From Medium.com

Meet Mr. Ticker

Meet Mr. Ticker. He's the hypothetical rogue banker described in Washington's newly proposed rule to reform Wall Street pay.

Six federal agencies charged with overseeing Wall Street—from credit unions to mega-banks—are proposing rules to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This section charges them to write rules that prevent "excessive" pay packages that lead to "inappropriate risk-taking."

The proposed rule spans 280 pages, most of which consists of explanation of the rule. The actual rule is about 20 of these pages. In an effort to communicate in "plain English," the agencies describe hypothetical bankers Ms. Ledger (who's honest) and Mr. Ticker (who's not).

In the inevitably prudish lexicon of the banking agencies, "Mr. Ticker is a significant risk-taker who is the senior manager of a trader and a trading desk that engaged in inappropriate risk-taking in calendar year 2021, which was discovered on March 1, 2024. The activity of the trader, and several other members of the same trading desk, resulted in an enforcement proceeding against ABC and the imposition of a significant fine."

Restated, Mr. Ticker and his team manipulated markets, and successfully hid it from the board for three years.

The fictional Mr. Ticker manipulated the markets, of course, to make himself a pile of money. That's the same motive behind the Huns of Wall Street who actually did crash the economy in 2008. That's why a central statute of President Obama and Congress' 2010 Wall Street reform aimed to repair the perverse compensation incentives. Only now, six years later, have the regulators come around to draft the specific rules for pay, including pay for crooks. Alone, this delay has been discreditable.

And how do the regulators propose to punish Mr. Ticker? How will they change the rules so rogue traders don't profit from their misconduct? What frightful fate awaits, so that Mr. Ticker won't even contemplate crossing the line?

"In this case, [Mr. Ticker's bank] decides to defer $30,000 of Mr. Ticker's incentive-based compensation for three years so that $10,000 is eligible for vesting in 2022, $10,000 is eligible for vesting in 2023, and $10,000 is eligible for vesting in 2024. No adverse information about Mr. Ticker's performance comes to light in 2022 or 2023 and so $10,000 vests in each of those years. However, Mr. Ticker's inappropriate risk-taking during 2021 is discovered in 2024, causing ABC to forfeit the remaining $10,000. Therefore, the amounts that vest in this case are $10,000 in 2022, $10,000 in 2023, and $0 in 2024."

That's it. That's Washington's idea of punishment. The bank identifies a senior employee who violates the law. If they catch the infraction within three years, they're encouraged to haircut a portion of the incentive part of his pay by about a third.

It's really even more lenient than this. Regulators say that only half of the incentive pay must be deferred. And the incentive part is on top of the regular pay. For example, the average bonus for Wall Street investors in 2015 was $146,200, according to the New York State Comptroller . That's on top of $258,000 in regular pay. (The regular pay figure is actually for 2014; the bonus figure from 2015.) In other words, Mr. Ticker would receive half of the $146,200 immediately, leaving $73,100 deferred. He then pockets two-thirds of the $73,100 before his bosses catch on to his illicit scheme. In the end, he only forfeits $24,366. The penalty for misconduct for Mr. Ticker, who is paid $404,000 a year, is $24,366.

There's even more leniency than that built into the proposed rule. Washington only requires the bank "to consider" this haircut. The regulators themselves won't order a pay penalty. Nor do the regulators propose requiring that the pay penalties be disclosed publicly.

At Citigroup's annual meeting April 26, I asked CEO Michael Corbat if the firm clawed back pay for misconduct. Yes, he said. Who were the individuals, I inquired. Their names are confidential, he replied. How many had pay docked for the fraud allegations Citi settled in various government arrangements, I pressed. He said that number was also confidential. Given that management failed to prevent what the government claimed was massive fraud, a cynic might question whether one should trust this same management to claw back money from its wayward Mr. Tickers.

Public Citizen supports full disclosure. If the price of misconduct includes the publication of names, that can bolster deterrence.

We also support much longer pay deferral periods. In early April, 2016, Goldman Sachs paid a $5 billion penalty for to settle claims of misconduct dating back to 2006. Presumably, all those Goldman employees who profited from this alleged fraud have long since purchased their yachts and Hampton retreats.

New York Federal Reserve President William Dudley (a Goldman alumnus) proposes pay clawbacks with real teeth: a substantial portion of pay would be set aside 10 years for a reserve that can pay for these sorts of penalties without regard to whether the senior employee committed the fraud. That would incentivize a new culture of fighting corruption within the ranks and C-suite. And while an innocent managr might suffer, the current system punishes the innocent shareholder. Or worse, the whole economy suffers. Ideally, the bankers will operate within the law and everyone gets paid—eventually.

While disappointing, this proposal remains just that; a proposal. The agencies now formally invite comment. These are due by July 22. Regulators must hear from the public—experts, victims of Wall Street abuse, vegetarians, libertarians, librarians,—who should convey the importance of strengthening this rule. Comments can be sent to any or all of the following:

regs.comments@occ.treas.gov; regs.comments@federalreserve.gov; comments@fdic.gov; rule-commdents@sec.gov.

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Options, Risk, Air & Fire

By: **Bartlett Naylor**

A stock option is to risk what air is to fire. That's not exactly what James Madison wrote in the Federalist Papers #10. ("Liberty is to faction what air is to fire"). But the nation's fourth president would certainly agree were he to comment on Washington's proposal to reform Wall Street pay.

