premiums should be used to provide incentives for IDIs to design incentive compensation programs that go beyond supervisory standards.

Moving Forward

Our research on incentive compensation finds, as did the recent interagency guidance, that there are improvements to incentive compensation practices that IDIs can take that could motivate their employees and better hold them accountable for the long-term risk that their activities pose to the IDI.

First, Boards of Directors and senior managers of IDIs should take primary responsibility for ensuring that the IDI's incentive compensation programs effectively align employees' motivations with the long-term interests of the IDI. This could be accomplished, for example, by adopting corporate governance structures that would include a separate compensation committee of the board of directors (this structure may be adjusted to accommodate the realities of staffing boards of directors in smaller institutions). At least annually, this committee would review and approve the compensation program(s) for senior executives and other highly compensated employees of the IDI.

Second, IDIs should require that portions of incentive compensation above certain levels be deferred at least for senior executives and designated employees who have the ability to directly influence the amount and type of risk undertaken by the institution. Such compensation, however, could be extended to other employees as appropriate. Additionally, the receipt of deferred compensation must be conditioned on the long-term results of the original justification of the award ("look-back"). Academics, international bodies, and compensation experts recognize that the full, immediate payment of an incentive compensation award may cause an employee to disregard the longer-term consequences of his or her activities that form the basis of the award. To focus employee behavior on longer-term consequences, deferred compensation must be coupled with an effective look-back mechanism that permits the institution to reduce or rescind the compensation if the original justification for the award proves to be invalid.

Whether these practices are implemented as a result of our collaboration with other regulators or by incorporating the risk posed by incentive compensation practices into our risk-based premium system, or a combination of actions, the FDIC believes their implementation is important for controlling risk to the DIF.

Conclusion

The FDIC recognizes that a broad range of compensation practices exist among IDIs. We understand (as many of the commenters to our ANPR noted) the importance of avoiding a "one-size-fits-all" approach when discussing how an IDI could improve its incentive compensation practices. FDIC staff will continue to work with our fellow regulators and continue to seek ways to bring our unique perspective and capacity as deposit insurer to bear on this important issue. IDIs that are significant users of incentive compensation programs need to ensure that their employees are motivated to consider not just the potential for short-term benefit from the risks they undertake on behalf of the IDI, but also to realize the longer-term consequences that undertaking those risks may pose.

Again, thank you for the opportunity to testify. I look forward to your questions.

Written Testimony

Darla C. Stuckey

Senior Vice President – Policy & Advocacy
Society of Corporate Secretaries and Governance Professionals

September 24, 2010

Committee on Financial Services
United States House of Representatives

"Executive Compensation Oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act"

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Written Testimony of Darla C. Stuckey – Senior Vice President - Policy & Advocacy, Society of Corporate Secretaries and Governance Professionals

Introduction

My name is Darla C. Stuckey and I am currently Senior Vice President – Policy & Advocacy, for the Society of Corporate Secretaries and Governance Professionals (the "Society"). The Society is a professional association, founded in 1946, with over 3,100 members who serve more than 2,000 companies. Our members are responsible for supporting the work of corporate boards of directors and their committees and the executive management of their companies regarding corporate governance and disclosure. At our companies we seek to develop corporate governance policies and practices that support our boards in the important work and that serve the interests of long term stockholders. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements. The majority of Society members are attorneys, although our members also include other non-attorney governance professionals. More than half of our members are from small and mid-cap companies.

I have previously served as Corporate Secretary at the NYSE and as Senior Assistant Corporate Secretary at the American Express Company. Prior to that I practiced law at Weil, Gotshal & Manges in the Securities Litigation department.

The Society is honored to give testimony before this Committee.

Background

The Committee has asked for the Society's views on the likely effects of the implementation of the compensation-related provisions of the Dodd-Frank Act, particularly with respect to whether they will be effective in correcting incentive compensation structures that can lead to excessive risk taking. You also asked for our views on the considerations that Federal regulators should take into account during their rulemaking to implement the compensation-related provisions of the Act. The majority of my testimony will be focused on the latter of these two requests, with some very specific suggestions for the Securities and Exchange Commission relating to the relevant provisions of the Dodd-Frank Act.

The Society is uniquely positioned to provide insight into the practical implications of the statute and the implementing rules, and the potential unintended consequences of them, because our members serve the boards of directors of their companies, including their compensation and risk committees, are familiar with executive compensation practices and risk management policies at their companies and are involved in the development of public disclosures of compensation practices and risk. In addition, a number of our members serve as Compliance Officers at their companies, in addition to performing the role of Corporate Secretary.

Without taking a position on the impact of the Act specific to financial services companies (since all companies are covered by Dodd-Frank), we do believe that the governance changes required under Dodd-Frank, along with the other SEC rules implemented since the financial crisis of 2008 generally will facilitate public companies' efforts to manage and oversee risk. More specifically, however, we note our concerns below with the implementation of the rules based on our perceptions of Congress' intent.

Our comments focus on five executive compensation sections, and the whistleblower provision in Section 922, of the Dodd-Frank Act.

1. Say-on-Pay

Section 951 of the Act requires public companies to provide their shareholders periodically (at least once every 3 years) with a non-binding vote ("say-on-pay") on the compensation of their executives, based on the compensation paid to the company's executive officers named in the proxy statement for the annual meeting, which includes the compensation committee report, compensation discussion and analysis, executive compensation tables and related disclosures. Say-on-pay is required for all shareholder meetings after January 21, 2011. The Act also requires public companies to provide their shareholders a non-binding vote on how frequently the shareholders would be presented with a say-on-pay vote ("say-when-on-pay") (discussed below).

Comments

SEC Final Rules and Guidance Needed Before January 21, 2010

The most recently published SEC implementation schedule targets adoption of say-on-pay and say-when-on-pay rules sometime between January and March of 2011. We respectfully submit that such a schedule is too late to afford public companies sufficient time to comply with the new rules in the upcoming 2011 proxy season, as required by the Act. We urge the SEC to propose these rules in early October so they can be adopted prior to January 21. This is because companies must soon begin to develop their executive compensation disclosures and say-on-pay (and say-when-on-pay) proposals. Most Boards meet in December, January or February to make final decisions on the executive compensation to be disclosed in that year's proxy statement. Many proxy statements are printed and distributed to shareholders in February and March for annual meetings taking place in April and May. In order for public companies to implement the new rules this proxy season, we respectfully submit that the SEC should propose formal rules in early October so that they can be adopted prior to January 2011.

Suggest Using TARP Model

Given the short time frame, we also suggest that the SEC follow the approach similar to that taken for the TARP companies last year which allowed companies flexibility to discuss in the text of the proposal why shareholders should approve the resolution. Indeed, if the SEC were to make clear that in 2011, companies could model their proposals on those used by TARP companies, it would reduce current uncertainty.

In addition, companies still subject to the Emergency Economic Stabilization Act of 2008 (the "Stabilization Act") should be able to satisfy the provisions in Dodd-Frank with a single say-on-pay resolution, including a resolution previously used under the Stabilization Act.

Proxy Advisory Firm Influence Should be Considered

Finally, we ask that the SEC carefully consider the influence of proxy advisory firms and their "one-size-fits-all" policy application in the area of executive compensation when writing these rules.

Almost half of Society members responding to a recent survey indicated that 30% or more of their companies' shares are voted in line with proxy advisory firm recommendations. And over 60% of those responding noted that proxy advisory firm recommendations had been based on materially inaccurate or incomplete information at least once, and of those recommendations, 60% were not corrected. This data indicates that proxy advisory firms frequently make mistakes when analyzing individual company's compensation plans.

Clarify that Preliminary Proxies Will Not Be Required as a Result of the Say-on-Pay Vote

We note that the SEC has informally indicated that preliminary proxies will not be required as a result of the say-on-pay vote, as was the case with TARP companies that were required to provide say-on-pay votes. We respectfully request the SEC to formalize its position and specifically exempt companies from the requirement to file preliminary proxies as a result of providing the say-on-pay vote, and also clarify that the exemption also will apply to those companies still subject to the TARP say-on-pay requirements.

2. Say on Pay Vote Frequency (or "Say When on Pay")

In addition to the vote on executive compensation, companies must also ask shareholders to cast a non-binding vote on whether the company should hold shareholder advisory votes on executive compensation every one, two or three years. After the first "say-when-on-pay" vote, shareholders must be asked at least once every six years whether they prefer an annual, biennial or triennial advisory vote. Finally, the say-on-pay votes will not preclude shareholder proposals "related to executive compensation."

Comments

Company Choice Regarding the Type of Resolution for "Say When on Pay"

Companies will need to determine the preference of their shareholders as to the frequency of say-on-pay votes, and many are canvassing investors at this time to get a sense of their preferences. The SEC rule making on this provision should provide boards a choice whether to offer a resolution with a single recommended choice (e.g. every two years), or a resolution that would give the board's preference but ask for a vote on a one, two or three year frequency in a multiple-choice fashion.

Without elaborating on the rationales for the different frequencies, we submit that this vote should be influenced by a board recommendation. Some boards whose companies have multi-year incentive compensation plans may be well-positioned to recommend a biennial or triennial approach, while others may recommend an annual vote based on its understanding of the interests of shareholders. Boards are in the best position to recommend the frequency of the vote, to ensure that the timing of the vote is aligned with the compensation program and the duration of the incentive structure. It will be up to the shareholders of each company to indicate their views under either type of vote.

