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May 31, 2011

Via Email
Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: *Incentive-Based Compensation Arrangements,* Rin-3064-AD56 & File Number S7-12-11

Dear Mr. Feldman and Ms. Murphy:

AFSCME is pleased to comment on the proposed rule on "Incentive-Based Compensation Arrangements" (the "Proposed Rule") issued by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration, Securities and Exchange Commission and Federal Housing Finance Agency (collectively, the "Agencies"). The American Federation of State, County and Municipal Employees ("AFSCME"), is the largest union in the AFL-CIO representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over $1 trillion. In addition, the AFSCME Employees Pension Plan (the "Plan") is a long-term shareholder that manages $850 million in assets for its participants, who are staff members of AFSCME and its affiliates.

AFSCME and the Plan have been forceful advocates for shareholders in public companies, including financial institutions, with regard to executive compensation. AFSCME has published an annual mutual fund report for the past five years which analyzes the proxy voting track record of mutual fund managers with respect to executive compensation at their portfolio companies. AFSCME championed the creation of a "Say on Pay" advisory vote on executive compensation.

**American Federation of State, County and Municipal Employees, AFL-CIO**
**TEL** (202) 429-1000 **FAX** (202) 429-1293 **TDD** (202) 659-0446 **WEB** www.afscme.org 1625 L Street, NW, Washington, DC 20036-5687

We commend the Agencies for the approach of the Proposed Rule, which we believe will constrain the compensation practices that contributed to the financial crisis from which our economy is still recovering. Several aspects of the Proposed Rule, however, must be strengthened or clarified if the Proposed Rule is to meet its objective of "helping ensure that incentive compensation practices at covered financial institutions do not threaten their safety and soundness, are not excessive, [and] do not lead to material financial loss."

Introduction

We strongly support the overall approach taken in the Proposed Rule, which provides for closer scrutiny of incentive compensation arrangements by regulators of financial institutions. Since 2008, a consensus has developed that the way in which financial institution employees were compensated contributed significantly to the financial crisis and resulting recession. Harvard Law School Professor and executive pay expert Lucian Bebchuk has characterized the link between pay arrangements and the financial crisis as "widely accepted."[1]

In particular, financial firms' reliance on compensation plans that rewarded executives and traders lavishly for short-term performance, without regard to risks over the medium and long term, led those employees to take excessive risks. That response is unsurprising. Incentive compensation is used because incentives are effective in shaping behavior. A recent study found "plentiful and strong evidence that the incentives embedded in [bank] CEO compensation contracts were important determinants of bank business policies and bank risk-taking" between 1994 and 2006.[2]

Although suboptimal compensation arrangements are in place at firms in all industries, factors unique to the financial industry provide a compelling justification for enhanced oversight of compensation by regulators. A significant proportion of a financial institution's financing may be provided by insured deposits. Unlike other kinds of creditors of a firm, depositors lack the resources and motivation to constrain financial institutions' risk-taking.

More broadly, moral hazard is created by the expectation that larger financial institutions are "too big to fail" and that the government will step in to shield them from failure through capital injections, guarantees, liquidity programs and similar measures. Bebchuk and Spamann have noted that this expectation may reduce the motivation of even

[1] Lucian Bebchuk & Holger Spamann, "Regulating Bankers' Pay," *Georgetown Law Journal*, Vol. 98, pp. 247-287 (2010).
[2] Robert DeYoung et al., "Executive Compensation and Business Policy Choices at U.S. Commercial Banks," at 4 (working paper 2010) (available at www.ssrn.com).

sophisticated bondholders to negotiate and enforce limits on the risks financial institutions take.

Financial Institutions Covered by the Proposed Rule

The Proposed Rule would apply to specified types of financial institutions with $1 billion or more in total consolidated assets. The mandatory deferral provisions, discussed below, would apply to financial institutions with $50 billion or more in total consolidated assets.

We are concerned that these definitions fail to account for assets (and accompanying potential liabilities) that are not accounted for on the balance sheets of financial institutions. FDIC Chairman Sheila Bair testified before the Financial Crisis Inquiry Commission that "off-balance sheet activities can seriously harm the finances of the consolidated organization and the economy more widely."[3]

Liabilities associated with off-balance-sheet assets contributed significantly to the financial distress experienced by Citigroup, where the value of off-balance-sheet assets was 50% of the value of the company's assets on the balance sheet dated March 31, 2008.[4] At the end of 2008, the off-balance-sheet assets at the four largest U.S. banks - Bank of America, Citigroup, JPMorgan Chase and Wells Fargo - totaled $5.2 trillion.[5] Merrill Lynch CEO John Thain admitted in a June 11, 2008 investor call that "[t]he riskiest assets we had, our CDOs, weren't even on our balance sheet."[6]

Subsequent accounting and regulatory changes have tightened rules on off-balance-sheet treatment and may have made off-balance sheet activities less attractive to companies from a regulatory standpoint. Nonetheless, we believe that basing the Proposed Rule's coverage on only the amount of assets reflected on financial institutions' balance sheets undermines the Proposed Rule's effectiveness in constraining risk-taking behavior at institutions whose stability is important to the financial system.