Six federal agencies charged with overseeing Wall Street are proposing rules to implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This section charged them to write rules that prevent "excessive" pay packages that lead to "inappropriate risk-taking."

Americans for Financial Reform, a coalition where Public Citizen leads the task force on executive compensation issues, calls for the reduction of stock options in pay packages. Stock options are agreements providing the opportunity (but not obligation) to buy or sell stocks at fixed prices within certain time frames.

Yes, stock options can align managers' interests with those of other shareholders. Yes, risk-taking is what companies including banks do when they make loans. This can make sense at a firm such as Apple. Managers could simply sit on the iPhone revenues and pay themselves huge sums in cash. But a shareholder prefers they develop the Next New Thing that generates increasing revenue and lifts the stock price. But just as air and fire are separately important, risk-taking can become volatile at a bank when mixed with stock options.

Why?

The problem with stock options is that they're only valuable if the stock price rises above what's called the strike price. Stock options are different than actual stock. If you own 1000 shares of Citigroup, which is trading at $50, you've got $50,000 worth of stock. If the price goes to

$60/share, you've got $60,000, which is better. If the price sags to $40, you've got $40,000, which is worse.

Now consider stock options. This is a deal that says you have the right to buy 1000 shares of Citi stock for, let's say, $50/share (the "strike price) during a certain period, (the "exercise period."). If the stock is selling for $50, your options are worthless. If the stock goes to $60, that's terrific, since you buy at $50, and sell at $60, and pocket $10,000. If the stock price goes down to $40, that's sad, but you haven't lost anything. You didn't suffer the way you would have in the previous example where you were sitting on 1,000 shares of Citi stock and it's worth $10,000 less than it was when it traded for $50/share.

If you're a manager, especially a senior manager, options incentivize risk taking. If you receive options at $50, and the stock price falls to $40, your options are worthless unless you take some drastic steps. Maybe a big derivatives bet? Maybe loosen the rules on mortgage lending so you can generate fees for the bank by bundling them into packages that can be sold to investors (and let these investors suffer the consequences)?. Betting the farm, if you're paid on options, means you either win big, or lose nothing.

Citi CEO Michael Corbat currently has 150,000 unexercised stock options. This means that he can buy 150,000 shares of Citi stock at a certain price. They were awarded in 2011, and are now fully vested, meaning he could use them to buy stock at any time. The problem is that they're worthless–underwater. He must pay (the strike price) $49.10. That was the price of Citi stock in February 2011 when these options were awarded. The plan was that under his fine stewardship, the stock price would rise well above $49.10. But no, the stock price is lower now than it was 5 years ago.

One can assume it's game time now for Corbat because these options expire in 2017. That means he loses the right to buy 150,000 shares of stock at $49.10 in early 2017. If Citi's stock price doesn't rise above $49 by then, they're worthless. And frankly, the stock price needs to rise by a considerable amount. To be worth $1 million, the Citi stock needs to hit $55. To be worth $10 million, Citi stock must rise to $115. To get the stock price to move so much would require extraordinary risk-taking.

That's why Bart Dzivi, one of the prime investigators for the Financial Crisis Inquiry Commission, believes that stock options have no place in a bank.

The good news is that Washington recognizes the dangers of options. The regulators observe: "Overreliance on options as a form of incentive-based compensation could have negative effects on the financial health of a covered institution due to options' emphasis on upside gains and possible lack of responsiveness to downside risks. "

Some firms now eschew issuing options for their most senior executives. JPMorgan counts as a prominent example. They've shifted to stock awards, and the top five officers receive between $11 million and $27 million each, largely consisting of such awards (so needn't worry about seeing their beseeching faces in a Save the Children appeal.) And Citi has also begun to back away in recent years. If these options were a substantial still part of Corbat's annual pay, he might make extraordinary, high risk moves. But since 2011, Citi has awarded Corbat substantial stock compensation instead of options. That means there is a downside should a reckless gamble fail.

The bad news is that Washington's proposed solution in the form of the Dodd-Frank Section 956 rule fails to limit the use of options significantly. A senior executive can be paid in an unlimited amount of stock options. Options are limited only in the part of the compensation that is deemed "incentive" compensation. Incentive compensation is defined as that which is variable based on meeting some goal. In this part, no more than 15% of the compensation can be based on options. But that doesn't stop a bank from loading up a manager with options where the only performance condition is based not on meeting a goal but rather on the price of the stock itself. If the regulators would simply follow their own advice, they'd ban options altogether in pay packages, or limit their use to 15% of total compensation.

Washington must do more than wring its hands at the problem. Public Citizen asks the public to write the regulators before the comment deadline of July 22. Demand that pay reform be real. No more stock options. Here are some email addresses:

regs.comments@occ.treas.gov; regs.comments@federalreserve.gov; comments@fdic.gov; rule-commdents@sec.gov. When you send in a comment, remember to use "Incentive Based Pay" in the subject line and please send us a note at action@citizen.org to let us know you took action.

Together, we can help Washington understand that stock options simply bring a leaf blower to a brush fire.

Bartlett Naylor is the financial policy advocate for Public Citizen's Congress Watch division.