The Rules Should Not Allow Shareholder Proposals on Alternative Frequency for Say-on-Pay Votes

The Society believes the SEC in its rulemaking should clarify that a shareholder proposal seeking an alternative one, two or three year scheme would be excluded to avoid unnecessary uncertainty, confusion or conflict with the company's proposal. The Dodd-Frank Act provides that the say-on-pay votes will not preclude shareholder proposals "related to executive compensation." This text means that shareholders should and will be able to continue to submit proposals relating to substantive aspects of executive compensation policies or practices, but not relating to the frequency of a say on pay vote, which we believe is procedural and not "related to executive compensation." Moreover, the statute clearly specifies that the frequency vote should be taken at least every six years, which would be meaningless if the statute were interpreted to allow proposals in any year on any frequency. With that interpretation, a company could be faced with three shareholder proposals each year for a one, two or three year frequency. We don't believe this was the intent of Congress, as it would provide no benefit to shareholders while consuming management time and resources.

3. Pay versus Performance Disclosure

Section 953(a) of the Act requires that companies disclose "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions." The definition of "executive compensation actually paid" will need to be determined and could differ from "total compensation" disclosed in the Summary Compensation Table today.

Comments

SEC Should Allow Flexibility to Make Disclosure Meaningful

We urge the SEC to implement rules with enough flexibility to allow compensation committees to explain their decisions, to explain when compensation is "actually paid," over which period performance is measured, and how performance is measured.

We believe there is a potential here for a comparison of compensation paid to financial performance to be based on a timing mismatch. For example, a graphical comparison of the total compensation figure as required to be disclosed in the Summary Compensation Table of the proxy statement to the company's stock price on a particular date would not capture the fluctuation in value of equity-based awards held by executives that were awarded in prior years as long-term compensation. This type of comparison would not accurately reflect the change in value (up or down) of the executive's compensation over time in the same way the change in value of an equity investment in the company would be shown on the same graph. While this would be a simple way of using data currently disclosed in the proxy statement, it would not tell the entire story of how the value of the executive's compensation relates to the company's performance over time. As there is a range of views about what type of depiction would tell the entire story, the SEC should allow those views to play out and not dictate one single method for companies to use when attempting in good faith to tell the full story.

4. Internal Pay Ratio

Section 953(b) of the Act states that companies must disclose the median of the annual total compensation of all employees of the company (other than the CEO) as well as the annual total compensation of the CEO, and then provide a ratio comparing those two figures. Calculation of "annual total compensation" of an employee for purposes of this provision must be determined in accordance with the rules for named executive officers in Item 402 of Regulation S-K, e.g., "the total compensation of an employee of the issuer shall be determined in accordance with section 229.402(c)(2)(x) of title 17, Code of Federal Regulations, as in effect on the day before the date of enactment of the Act." Furthermore, this disclosure will be required in any filings "described in Section 10(a)," which covers much more than proxy statements and annual reports on Form 10-K.

Comments

The SEC implementation schedule contemplates these rules will be in place for the 2012 proxy season. The Society supports a later implementation for this provision given the broad scope of the statute and the many technical clarifications that will be needed before companies can start gathering the data necessary to comply, some of which data could be particularly time-consuming and costly to produce depending on what those clarifications say. We believe the clarifications should be driven both by Congress' intent for the statute and the practical realities of collecting the data needed to comply. We believe that it was Congress' intent to have companies show a rough comparison of the compensation of the average or median laborer in the United States to the compensation of corporate CEOs.

However, a plain reading of the statute would lead most regulators and companies to conclude that the comparison must be one of the median worker in the company's entire global workforce to that of the CEO. This latter interpretation would necessitate a much different and more involved exercise in gathering data from around the world. It would also involve issues of how to value certain unique types of compensation given only in certain countries, what exchange rates to use, and differences in accounting for benefits such as pensions in different counties. We don't believe it was Congress' intent to introduce these types of cross-border issues. Also, we believe that a comparison of the compensation of the average or median U.S. worker to that of the CEO would be a more relevant and meaningful comparison for the investing public than a comparison of the compensation of the average or median worker worldwide to that of the CEO. Based on this understanding of Congress' intent, we would suggest the following:

Clarify that the Scope Includes Only U.S.-Based Full-Time Workers

We believe the statute, either through SEC rule-making or technical amendment, should be clarified to provide that "all employees of the issuer" means only U.S.-based, full-time employees. This change alone will greatly clarify Congress' intent and at the same time will reduce many of the data-gathering challenges for companies with significant operations in other markets.

Limit Total Compensation to Total Direct Compensation—Exclude Pension Accrual

We believe the statue should be clarified to provide that "total compensation" be interpreted broadly to include total direct compensation, that is, all cash compensation (base salary and cash bonuses) and equity-based compensation, but <u>exclude</u> pension accruals, benefits and other non-cash items. Alternatively, we would request that the SEC allow companies to identify the median worker without including pension accrual, benefits and other non-cash items. Thereafter, once the median worker is identified, a single calculation for that worker, including pension accrual, benefits and other non-cash items, could be done and added into total compensation for purposes of determining the ratio.

Require the Ratio Only in a Company's Annual Meeting Proxy

We believe the statue should be clarified to require that this ratio be disclosed only in an annual meeting proxy, rather than in all publicly filed documents. We have reason to believe this was Congress' intent.

Clarify that the "total compensation" takes into consideration future changes in Section 402 of Regulation S-K

We believe that the statute should be clarified to provide that the SEC has authority to implement rules that define "total compensation" under the executive compensation disclosure rules set forth in section 229.402 of title 17, Code of Federal Regulations, **or any successor thereto**, so that the computation of "total compensation" keeps pace with any future changes to the SEC's rules. Further, the SEC should be given express authority to interpret the terms used in Section 953(b) and promulgate rules as it believes is in the best interest of investors and companies.

Allow Issuers to Make Reasonable Estimates

We believe that issuers should be permitted to make reasonable estimates and assumptions when determining their median employee for purposes of identifying the median of the annual total compensation of all of their employees, so long as those estimates and assumptions are adequately explained as part of the required disclosure.

5. Clawbacks

Section 954 of the Act creates a new Section 10D of the Exchange Act requiring listed companies to develop and implement policies to recapture—or "clawback"—incentive compensation "based on financial information required to be reported under the securities laws" that is "erroneously awarded" to executives that would not otherwise have been received in the event of a restatement of the company's financial statements. This requirement is mandatory, provides a Board no explicit discretion as to whether or how much to recoup, covers all present and former executive officers, and does not require misconduct by the company or any officer as a condition to invoking the clawback. Given its broad application and relatively expansive scope, the clawback provision may be one of the most significant aspects of the Act.

The clawback provisions of the Dodd-Frank Act go well beyond existing law and practice. The Act requires a listed company in the case of an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement, to recover:

• from all present and former "executive officers" (not just the executives named in the proxy statement)
• any incentive-based compensation (including stock options) received in excess of what would have been paid under the accounting restatement
• for three years preceding the date on which the company is required to prepare the restatement

• regardless of whether there was any fraud or misconduct involved (that is, the policy must apply to any accounting errors, intentional or not, resulting in a material restatement).[1]

Comments

Boards Should Have Discretion to Determine Whether to Claw Back

Because some incentive compensation (especially the annual incentive) is awarded based in part on achievement of certain metrics and in part based on the compensation committee's judgment, the committee or full board must be able to determine under what circumstances to recoup such compensation. The board should be given the same amoun of discretion in recouping awards as was used in the original grant of an award. In addition, the Board must be allowed to determine if recoupment would cost more than the expected recovery amount is worth—and that is whether it would have to pursue litigation to recoup, the likelihood of recovery and any violation of existing contract or state law prohibitions. It would be perverse to require a clawback in every instance even where the recovery would be result in a higher cost to recover than is the amount being recouped. We do not believe that was the intent of Congress, and the SEC should interpret the statute to allow such discretion for the board in the exercise of its fiduciary duties to determine what is in the collective best interest of the company and its shareholders.

Boards Should Have Discretion to Determine How to Recoup Funds

Similarly, Boards or compensation committees should have the ability to make the company whole by canceling unvested awards, setting off amounts owed from existing deferred compensation accounts if applicable, or any other method that would result in recovery of the value owed by the executive.

SEC Must Clarify Which Compensation is Subject to Recoupment

The no-fault clawback provision will have a significant impact on all executive officers who have received pay tied to metrics based on financial measures. The SEC should make clear which compensation will be subject to recoupment and which will not. Reported financial information includes revenue, net income and earnings per share. Incentive compensation, however, is sometimes granted based on metrics such as stock price, total shareholder return, and market share and/or customer satisfaction.

A Clawback Provision Which Is Less Prescriptive Would Support the Intent of Congress

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[1] The Society acknowledges comments submitted by the Center on Executive Compensation to the SEC, dated September 1, 2010, and recommends them to the Committee, particularly Section IV regarding the many unique incentive compensation plan structures, and how the recouped amount would be determined under each of several different scenarios. The letter is attached hereto as Appendix A.

The House provisions on compensation recovery accommodated many of these concerns. Section --- of the Shareholder Empowerment Act of 2009 appropriately balanced the policy objective of requiring clawback while giving the board the responsibility to develop the policy and recognizing that recoupment would occur where it is feasible and practical to do so.

6. Whistleblower Rewards

Section 922(a) of the Act provides that the SEC "shall pay an award" to whistleblowers cash rewards of between 10% and 30% of any monetary sanctions exceeding $1 million that either the SEC or the US Attorney General, or any other self regulatory organization or state attorney general recovers as a result of the whistleblower's assistance. Rulemaking must be done in 270 days.

Comments

The Whistleblower Provision Will Encourage Employees to Bypass the Company's Existing Compliance Programs and Prevent a Company from Taking Prompt Corrective Action When Necessary

The Society is concerned that the whistleblower provision will so significantly incentivize and encourage employees to report concerns of potentially improper conduct directly to the SEC that employees will bypass the extensive compliance programs that companies already have in place, and thus undermine their effectiveness. In short, the unintended consequence of the Act may be that companies will have a more difficult time detecting and investigating misconduct and taking prompt corrective action when violations are found.