We are particularly interested in the $50 billion threshold for larger financial institutions, because there is evidence that compensation incentive effects have tended to be substantially stronger for large bank CEOs than small bank CEOs. DeYoung et al., discussed *supra*, found that large bank CEO compensation *vega*—the change in wealth

[3] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission," Jan. 14, 2010 (available at http://www.fdic.gov/news/news/speeches/chairman/spjan1410.html).
[4] See Bradley Keoun, "Citigroup's $1.1 Trillion of Mysterious Assets Shadows Earnings," Bloomberg, July 13, 2008 (available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a1liVM3tG3aI&refer=home).
[5] David Reilly, "Banks' Hidden Junk Menaces $1 Trillion Purge," Bloomberg, Mar. 25, 2009.
[6] Keoun, *supra* note 4.

with respect to changes in stock return volatility—was up to five times stronger than small bank CEO compensation *vega* during the 1994-2006 period analyzed in the study. CEO compensation *delta*—the sensitivity of wealth to changes in the firm's stock price—at large banks was at least three times larger on average than small bank *delta* during most of that period.[7] Accordingly, we urge the Agencies to include assets not accounted for on the balance sheet in the definitions of larger covered institutions, even if they decline to include such assets in the definitions of covered institutions.

Definition of Incentive Compensation

The Proposed Rule would define incentive-based compensation as "any variable incentive that serves as an incentive for performance." The Proposed Rule makes clear that the form of payment is not relevant in determining whether compensation is incentive-based.

We are concerned that the definition of incentive-based compensation—specifically the use of "serves as"--appears to turn on the subjective intention of the financial institution or the executive or both. Our experience in engagements with board compensation committees and members of management responsible for executive compensation makes us wary of this approach.

For example, it is not unusual for a company to award a significant amount of stock to an executive who is moving from another firm to compensate her for compensation she is leaving behind. Companies often justify such awards as necessary to attract talented executives. The new employer could argue that the inducement grant was not intended to serve as an incentive for performance within the meaning of the Proposed Rule. Similarly, a financial institution might grant options or award stock with a value calculated solely by reference to the recipient's base salary and condition vesting or lapsing of restrictions solely on continued employment. Under the Proposed Rule's current language excluding arrangements where payment is solely tied to continued employment and where the amount of compensation is determined based solely on the covered person's level of fixed compensation, a financial institution could argue that such a grant or award is not incentive-based compensation, even though its future value to the employee turns on the price of the financial institution's stock.

In our view, three changes to the Proposed Rule would be useful in preventing this kind of gamesmanship. First, the Proposed Rule should define incentive-based compensation in a functional way rather than focusing on the purpose the compensation serves. One possibility would be to define incentive-based compensation as compensation whose current or future financial value to the recipient is determined in whole or in part by the recipient's individual performance and/or the performance of the financial institution

[7] DeYoung, supra note 2, at 23.

(including, but not limited to, the value of the financial institution's securities). This definition would encompass the equity-based compensation arrangements described above because, regardless of the firm's intention in paying the compensation, the value to the employee will be determined by the stock price.

Second, the Proposed Rule should identify arrangements that will always be considered incentive-based compensation, while making clear that the list is not intended to be exhaustive and that financial institutions must analyze all compensation arrangements using the principles-based definition. We suggest that stock options and stock awards would be appropriate arrangements to include in such a list. The identification of arrangements that are always considered incentive-based compensation would limit the mischief occasioned by the language regarding exclusions from the definition that is currently in the Proposed Rule.

Finally, financial institutions should be required, as part of the reporting to the Agencies discussed below, to identify the compensation arrangements that are <u>not</u> considered incentive-based. The Agencies can follow up this reporting with specific questions about any compensation arrangement whose classification as not incentive-based seems potentially erroneous.

<u>Definition of Excessive Compensation</u>

The Proposed Rule would prohibit incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risks by providing excessive compensation. The Proposed Rule would define "excessive compensation" as compensation that is "unreasonable or disproportionate" in relation to the services being performed by a covered person. Under the Proposed Rule, the Agencies may consider a list of enumerated factors in determining whether compensation is excessive and may also consider any unlisted factor they determine to be relevant.

The factors listed in the Proposed Rule are unobjectionable. We believe, however, that (a) additional factors should be included and (b) clarification regarding certain factors is necessary.