The 10-30% award could be worth millions of dollars to an employee. Unfortunately, however, to be eligible to collect an award an employee must provide "original information" to the SEC, that is, information that is not already known to the SEC from the company or another tip. Thus, if an employee is aware of a potential violation of law or company policy and wants to report the issue, in order to ensure that he or she is eligible to receive an award under the statute, he or she will have to choose whether to raise it to a superior or directly with the SEC. Employees have long been trained to raise an issue first with a superior, or alternatively with an ombudsman or "ethics hotline", or even to the Chair of the company's audit committee. Under new whistleblower provisions, an employee will now have a significant financial incentive to bypass raising the issue with the company at all for fear of losing a potential multi-million-dollar award. Such a result, we believe, would be unintended, and contrary to long-established public policy and the principles found in the Federal Sentencing Guidelines.

We believe that Section 922 should be considered carefully by the SEC with particular reference to the defense and health care industries which have long had to deal with False Claims Act cases. To implement Congress' intent to provide more tips to the SEC for potential company abuses, we suggest that the statute grant awards, but not when the person making the report has bypassed the company and its Audit Committee's internal concerns reporting processes.

Conclusion

The Society supports good governance practices -- those which are desired by all shareholders and those which foster long-term success and shareholder return. The executive compensation provisions of Dodd-Frank, coupled with risk disclosure and the intense media and Congressional focus on pay and governance practices, have increased shareholder rights and generally encourage greater corporate accountability. We respectfully offer these suggestions with regard to implementation of the Act to avoid negative unintended consequences and to effect the intent of Congress.

Respectfully submitted,

Darla C. Stuckey

Center On Executive Compensation

September 1, 2010

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

RE: Comments on Executive Compensation and Governance Provisions in Title IX, Subtitle E of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Ms. Murphy:

The Center On Executive Compensation is pleased to submit comments to the Securities and Exchange Commission ("Commission") providing its perspective on how the Commission should interpret the executive compensation and corporate governance provisions in Title IX, Subtitle E of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). For the most part, these provisions of the Dodd-Frank Act are unprecedented in their vagueness and breadth, and we urge the Commission to take a practical and Board-centric approach to implementation.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 300 large companies, and the Center's more than 70 Subscribing Companies are HR Policy members that represent a broad cross-section of industries. Because senior human resource officers play a unique role in supporting the compensation committee chair, we believe our views can be particularly helpful in understanding the important role that carefully constructed executive compensation packages play in ensuring a strong link between pay and performance. Our comments are focused on a practical approach to ensuring that the Commission's implementation of Dodd-Frank Act does not impose significant unintended consequences.

I. Executive Summary

The executive compensation and corporate governance provisions of the Dodd-Frank Act are unprecedented in their breadth and vagueness. The Center believes that in its proposed release or releases implementing these sections, that the Commission should seek practical and workable approaches that reinforce a board-centric view of corporate governance and a company-specific approach to performance-based compensation. The following summarizes the Center's most important views on the issues under consideration in Dodd-Frank.

Say on Pay. The Center urges the Commission to develop guidance quickly so that issuers, particularly those with annual meetings in January and February can understand their obligations

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under the law. We suggest that the Commission give companies flexibility in structuring the resolutions implementing the periodic nonbinding vote on pay, as it did for TARP companies. More importantly, with respect to the advisory vote on whether say on pay votes should happen annually, biennially or triennially, boards should have the flexibility in whether to offer a vote or all three frequencies or an up-or-down vote on the alternative (e.g., one year) selected by management.

Disclosure and Vote on Change-in-Control Arrangements. The Center recommends that the Commission implement the disclosure requirements applicable to change-in-control arrangements by including in the proxy statement related to the merger, etc., the relevant information from the post-termination disclosures already required under section 402(j) of Regulation S-K in annual proxy statements. In addition, the Center believes the SEC should clarify that a separate shareholder vote is necessary only if the structure of the change-in-control arrangements have changed since the last periodic say on pay vote.

No-Fault Clawback Policy. The Center believes that clawback policies are an important corollary to pay for performance and to risk mitigation. We also believe that to be effective, the clawback policy articulated in Section 954 of the Dodd-Frank Act requires careful consideration of how incentive compensation arrangements are structured so that the proposed release reflects those practicalities. Specifically:

- The Center believes that the clawback policy articulated in the statute applies only to incentive compensation based on financial information required to be reported under the securities laws." Based on this definition, the Center urges the Commission to exclude time-vested stock options and restricted stock from this definition.
- The Center also recommends that the Commission explicitly recognize the role of Board discretion in executing clawbacks of incentive compensation covered by the mandate, especially: where discretion was used in making the award; where the cost of recoupment exceeds the amount to be clawed back; and in determining how to recoup the excess compensation over what would have been received.

Our comments include several examples of common incentive arrangements and address implementation issues, such as the need for the new standards to apply prospectively with sufficient transition.

Disclosure of Pay Versus Performance. The Center believes the Commission should provide flexibility in defining compensation "actually paid," consistent with principles-based disclosure, rather than taking a uniform approach. Companies that grant long-term incentives based on the prior year's performance may view the total annual planned compensation value as compensation "actually paid." By contrast, companies that do not believe that the accounting estimates in the Summary Compensation Table reflect the pay for performance linkages underlying the Board's decisions may disclose how compensation realized in the reporting year links to long-term performance. We also believe that companies should compare compensation "actually realized" to financial performance as determined by the financial metrics used in their incentive plans, but that companies should be allowed to include this in an overall assessment of pay and performance if they choose to do so.

Pay Ratio Disclosure. The Center believes that the pay ratio requirement in section 953(b) of the Dodd-Frank Act makes accurate compliance extremely difficult, if not impossible for global employers because it requires them to individually calculate the pay for "all employees," however defined, using the SEC's requirements for the named executive officers. Within the framework of the statute, we urge the Commission to limit the calculation to full-time U.S. employees and to simplify the calculation to the greatest extent possible. Because of the difficulty of calculating the median under the Commission's executive rules, we urge the Commission to make the ratio a furnished, rather than filed disclosure.

The Center's detailed comments on these issues follow.

II. Shareholder Vote on Executive Compensation Disclosures

Section 951(a) of the Dodd-Frank Act mandates that corporate issuers hold nonbinding shareholder votes on executive compensation once every three years and requires a separate shareholder vote to determine the frequency of such "say on pay" votes. In sum, the Center believes the Commission should interpret this requirement as follows:

- The Commission should be mindful of the influence of proxy advisory firms over shareholder votes such as say on pay and should ensure that advisory firms employ sound methodologies that result in accurate and unconflicted recommendations to institutional investors.
- Issuers should have flexibility in structuring the text of the nonbinding say on pay resolution, so long as the statutory requirements are met.
- Companies should have the flexibility in structuring the shareholder vote on the frequency of say on pay resolutions, either as an up-or-down nonbinding vote on a frequency (one, two or three years) chosen by management or as a vote allowing shareholders to choose whether votes should be held every one, two or three years.
- The statute should be read to prohibit shareholder resolutions seeking a different frequency of say on pay votes. The statute already requires a periodic shareholder vote on the frequency (at least every six years), and the rule of construction in new section 14A(c)(4) should not be read as allowing such resolutions.
- Companies should not be required to file preliminary proxy statements in 2011 merely because they have a say on pay resolution on the ballot.

These issues are discussed in detail in the following paragraphs.

A. Mandatory Say on Pay and the Expanded Influence of Proxy Advisory Firms

As the Commission begins to consider its approach to implementing Section 951 of the Dodd-Frank Act, the Center urges the Commission to be mindful of the impact of proxy advisory firms on the executive compensation process, and the need for these firms to transmit accurate, unconflicted analysis to institutional investors. Many commentators have expressed concern that advisory firm methodologies may cause investors to favor "cookie cutter" pay packages at the

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expense of company-specific performance-based compensation approaches.[1] Likewise, inaccurate analyses may impact investor proxy votes. For example, Center On Executive Compensation research among its subscribing companies suggests that as much as 10 percent of final reports from proxy advisory firms contain significant inaccuracies that were not corrected.

Because institutional investors can rely on the analysis of proxy advisory firms in making their voting determinations, the advisory firms wield considerable influence over their voting determinations. Although say on pay is an advisory vote, it will still have substantive implications because of the impact a substantial percentage of votes against a say on pay can have on compensation committees. For example:

- Academic research has shown that a negative recommendation on a management proposal can reduce the support of institutional investors by up to 20%;[2]
- Recent statistics from proxy solicitation firm Innisfree M&A found that clients of Institutional Shareholder Services, the largest proxy advisory firm, typically control 20-30% of outstanding shares of mid-cap or large-cap companies, and Glass-Lewis clients typically control 5 to 10%;[3] and,
- A 2010 survey of 251 companies by TowersWatson found that 59% of respondents believed that proxy advisors have significant influence over pay decision making processes at U.S. companies.[4]

If a proxy advisory firm recommendation is based on a flawed methodology or inaccurate information, executive compensation could be affected considerably at some companies. The purpose of a shareholder advisory vote should be to obtain the views of shareholders on executive compensation practices, not to further cement the influence of proxy advisory firms over executive compensation. We urge the Commission to take action, through its review of the proxy voting process, to more closely oversee and regulate the industry so that analyses are unbiased, reports are accurate, and votes are not improperly influenced.

B. Give Companies Flexibility in Structuring Say on Pay Resolutions

The Center believes that the Commission should provide companies with flexibility in how they structure the text of the nonbinding resolution on pay, so long as the statutory requirements are met. The statute requires the resolution be simply "to approve the compensation of executives" as disclosed in the Commission's executive compensation disclosure rules in Item 402 of Regulation S-K. The Center recommends that the SEC follow an approach similar to the one it adopted for companies subject to a say on pay vote under TARP, which allowed companies considerable flexibility to discuss why shareholders should approve the resolution.

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[1] *See, e.g.*, Jeffrey Gordon, "Say on Pay: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In," 46 Harvard J. on Leg., 323 (2009); Peter C. Clapman, "Next Steps? Be Careful What You Wish For," Directors and Boards, July 2008.
[2] *See, e.g.*, Jennifer E. Bethel and Stuart L. Gillan, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," Financial Management, Vol. 31, No. 4 (Winter 2002).
[3] Yin Wilczek, Bounty Program to Cramp Corporate Boards; ABA Speakers Discuss Governance Provisions, Daily Report for Executives (BNA), Aug. 10, 2010, at EE-4.
[4] Towers Watson Press Release, "Few U.S. Companies Well Prepared for Executive Say-on-Pay Legislation, Towers Watson Survey Finds," June 29, 2010.

C. The Frequency Vote Should Allow an Up or Down Vote, Not Merely A Multiple Choice Approach

New sections 14A(a)(2) and (3) require a separate management resolution allowing shareholders to vote to determine whether say on pay votes will be held every one, two or three years. The vote is to occur in the first year say on pay is applicable and at least every six years after that. The Center believes that Board flexibility in implementing the "frequency vote" is important to a board-centric approach to governance and is not inconsistent with the statute. We believe that the Commission should allow boards to decide whether there should be an up-or-down vote on a management recommended frequency (i.e., management could offer a resolution that recommends that the shareholder vote should occur every year, and shareholders would vote up or down on the resolution) or whether shareholders would be provided with a choice among having a say on pay vote every one, two or three years. For legal, practical and procedural reasons, we believe that allowing a choice is the preferable approach as opposed to mandating that shareholders be only allowed to choose among one, two or three years.

The Frequency Vote Is Nonbinding. One important reason the Commission should adopt flexibility on the frequency vote is that a plain reading of the statute indicates that the frequency vote is nonbinding, just as the actual say on pay vote is, and we recommend that the Commission confirm the plain language reading in its proposed rules. The rule of construction in new section 14A(c) states "The shareholder vote referred to in subsections (a) and (b) *shall not be binding* on the issuer or the board of directors of an issuer" and section 14A(c)(1) states that the vote "*may not be construed as overriding a decision by such issuer or Board of Directors.*" Because the frequency vote is advisory, management should be allowed to propose a selected frequency and have shareholders support, oppose or abstain from it, as well as provide for a choice among three alternatives.

The Center also believes that it is important that in its regulations implementing the mechanics of the say on pay and frequency votes, the Commission distinguish between the language of the statute in describing the votes and their actual impact. Section 14A(a)(1) states that the say on pay resolution is "to *approve* the compensation of executives," but read together with Section 14A(c),which states that the vote is nonbinding, it is clear that shareholders are not actually approving executive compensation but providing their general views on executive compensation. Similarly, with respect to the frequency vote, section 14A(a)(2) states that the proxy shall include a "separate resolution subject to shareholder vote to *determine*" whether say on pay votes will take place annually, biennially or triennially. Because the frequency vote is nonbinding, shareholders are not actually determining the frequency but providing their input on frequency, with a decision to be made by management, and this should be made clear in the implementing release.

A Management-Determined Resolution Is Consistent With Existing Commission Rules. The Commission's current rules provide that shareholders may not have a choice on a shareholder resolution other than to vote for, vote against, or abstain. The Center believes that new Section 14A(a)(2), should be read as being consistent with the rules and as giving management a choice between applying the existing rules, allowing companies to choose among one, two or three years or providing shareholders a choice from among the options. From a practical perspective, allowing a "multiple choice" approach makes it possible, if not likely, that none of the three alternatives will win a majority of votes, leaving the direction to management uncertain. Even though it is possible shareholders will not support a management resolution seeking an up or down vote on frequency, a rejection would give management clear direction as to the will of the shareholders.

The Commission Should Ensure That the Proxy Voting Industry Can Handle a Three-Way Vote. In addition, the Commission should seek comment from the proxy distribution and tabulation firms in its proposed implementing release whether these firms will have their proxy cards and computer systems ready for the first shareholder meetings after say on pay takes effect on January 21, 2011.[5]

Management Should Be Allowed to Recommend a Vote Frequency. Regardless of how the say on pay resolution is framed, just as with any management resolution, management should be allowed to recommend the frequency of the say on pay vote it would prefer and provide its reasons for that choice. From a practical side, management is in the best position to recommend how frequently say on pay votes should occur based upon the nature of their business cycles, strategies and the related compensation program designs which reflect those considerations. For example, it may be that a company in an industry with long lead times may recommend a less frequent say on pay vote, but one with shorter cycles may propose a shorter frequency for the shareholder vote.

D. The Statute Should be Read to Prohibit Shareholder Resolutions Seeking Alternative Voting Frequencies

The Center believes that new section 14A should be read as preempting shareholder proposals seeking more or less frequent votes on say on pay than management has implemented. The statute has put in place a system for obtaining shareholder input on the frequency of the vote and specifies that shareholders be given the opportunity to vote on the frequency at least every six years. Thus, the Center believes that the combination of a mandated vote on pay and the mandate that shareholders be allowed to vote on the frequency of the vote fully occupies the space on this issue. Any subsequent shareholder resolutions in this area should be considered "substantially implemented" as a result of the statutory requirements.

Allowing for annual shareholder resolutions asking companies to change the frequency of the shareholder vote (either more or less frequently) is redundant and overly burdensome, given the cost of assessing the propriety of a resolution, engaging the proponent, fashioning a response and then publishing the resolution in the annual proxy. Moreover, because there is evidence that institutional investors disagree over the best frequency of a say on pay vote,[6] it is possible that in

[5] An informal review of Center Subscribers showed that five out of 67 companies that are U.S. publicly traded companies have annual meetings scheduled between January 21, 2011 and March 15, 2011, or just over seven percent of total Subscribers. Extrapolating this figure to the roughly 1,600 corporations deemed large accelerated filers, there would be roughly 119 companies holding annual meetings during that period.

[6] *See, e.g., "Say on Pay" Rolls Forward, But Some Investors Wary*, Reuters, July 22, 2009, *last viewed at* http://www.reuters.com/article/idUSTRE56L52O20090722 (stating the United Brotherhood of Carpenters "has proposed holding say-on-pay votes every three years rather than annually, and only at the largest U.S. corporations. It says this would give investors more time to assess pay plans, which must be reviewed individually because

any given year, a company could receive two resolutions seeking alternative time frames (e.g., a company that has chosen to hold a say on pay vote every two years could receive resolutions seeking say on pay votes every year or every three years).

In addition, nothing in the statute prevents a company from proposing a resolution on the frequency of say on pay more often than every six years. If a company determines that there is a groundswell of support among shareholders for changing the frequency of the vote, it can choose to offer a resolution proposing a different frequency.

The Center believes that this interpretation is consistent with the rule of construction in section 14A(c)(4), which states that the shareholder vote "may not be construed to restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials *related to executive compensation*." The Center believes that shareholder proposals seeking a more or less frequent vote on executive compensation are not "related to executive compensation" as contemplated by the statute because they do not seek to address a specific aspect of compensation. Instead the resolution is related to the process of the Board, specifically, how frequently the company will hold a statutorily mandated vote.

In addition, the SEC has long allowed exclusion of shareholder proposals under Rule 14a-8 that would conflict with a management proposal. The staff's analysis recognizes that the Board would not know how to respond if, for example, conflicting proposals each receive a majority vote.[7] Allowing shareholder proposals in this case would appear to create the potential for such conflicts.

In sum, the Center believes that the Commission should exclude shareholder proposals seeking a different frequency of the say on pay vote than that implemented by the company. The statute provides a clearly established process requiring the company to reevaluate the views of shareholders on the frequency of the say on pay vote every six years. In addition, the Center believes that the exclusion of such votes is permissible under the section 951 rule of construction.

E. The Commission Should Not Require Companies to File Preliminary Proxy Statements

The SEC should not require companies to file a preliminary proxy statement in 2011, merely because they have a say on pay resolution on the proxy. This is consistent with the interpretation the SEC took for TARP companies, and it should apply equally in this case. Because the say on pay requirement will apply to nearly all publicly held companies in 2011, the preliminary proxy filing requirement would shorten the amount of time companies have to tailor their disclosures in advance of the first say on pay vote. Moreover, as a practical matter, it is difficult to imagine that the staff would have the time or resources to review more than a very small percentage of preliminary statements filed.

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policies on calculating an executive's salary, bonus, stock options, perks and retirement benefits vary widely."); AFSCME and Walden Asset Management Press Release, "More Than 50 Companies Voluntarily Adopt "Say on Pay" as Institutional Investors Continue to Press for an Advisory Vote," March 2, 2010, *last viewed at* http://www.afscme.org/press/27802.cfm. ("Investors pushing for annual advisory shareholder votes on executive compensation today announced that more than 50 companies have now voluntarily adopted giving their shareholders *an annual advisory vote* on executive compensation, colloquially known as "Say on Pay.") *emphasis added.*

[7] Rule 14a-8(i)(9).

III. Disclosure and Shareholder Vote on Certain Golden Parachute Payments

Section 951(b) of the Dodd-Frank Act requires public companies who enter into a merger, change-in-control, purchase, etc., to provide additional disclosure "in a clear and simple form" of any agreements or understandings the company has with the NEOs of either company (whether present, deferred or contingent). It also requires a separate nonbinding shareholder vote on the change-in-control arrangements where the arrangements have not been previously included as part of a say on pay vote.

A. Additional Disclosure Requirement Should Incorporate Approach From Existing Post-Termination Payment Disclosure

The Center believes the Commission should address the additional disclosure requirement by simply incorporating the current disclosures for post-termination payments in Section 402(j) of Regulation S-K, which companies currently are required to include in their annual proxy statements, in proxy statements related to merger or change-in-control agreements. The current disclosures address the statutory requirements and provide for consistency in reporting annual compensation and compensation in the event of a merger/change-in-control. This approach also will make it clear to shareholders whether there have been material changes in the structure of change-in-control agreements, thus enabling them to determine whether a separate shareholder vote on the change-in-control payments is warranted.

B. Shareholder Vote Should Only Be Required If Structure of Payments Has Changed Since Last Say on Pay Vote

The Center believes the SEC should clarify that a separate shareholder vote is necessary only if the structure of the change-in-control arrangements have changed since the last periodic say on pay vote. There should not be a separate vote merely because the value of the change-in-control agreement changes due to stock price fluctuations or changes in performance levels affecting other metrics. Otherwise, the statute's requirement that a separate vote be held only when there have been changes in the agreements or understandings related to the change-in-control arrangement would be meaningless. A contrary interpretation – i.e., that a say on pay vote be held any time the amounts of executive compensation payments that are projected to result from a change-in-control agreement differ from previously disclosed amounts require a separate shareholder vote each time there is a merger, acquisition, or combination.

Finally, in the event where only certain elements of a change-in-control agreement are added or changed, the shareholder vote should focus on the elements that have been changed.

IV. No-Fault Clawback Policy

Section 954 of the Dodd-Frank Act requires the SEC to promulgate rules directing the securities exchanges and securities associations to develop listing standards requiring companies to adopt and disclose a no-fault clawback policy. Specifically, the policy to be disclosed must provide, in the event of a material restatement, for the recoupment of incentive compensation that is "based on financial information required to be reported under the securities laws" from current and former executive officers of the company, if such compensation is in excess of that which would have been paid in view of the restatement. This mandate raises a number of issues, including:

- which compensation is "based on financial information required to be reported under the securities laws;"
- the mechanics of determining the amount to be recouped in the event of a material restatement;
- the role of board discretion in executing the recoupment policy, particularly where board discretion was applied in originally awarding the incentive compensation; and
- the need to provide companies with sufficient lead time to implement a policy before the clawback mandate takes effect.

Each of these examples is discussed below.

A. Clearly Delineate Compensation Subject to the No-Fault Clawback Policy

The linchpin of the requirement in section 954 of the Dodd-Frank Act is that companies are required to disclose and enforce a policy that provides for recoupment of incentive compensation that is "based on financial information that is required to be reported under the securities laws." Thus, if incentive compensation is "based on" financial results that are reported under the securities laws, it is potentially subject to recoupment. Consistent with principles-based disclosure and recognizing the complexity of issues that are created by the language of the statute, the Center believes that in its proposed release the Commission should differentiate incentive compensation that is subject to the recoupment requirement from compensation that is not subject to it. This will enable Boards of Directors and Compensation Committees charged with enforcing it to better understand their obligations.

Financial information that is required to be reported under the securities laws includes measures such as revenue, net income and earnings per share. It also may include non-GAAP measures such as earnings before interest, taxes, depreciation and amortization and return on net assets.

Incentive information that is not required to be disclosed under the securities laws includes stock price, total shareholder return (which is based on the change in share price plus dividends over a period of time) and operational performance measures specific to the business such as market share and customer satisfaction. Such measures are not financial information that is filed with the SEC and therefore would not be subject to clawback under section 954.

The Center believes that it is important for the Commission to understand how incentive plans are structured, so that it may factor this information into its proposed regulations. Although compensation arrangements vary widely, depending upon the company, industry, competitive condition and global focus, below we present five hypotheticals, illustrating four common types of compensation arrangements:

(1) Purely formulaic incentive plans, based on financial metrics, that pay out in cash;

(2) Formulaic incentive plans in which a pool is funded based on the achievement of objective financial measures, but the board has discretion whether to allocate the entire bonus pool toward incentives, where a recoupment would not be required;

(3) Identical to (2), except the facts change so that recoupment is required;

(4) Formulaic long-term incentive plans based upon financial performance with overlapping awards; and

(5) Nonqualified stock option grants, that are not granted or vested based upon performance.

Annual and Long-Term Cash Incentive Measures Based Upon Financial Metrics. The implementation of the recoupment policy is easiest when dealing with incentive plans that are purely formulaic, based exclusively on financial measures, and paid out in cash. In that situation, the clawback is the excess of what was actually received compared to the amount that would have been received under the formulaic plans had the financial statements been correct.

Example 1: Formulaic Incentive Plan With Incentives Based on Financial Metrics

- Annual bonus is based on achievement of targeted level of net income.
- The performance for 2009 equaled 105% of the targeted level of net income.
- The incentive formula increases payout by 3% for each 1% by which performance exceeds the target.
- The payout at 100% performance is 50% of salary.
- The payout based on the performance results would be 115% of the targeted payout.
- 115% of 50% of salary would produce an annual incentive payout of 57.5% of salary.
- Assume the performance results for 2009 had to be restated in 2011 and the impact was to reduce net income to 90% of the targeted level of performance.
- The incentive formula reduces payout by 3% for each 1% by which performance falls short of target.
- The incentive payout on the restated earnings would have been 70% of the targeted payout of 50% and would have produced an incentive payout of 35% of salary.
- The amount of annual incentive that would be clawed back would be the difference between what was paid (57.5% of salary) and that which would have been paid on the restated earnings (35%), which would equal 22.5% of salary.
- Assuming the executive had a salary of $500,000, the bonus amount to be clawed back would equal $112,500 (the difference between an incentive of $287,500 at 57.5% of salary and an incentive of $175,000 based on 35% of salary).

Formulaic Incentive Plans Where Financial Measures Fund a Bonus Pool. Where the financial measure funds a pool which is distributed based upon financial and non-financial measures, the application of the clawback policy will differ based upon whether the Board and/or the Compensation Committee had discretion in determining how much of the pool to allocate for incentives and whether the Board and/or the Compensation Committee has discretion in determining the individual awards.[8] Assuming the Board or Compensation Committee had discretion in determining the amount of the bonus pool to allocate to individual awards and the individual awards are determined based upon some measures that require the judgment of the board (rather than formulaic), a material restatement could require the Board to revisit its decisions. Examples 2 and 3 illustrate the pool concept and the role of Board discretion:

Example 2: Incentive Pool Approach With Restatement; Recoupment Not Required

- The annual incentive pool is generated based upon a percentage of net income, and at targeted level of net income for 2009 the pool would be sufficient to provide incentives equal to the sum of the incentive targets for the participating executives.
- The amount of incentive payout any individual would receive is based upon his or her individual performance against non-financial objectives in the areas of (1) talent development, (2) productivity and cost-savings, (3) operational performance measures and (4) modeling the desired company culture and promoting ethical behavior (weighted 25% each).
- In total the payouts to executives cannot exceed the incentive pool, but there is no requirement that the board allocate the entire pool to incentive payments.
- For 2009, the company hit 100% of the net earnings target, and the incentive pool was generated on that basis.
- The board allocated 95% of the pool for incentives.
- No executive received an incentive payment directly based upon the achievement of the net income target. Some executives received incentive payments above their targeted incentive; some received less than their targeted level of incentive and some received their targeted level of incentive. The amount received by an individual executive was based on the assessment of performance in the four areas listed above.
- Assume the performance results for 2009 had to be restated in 2011, and the impact was to reduce net income such that the incentive pool equaled 98% of the sum of the incentive targets for the participating executives.
- At this restated level of performance the bonus pool was sufficient to cover the actual amount of incentives paid (98% pool, 95% actually paid out).
- In this situation there does not appear to be a need to recoup any of the incentives paid unless the board determines it would have made different individual incentive decisions in view of the restated earnings.

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[8] If the Board does not have discretion (i.e., the bonus pool and the individual awards are formulaic), the clawback would be applied similar to Example 1 for the portion of the award based on the restated financial performance.

Example 3: Incentive Pool Approach; Recoupment Required

- Same as Example 2 but the restated earnings would have produced an incentive pool equal to 90% of the sum of the incentive targets for the participating executives.
- The Board has three options regarding how to recoup the 5% that exceeded the amount allocated to the incentive pool.
  - Ratably reduce all executive incentives by 5% (non-discretionary recoupment although the incentive paid to each individual was based on board discretion);
  - Discretionary recoupment on an individual-by-individual basis (the same way the bonus amounts were awarded) such that the total amount recouped equaled the 5% overpayment (discretionary recoupment);
  - Recoupment is left to the discretion of the board, pursuant to the company's recoupment policy.

The Center believes that the Commission should recognize the need for Board discretion in such situations. Thus, the Board should have the ability to decide to use any of the three options, so long as its rationale is explained in the company's next proxy statement.

Overlapping Long-Term Awards and the Impact of a Material Restatement on Target Setting. Long-term incentives are often three-year awards granted annually so that the awards are overlapping. In this situation a material restatement, and any required recoupment could affect up to four cycles of long-term incentive grants (the three outstanding performance cycles, plus the basis for setting the next award depending on whether the financial measures included in the restatement affect the long-term incentive program and also serve as the base year for setting performance targets for the next award). Example 4 illustrates the mechanics of this model:

Example 4: Overlapping Long-Term Incentive Awards

- Assume that Performance Unit Awards are granted annually and have the following design:
  - Units are denominated as a dollar amount (e.g., $100,000 value for achieving targeted performance).
  - Performance in excess of the targeted level of performance increases the payout by 3% for each 1% by which targeted performance is exceeded.
  - Performance that falls short of target reduces the payout by 3% for each 1% shortfall in performance versus targeted level of performance.
  - The performance metric is cumulative earnings per share (EPS) over the three-year performance period.
- Since the awards are granted annually, and given that the performance period is three years, a participant will have 3 overlapping awards outstanding at any given time.
- Therefore, a given year will be included in three separate award cycles and, depending how performance targets are set, may serve as the base year upon which the performance targets for a 4^{th} award cycle are set.

- Outlined below is an example of the outstanding awards under a performance unit program:

	2007	**2008**	**2009**	**2010**	**2011**	**2012**
2007 Award:	2007-------	2008------	2009			
2008 Award:		2008------	2009-----	2010		
2009 Award:			2009-----	2010---	2011	
2010 Award:				2010---	2011-------	2012

- Assume that in mid-2010 the company materially restates downward the earnings for 2009, thereby reducing 2009 EPS.
- The impact of the restatement would be to reduce the performance for the 2007, 2008 and 2009 award cycles.
- The restatement would also lower the base year upon which the board set the EPS targets for the three-year award cycle beginning in 2010.
- The 2007 awards would have been paid out to the participants and therefore the company would have to initiate recoupment for the excess payment that was based on the pre-restated 2009 EPS.
- The 2008 and 2009 award periods would not yet have been completed and therefore the potential payout of the performance units would be automatically reduced. No recoupment would be required.
- The board should also revisit the targeted cumulative EPS goals for the performance cycle beginning in 2010 to determine if the goals would have been set at a lower level had the board been aware of the restated EPS for 2009 at the time the goals were set.

Performance-Granted and Performance-Vested Equity Awards. Section 10D(b)(2) of the statute states that the clawback policy applies to "incentive-based compensation (including stock options awarded as compensation)." The Center believes this language should be read as requiring that the clawback policy applies to (1) incentive-based compensation as defined under the Commission's disclosure rules that is based upon information required to be reported under the securities laws; and (2) stock options that are awarded as compensation and that are incentive-based compensation as defined under the Commission's disclosure rules where the incentive is based on financial information required to be reported under the securities laws. This approach makes the clawback language in section (b)(2) consistent with the reporting language in (b)(1), which requires companies to disclose the policy of the company on recoupment of incentive-based compensation under the securities laws.

Applying this interpretation, the Center believes that performance-granted and performance-vested equity awards can be incentive compensation subject to the recoupment mandate, if the above definitions are met. Unlike nonqualified time-vested stock options, restricted stock or restricted stock units, which are not considered incentive compensation under the Commission's rules, performance-granted or performance-vested stock options, for example, are incentives that are often granted based on financial performance or other performance measures.

Time Vested Stock Options. Stock options generally take one of two forms: (1) performance-based stock options for which the granting or vesting of the award is based on the achievement of financial performance, as discussed above or, (2) time-vesting stock options for which the award is based on considerations other than financial performance and the vesting of such awards is based on the passage of time and is not contingent on achieving financial performance objectives. Stock options that vest merely on the basis of time are not considered incentive compensation under the SEC's disclosure rules and therefore should not be subject to a mandatory clawback. Many companies determine the level of stock options granted to an individual based on the executive's level, tenure and expected performance level, which are not linked to financial performance. In this case the following example should apply:

Example 5: Stock Option Awards

- Stock option awards are determined on an executive-by-executive basis.
- The actual award received is a function of salary grade, title, performance and potential.
- The determination of the performance of an individual executive for purposes of granting stock option awards is not tied directly to the financial results of the overall company.
- The option awards granted in 2006 have vested but the executives have not exercised the stock options.
- Assume the results for 2006 were restated in 2009 and the net income of the company was reduced by 1%.
- Correspondingly, the stock price dipped on the day of the restatement by 10% and has recovered over subsequent weeks but the recovery in stock price has trailed the overall movement of the market and the stock price appreciation of industry peers.
- In view of the fact that there has been no gain to the executives since the options have not been exercised, and in view of the fact that the size of the grant was not influenced by the net income of the company, no recoupment is warranted.
- An alternative stock option design would be a stock option that vests on the basis of achieving financial targets. In this case, the number of stock options that would not have vested based on the restated financial performance outlined above would be subjected to recoupment due to the material restatement.

In sum, the Center believes that the better way to interpret the clawback language in section 954(b)(2) is to consider any incentive compensation that is awarded, granted or vested based on financial measures required to be reported under the securities laws as subject to recoupment. Conversely, vehicles such as time vested stock options, restricted stock and restricted stock units should not be considered incentive compensation, and if the granting of such awards was not based on the restated financial performance, it is therefore not subject to the clawback requirement. However, if the granting of individual stock option awards is based on the restated financial performance, the number of shares awarded would be subject to the clawback based on the excess of the award over that which would have been awarded based on the restated financial performance.

B. The Commission Should Provide for Board Discretion in Executing the Recoupment Policy

In implementing the clawback requirement, the Commission should recognize the role that Board or Compensation Committee discretion plays in setting executive compensation, and explicitly provide for Board and Compensation Committee discretion in the determination of the amount to be recouped and how that recoupment is to be executed. This interpretation recognizes that Board discretion often plays a role in how incentive compensation is awarded and allows the Board to make determinations to ensure that the recoupment is in the best interests of shareholders.

The Level of Discretion Used by the Board/Committee in Determining Amount to Be Clawed Back Should Be the Same as That Used in Making Original Grant. Boards should be given the same level of discretion to determine the amount to be clawed back as was used in making the initial compensation decision. As illustrated in the examples above, this may involve discretion under section 162(m) incentive plans in which financial performance funds a pool to be used for the distribution of compensation to NEOs or other executive officers. Committee discretion may also be used in applying other financial criteria used to make individual awards.

Board or Committee discretion is also increasingly an element of a company's risk mitigation system. Affording the Compensation Committee discretion allows it to reduce (or add) incentive payouts, when the committee takes the entirety of the circumstances into account. In addition, long-term incentive grants, whether granted on a value or a number of shares basis, are often made based on a formula, to which Committee discretion is applied in determining the actual grant.

Discretion Not to Claw Back Where the Cost of Executing the Clawback Would Outweigh the Benefits to Shareholders. The Center believes that in addition to discretion as discussed above, the Commission should recognize that Boards should have discretion in determining not to execute a clawback against a current or former executive officer where, for example, the amount to be clawed back is de minimis or the Board believes that protracted litigation would be required to recoup the compensation. In cases such as this, the Center believes the Commission should explicitly recognize the Board's ability to decide not to claw back and to disclose that decision in the proxy. This is especially important with respect to executive officers in certain countries or other jurisdictions that are extremely protective of employees, where it may not be possible to recoup the entire amount. For similar reasons, in crafting its proposed release, the Commission should consider situations in which a Board would be permitted to settle a clawback for less than the full amount.

Discretion in Determining How to Recoup Compensation From a Current Or Former Executive Officer. The Center believes that since the statute is silent as to how clawbacks are to be executed, the Commission should explicitly recognize Board/Compensation Committee discretion in executing recoupment by any method the Board deems to be appropriate (and discloses in the next proxy statement), including cancellation of unvested awards (equity and nonequity awards) and offsetting against amounts otherwise payable by the company to the executive (for example, deferred compensation) in place of having executives write a check, if the circumstances warrant. This flexibility helps to mitigate some of the procedural complexities involved in executing a clawback, including the need to file amended tax returns by both the company and the executives.

C. The Three-Year Recoupment Period Should Be Linked to the Restatement Filing Date

The Center also believes that the trigger for recoupment (i.e., when a company is "required to prepare an accounting restatement") should be when the company actually files an accounting restatement due to the material noncompliance of the company with a financial reporting requirement under the securities laws. This creates a verifiable date certain from which to determine the three-year period over which the recoupment applies. It also avoids speculation over when a company determined it should have known it was required to prepare a restatement.

The Center encourages the Commission to exclude restatements based on changes in Generally Accepted Accounting Principles from the types of restatements that trigger a recoupment. These restatements are not based on oversights or deliberate errors by the company, but rather a change in the framework for reporting. Mandating a recoupment in such circumstances does not fulfill the policy objective sought by the clawback mandate: namely, if an executive did not earn incentive compensation based on financial results, he or she should be required to return it.

D. Include Sufficient Lead Time to Implement the New Clawback Requirements

The Center urges the Commission to provide in its implementing release that the clawback policy will apply only to any new incentive compensation that is received after the effective date of the listing standards approved by the Commission. To apply the recoupment policy to compensation already granted would create excessive complexity in term of amendments required to outstanding compensation plans and executive contracts.

In addition, the Center believes that the Commission should give companies sufficient time to put such policies into place prior to the effective date of the listing standards incorporating the disclosure and recoupment obligation taking effect because of the considerable number of issues, such as plan amendments and contract renegotiation that must be addressed. We believe that a reasonable time is 12 months after the Commission approves the listing standards.

V. Disclosure of Pay Versus Performance

The Center believes that the Commission should interpret the additional disclosure required by new section 14(i)(a), entitled Disclosure of Pay Versus Performance, by taking an approach consistent with principles-based disclosure that recognizes the need for flexibility in properly portraying the unique aspects of individual company pay philosophies, programs and decisions. The statute requires companies to disclose "information that shows the relationship between compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any

Ms. Elizabeth M. Murphy
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distributions." We believe this disclosure should reinforce the purpose of the CD&A, namely to "put into context the compensation disclosure provided elsewhere."[9]

With this in mind, the Center believes this disclosure should reflect the Board's and Compensation Committee's perspectives on compensation and financial performance in making its compensation decisions. Rather than focus on uniform disclosure, the requirement in new section 10(i) should be interpreted to focus on explaining the link of compensation "actually paid" to performance, allowing companies the flexibility to explain the committee's decisions in the context of its overall pay philosophies.

<u>Definition of Compensation "Actually Paid."</u> We believe that the determination of "actually paid" will vary based on how the Compensation Committee and the Board structured the performance basis of incentive compensation granted to executives. This is consistent with the requirement that the CD&A "focus on the material principles underlying the registrant's executive compensation policies and decisions and the most important factors relevant to analysis of those policies and decisions."[10]

Because much of the CD&A focuses on the amounts in the Summary Compensation Table, the intended performance linkage between pay and performance may not be clear from the amounts in that Table, depending upon the philosophy of the company, especially with respect to long-term incentives. The linkage between pay and performance is fairly consistent as it relates to salary and annual incentive because the amounts realized are reported in the same year as the corresponding performance. However, the design of long-term incentive plans can vary considerably among companies depending on the basis upon which awards are granted, performance periods, performance objectives and incentive vehicles used.

Long-term Incentives as Awards for Past Performance. For example, a Compensation Committee may grant long-term incentives as a reward for past performance. In this case, the grant date fair value estimate for long-term equity-based incentives in the Summary Compensation Table more appropriately reflects the decisions made by the Compensation Committee and the Board and thus the linkage between compensation "actually paid" and performance.

Example 1: The Company has a tremendous year in terms of financial performance and the senior executive team is granted above guideline stock option awards to reflect the accomplishments of the prior year in the total planned annual compensation value. In this case, the Compensation Committee and the Board would discuss the relationship between the financial results and the date of grant value of the stock option awards, as reported in the Summary Compensation Table, when combined with other forms of incentive compensation reported in the Summary Compensation Table, as reflecting the relationship of pay and performance. If performance had been below expectations, a lower planned grant value could result. This pay for performance philosophy is in large part backward looking in that long-term incentive grants are the result of past performance.

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[9] U.S. Securities and Exchange Commission, Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A, 34-54302A, 71 Fed. Reg. 53,157, 53,164 (September 8, 2006).
[10] *Id.* at 53,242.

Alternative: Realized Compensation as "Actually Paid." By contrast, some companies are concerned that the long-term incentive estimates disclosed in the Summary Compensation Table do not completely reflect the pay for performance linkage underlying the committee's decisions. As a result, they may choose to put those amounts into context by discussing how compensation actually realized -- the compensation actually received by the executive at the end of the performance period based on the degree of achievement of the underlying performance objectives -- is the proper reflection of pay for performance rather than grant date value of the award.[11] This approach requires an explanation of how pay and performance were linked over the period the awards were outstanding and gives shareholders a sense for how such forward-looking incentive programs operate in practice.[12]

Example 2: The Company is in a turnaround situation and the Compensation Committee believes that it is important to grant a market-competitive level of long-term awards to the executive team to motivate them to improve the performance of the company. In this case the philosophy of the company is that the link between pay and performance is best reflected based upon the pay that will be actually realized by the degree to which performance goals are achieved and the long-term awards create gains to the executives. This pay for performance philosophy is forward looking in that future performance will determine the pay received from the performance-contingent awards.

Some companies have begun disclosing the realized value of long-term incentive amounts in a table, similar to the following (which is separate from example 2):

Form of Compensation	Total Received ($)	Annualized Amount	Performance Results Over Performance Period That Produced the Compensation
• 2008-10 LTIP Payout	$3,384,275	1,128,092	The total 2008-10 Long Term Incentive Plan award was $3,384,275. Performance criteria for this award were: (1) Total return to shareholders vs S&P Industrials Index companies, weighted 50%, for which the company ranked in the top 25 percent of companies, producing a near maximum payout for this component. (2) ROIC, weighted 25%, which exceeded the targeted level by 100%, resulting in maximum payout; and (3) Cash flow, weighted 25%, which exceeded the target by 15%, which resulted in a target payout. Overall the payout represented 150.25% of target.

[11] This approach is also reflective of the way the Commission has distinguished estimates of compensation included in the Summary Compensation Table and compensation earned and paid out in the preamble to its 2006 disclosure release. *See, e.g.,* U.S. Securities and Exchange Commission, Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A, 34-54302A, 71 Fed. Reg. 53,157, 53,169 (September 8, 2006) ("This table, as amended, shows the named executive officers' compensation for each of the last three years, whether or not actually paid out.") *referring to the Summary Compensation Table*); *Id.* at 53,174("No further disclosure will be specifically required when payment is actually made to the named executive officer.") *discussing the treatment of equity awards on the Summary Compensation Table.*

[12] This approach may also be useful in turbulent economic times where the accounting estimate of long-term incentive awards included in the Summary Compensation Table may vary considerably from the amounts actually realized.

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The appendix to these comments includes a more complete version of this disclosure. As the two examples above demonstrate, it is important that the Commission's regulations allow flexibility for the Compensation Committee and the Board to present the pay for performance relationship in a manner that is consistent with the company's pay philosophy.

Regardless of the approach used to describe the relationship between incentives and performance, the Center does not believe that the actuarial increase in defined benefit pension plans should be included in the calculation of compensation "actually paid" because the amounts are based on credited service, age, interest rates, and historical earnings, factors not generally related to financial performance, and given that pension estimates have not yet been received by the executive and thus should not be considered pay actually paid. The Center also believes that "other compensation," should be excluded as it is not related to financial performance.

Definition of Financial Performance Should Be Company-Specific. We believe that the definition of "financial performance" should link the compensation "actually paid" to the financial metrics the Compensation Committee and the Board have incorporated into the company's incentive plans. Companies choose these financial measures because they link to short-term and longer term financial objectives intended to drive long-term shareholder value that will ultimately be reflected in stock price. We suggest that a company be required to clearly state the extent to which financial performance measures are used in determining the incentive compensation "actually paid" to named executive officers and how those amounts relate to financial performance.

Example 3: For example, a company that links its long-term incentives to financial performance may state: "our company provides a long-term incentive program for senior executives that is paid out in shares of company stock at the end of the period, based on the achievement of certain financial results. A certain number of performance share units are granted at the beginning of the three-year performance period and adjusted based on performance at the end of the period. The financial performance on which the payout is based is:

- 60% Earnings per share;
- 20% Return on Invested capital; and
- 20% Cash flow."

The company would then provide the pay (either on an estimated basis or realized pay basis) that is linked to the financial performance.

We also encourage the Commission to permit companies to incorporate into this disclosure comparison of how other, nonfinancial measures compare with performance, consistent with the Commission's existing disclosure rules, so long as the link between financial performance and compensation actually paid is clear. This approach would allow companies to describe the link between pay and the performance on which it is based, whether financial, operational or strategic. Companies that base compensation decisions or measure performance based on financial and operational measures would report the compensation decisions or compare compensation received with the achievement of those objectives, while companies that base compensation actually paid on total shareholder return would measure performance on that basis.

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Example 4: Company A determines a total long-term incentive value based on the committee's evaluation of the external market and allocates that total among two long-term incentive vehicles:

- 40% time-vested stock options, which vest after three years and provide value if the company's stock price exceeds the grant price and
- 60% performance shares, which are based equally upon the achievement of earnings per share and total shareholder return measures.

In this case, only the performance shares are related to financial performance. However, rather than requiring a separate disclosure in which the company shows the link between the portion of the long-term incentive that was based on financial performance and compensation, the company should be able to disclose how each element of the long-term incentive produced or is expected to produce compensation based on performance (depending on the committee's philosophy in granting compensation as discussed above), and to highlight the elements that are based on financial performance.

Of course, as is the case under current disclosure rules, companies would not be expected to disclose non-public performance metrics that would lead to competitive harm if disclosed to competitors.

In sum, compensation is not a one-size-fits-all exercise, and companies use different approaches that fit their size, industry, strategy, competitive outlook and talent retention and development needs. The Commission should help promote clearer shareholder understanding of the decisions made by a Compensation Committee and/or the Board by implementing a principles-based approach to disclosure of the relationship between pay and performance.

VI. Pay Ratio Disclosure

The new disclosure requirements created by section 953(b) of the Dodd-Frank Act, which requires companies to calculate the median pay for "all employees," would be extremely difficult, if not impossible for large companies, especially those with substantial global operations. While the Center opposes the ratio because it does not believe it will provide any meaningful or material information that will be used by investors, the Center recognizes that the Commission has obligation to implement the language. For this reason, the Center believes that the Commission should interpret the statutory language in a way that fulfills the statutory mandate while making it practicable for corporations to comply. In sum, the Center believes the following:

- The phrase "all employees" should be interpreted to mean all full-time U.S. employees because of difficulty in aggregating and calculating disparate pay data from dozens of locations and systems;
- Total compensation for non-NEO employees should exclude certain items, including pension values and other compensation; and
- Because of the difficulty in aggregating the information globally, companies should be able to present a reasonable, good faith estimate, and the amounts should be considered as "furnished" rather than "filed."

Our rationale for each of these recommendations is discussed below.

A. "All Employees" Should Be Interpreted as "All Full-Time U.S. Employees"

The Center believes that the SEC should propose reasonable and workable interpretation of section 953(b) that takes into consideration the practical ability of companies to calculate the "median of annual total compensation." The critical part of the section states that an issuer is required to disclose "the median of the annual total compensation of all employees of the issuer except the CEO," using the same calculations the company uses to determine total pay under the SEC's proxy disclosure rules. Because the definition of median means "midpoint," depending on how the phrase "all employees" is defined, companies could be required to calculate pay as specified by the proxy rules for each individual employee globally and then determine the median of those values. For large employers, this means they will have to accurately calculate pay for tens of thousands and in some cases, hundreds of thousands of employees to determine the median. For some companies it will be nearly impossible to develop this number with the same accuracy that applies to NEO pay disclosures.

For many global employers, compensation data is housed in dozens of computer systems, and the data may not be sufficiently accurate for SEC disclosure purposes. The following examples of the number of employees and systems affected illustrate why this is a difficult and costly challenge for global employers and why the Commission should adopt a narrow interpretation of the provision:

- Company A: over 200,000 employees operating in over 60 countries has data housed in over 100 different systems;
- Company B: 33,000 employees in 35 countries and had data in roughly 75 systems;
- Company C: 107,500 employees in 52 countries with 115 pay systems and over 100 vendors.

In each of these situations, the company would be required to develop and coordinate a consistent calculation for each employee in all countries and then ensure that the results were accurate. In addition to the challenges of computing employee compensation as required under the Commission's executive compensation disclosure rules, the global compensation data would need to be translated into U.S. dollars, and those amounts could fluctuate considerably based upon unpredictable exchange rates. Moreover, unless the Commission makes the ratio a "furnished number" the data disclosed will need to be sufficiently accurate that company CEOs and CFOs could sign off on the disclosures as required under section 302 of Sarbanes-Oxley.

Because of these difficulties, and recognizing that the phrase "all employees" is not defined in the legislation or the legislative history, the Center urges the Commission to use its interpretive discretion to define "all employees" as "all full-time U.S. employees." This approach provides greater consistency because the comparison is being made within one geographic market, and nearly all U.S. employers would be able to readily obtain basic compensation information, which would not be the case if the phrase were interpreted to include all global employees. Limiting the disclosure to full-time employees eliminates the need to determine which employees are eligible for the disclosure and simplifies data collection without substantially affecting the calculation.

B. The Commission Should Exclude Pension Values and All Other Compensation Amounts for Non-NEO Employees

Section 953(b) requires companies to calculate compensation as is required for the named executive officers. No public company currently calculates each employee's total compensation as it calculates total pay on the Summary Compensation Table for the named executive officers, because disclosure of executive pay has a different purpose than internal accounting. With this in mind, the Center urges the Commission to eliminate the calculation of the actuarial increase in pension benefits and all other compensation for the purposes of the pay ratio. As a practical matter, few rank-and-file employees are likely to have such amounts, but eliminating them from the calculation would avoid the requirement that employers have to check for them with respect to each employee.

C. The Pay Ratio Should Be Considered a Furnished, Rather Than Filed Number

Even if the scope of the disclosure is limited as discussed above, the Center believes that the Commission should make the total median pay of all employees and the pay ratio disclosure a furnished rather than filed number, due to the complexities in developing an accurate calculation. Making the ratio a furnished number would not affect any of the executive compensation disclosures, including the disclosure of CEO compensation under the Commission's executive compensation rules. This approach would, however, encourage employers to provide a reasonable good faith calculation of the ratio while recognizing the substantial resources required to develop the median total compensation for all employees that would be sufficiently accurate for CEO and CFO certifications. Because of the difficulties described above, many companies have stated anecdotally, that they may only be able to provide an estimate. Making the ratio "furnished" rather than filed is a reasonable solution that also satisfies the policy objectives of the legislation.

In sum, the Center opposes the pay ratio disclosure requirement. However, we understand that the Commission must implement the law as passed by Congress. We urge the Commission to adopt a narrow interpretation which would satisfy the intent of the provision while mitigating the extraordinary expense employers would be required to bear to create the information, which very few shareholders would find useful.

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Conclusion

The Center On Executive Compensation appreciates this opportunity to provide comments on our suggested approaches to regulation under the pay and governance provisions of the Dodd-Frank Act. If you have any questions about these comments, please contact me at tbartl@execcomp.org.

Sincerely,

Timothy J. Bartl

Timothy J. Bartl
Senior Vice President and General Counsel

Attachment: Pay for Performance at a Glance Disclosure

cc: Securities and Exchange Commission
Hon. Mary L. Schapiro, Chairman
Hon. Kathleen L. Casey, Commissioner
Hon. Commissioner Elisse B. Walter, Commissioner
Hon. Commissioner Luis A. Aguilar, Commissioner
Hon. Commissioner Troy A. Paredes, Commissioner

Securities and Exchange Commission -- Division of Corporation Finance
Ms. Meredith Cross
Ms. Paula Dubberly

Appendix: Example of Disclosure of Compensation Actually Paid to Financial Performance Using a Realized Pay Approach

(NOTE: For the sake of illustration, mock up assumes disclosure is made in 2009 and the reporting year is 2008)

Executive Summary

-for-performance philosophy that seeks to link the interests of the named executive officers with those of the shareholders and that guides the Committee's decisions regarding executive compensation. Despite an unfavorable economic environment in the second half of the year, in 2008, the company still generated positive earnings and posted an increase in cash flow. Long-term results were also positive and on par with peer companies.

To assist shareholders in assessing the extent of the pay for performance link, the company has a supplemental table that shows how realized pay compares with actual performance. This table differs from the Summary Compensation Table (page X) in that the Summary Compensation Table is a mixture of actual pay realized in 2008 and the accounting expense for long-term incentives that are contingent upon future performance. The Summary Compensation Table also includes elements considered compensation under SEC rules which are not directly related to performance, specifically items included in "All Other Compensation" and the actuarial increases in pension value and nonqualified deferred compensation earnings. The tables are not intended as a replacement for the Summary Compensation Table, and while no approach to explaining the link between compensation programs and performance is perfect, the company believes the following tables provide greater clarity into the relationship.

Table 1 provides information as to the actual levels of compensation realized during 2008 by Mr./Ms. (Name), the company's Chief Executive Officer, and a description of the performance results that generated the realized compensation. In the case of long-term incentive payouts, gains on stock options exercised and restricted shares that vested during the year, these awards were earned over multiple years but were realized in 2008. For this reason, Table 1 provides both the total compensation realized and the annualized amount of compensation ratably attributable to 2008 and the other years between the grant date and 2008. Because the ratable amount is not known until the year in which the award is realized, and this is the first year the company has used this format, the ratable portion for years before 2008 is not reflected in previous years' compensation. Going forward, the company intends to use this framework annually, which should enhance the comparability of realized pay year-to-year.

Staff contact: Tim Bartl (tbartl@execcomp.org)

Table 1: Comparison of Actual Pay Received in 2008 to Actual Performance*

Form of Compensation	Period Covered	Total Received ($)	Annualized Amount ($)	Performance Results Over Performance Period That Produced the Compensation
Salary	2008	$1,000,000	$1,000,000	The company generally targets salary for all executives at the 50th percentile of peer group companies. Based on this analysis, no adjustment was necessary for 2008.
Annual Incentive	2008	$1,800,000	$1,800,000	The annual incentive paid to NEOs is based on EBITDA, which measures economic profit and is a good measure of short-term performance; free cash flow from continuing operations, which reflects the company's ability to generate cash; and other corporate objectives, which are not disclosed due to competitiveness concerns. 2008 EBITDA increased by 11.4% over the prior year and exceeded the targeted level of performance. Free cash flow from continuing operations increased by 7% over 2007, totaling $3.3 billion and exceeded target. The Compensation Committee determined that accomplishment of other targeted corporate objectives fell short of expectations and thus resulted in no payout.
Long-Term Incentive Payout	2006-2008	$6,450,000	$2,150,000	The Long Term Incentive award was earned over the three-year performance period, 2006-2008, and produced a total payout of $6,450,000, or $2,150,000 per year. Performance criteria for this award were: (1) EPS growth, weighted 50%, which exceeded the targeted level; EPS reflects the company's profit per share and is a measure of the after-tax returns generated by the company. (2) Opening new markets in key strategic regions, weighted 25%, which was not achieved at the targeted level, and (3) Total return to shareholders compared against peer group companies, weighted 25%, for which the company ranked 7th out of 15 peer companies, producing a payout at target. Overall the payout represented 105% of target.
Equity Compensation				
Stock Option Exercises	2000-2008	$8,000,000	$1,000,000	The gains upon exercise of stock options in 2008 were $8 million, based upon stock price appreciation between 2000 and 2008. During that time, the stock price appreciated from $15 to $35 per share, reflecting the company's strong growth and profitability. Because the $8 million was earned over the 8 years the award was outstanding, the annualized gain (i.e., the gain spread equally over the period the options were held), is $1 million for each year the options were outstanding, reflecting the amounts earned over the performance period.
Restricted Stock Vesting	2006-08	$4,500,000	$1,500,000	Similarly, the value of the restricted stock that vested in 2008 was $4.5 million, and was earned over the three-year period from 2006 and 2008. Because the total gain was earned based on stock over the three-year vesting period, the annualized gain (i.e., the gain spread equally over 2006, 2007 and 2008) is $1.5 million per year. The company uses restricted stock to retain our top talent and to further align their interests with those of shareholders.
Total Actual Compensation Earned in 2008	2000-2008	$21,750,000**	$7,450,000**	See explanations under the Salary, Annual Incentive and Long-term Incentive boxes above. For amounts earned over more than one year, the annualized amount represents the pro-rata portion attributable to 2008. It includes the annualized gain for LTIP payout, stock option exercises and restricted stock, as well as total annual salary and annual incentive.

Note: This Table differs substantially from the Summary Compensation Table required by the U.S. Securities and Exchange Commission and is not meant a substitute for that table.

* Sample disclosure for illustrative purposes only.