The most notable omission is any consideration of risk. We note that the Proposed Rule includes risk adjustment in the analysis that financial institutions must do in order to comply with the prohibition on compensation arrangements that encourage inappropriate risks that could lead to material financial loss. We believe that risk adjustment should be part of the evaluation of whether compensation is excessive as well. In the investment world, returns generated by an investment strategy are typically evaluated in the context of the risks inherent in the strategy. The same principles should be used to evaluate the need for risk adjustment in the context of analyzing excessiveness that are used to determine whether compensation arrangements encourage inappropriate risks that could lead to material financial loss. The release setting forth the Proposed Rule describes a range of potentially acceptable measures, including quantitative formulas and adjustments based on managerial judgment, subject to appropriate oversight.

The financial institution's financial performance is a second factor that should be added. Compensation is excessive when it's disconnected from the performance of the institution, e.g., when increasing compensation does not match declining institution performance. An institution's financial condition (one of the factors set forth in the Proposed Rule) may be sufficiently healthy to allow it to pay compensation, but that compensation may be excessive because the institution's financial performance has been subpar. Performance should be evaluated at least in part by reference to an appropriate peer group because any determination of excessiveness should take into account the performance of a financial institution relative to its peers.

The Proposed Rule identifies compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets, as a factor in the excessiveness analysis. We believe that additional guidance should be provided on what constitutes a "comparable" institution. There is ample evidence that companies skew the selection of peer group companies identified in the proxy statement for executive compensation purposes and a recent study showed that such manipulation is associated with abnormally high compensation amounts.[8] The Agencies' familiarity with firms within their jurisdiction gives them a solid basis for defining comparable institutions.

The Agencies should also clarify what is included in a covered person's compensation history. In our view, the Proposal Rule should be revised to state that the excessiveness of compensation should be analyzed in the context of all of the compensation paid to a covered person during his employment, as well as the unrealized wealth he has accumulated during that time.

For example, a financial institution might conclude that a large stock award to an executive officer with a long tenure at the institution, who has amassed substantial holdings of the institution's stock (and enjoyed substantial appreciation in the value of that stock) is excessive compensation, even though the same award to an executive who is new to the institution might not be considered excessive. This kind of analysis, sometimes referred to as "accumulated wealth" analysis, is used by some compensation consultants to help boards move beyond a purely year by year approach to deciding how much compensation is too much as well as how best to motivate future performance.

<u>The Mandatory Deferral</u>

[8] IRRC Institute and ProxyGovernance, "Compensation Peer Groups at Companies with High Pay" (June 2010) (available at http://www.irrcinstitute.org/projects.php?project=47 )

We commend the Agencies for proposing a mandatory three-year deferral of 50% of incentive-based compensation of executive officers at larger covered financial institutions and for requiring that deferred amounts be adjusted for actual losses or similar performance measures of the covered financial institution during the deferral period. The AFSCME Employees Pension Plan was the first U.S. institutional investor to formally advocate this type of arrangement—often referred to as "bonus banking"—at financial institutions, using the shareholder proposal process.

A mandatory deferral would create a longer-term focus for executives and would help ensure that they are not compensated for what the University of Chicago's Raghuram Rajan calls "fake alpha": "appearing to create excess returns but in fact taking on hidden tail risks, which produce a steady positive return most of the time as compensation for a rare, very negative, return." Encouraging the creation of true alpha, Rajan says, requires that "[s]ignificant portions of compensation [be] held in escrow to be paid only long after the activities that generated the compensation occur."[9] Mandatory deferral would also bring U.S. financial institutions into line with evolving global practice.

We support the contours of the deferral outlined in the Proposed Rule. We believe, however, that using a single deferral period for all executive officers of larger financial institutions may not be ideal. The purpose of the deferral is to align employees' incentives with the risk they undertake. It seems unlikely that the risks undertaken by all executive officers at a financial institution (or, more accurately, undertaken under executive officers' supervision) can be fully assessed within a three-year period. Instead, the deferral would best accomplish its objectives if it were based on an average time horizon for evaluating the risks for which the executive officer is accountable. At the highest levels of management, such an average might be calculated across the entire institution. For business line heads, the average would be limited to particular business lines.

If the Agencies prefer to use a single period for the deferral, we believe that the three-year period, at least in combination with the 50% deferral requirement, puts too little incentive-based pay at risk to promote optimal alignment. In our view, a five-year period with backloaded payouts, would be preferable. Or, a covered institution could be permitted to use a three-year period if it deferred a larger proportion—say, two-thirds or 70%--of incentive-based compensation.

Finally, the mandatory deferral should apply to a larger group of employees than just executive officers. Especially at the larger covered financial institutions—whose failure would pose the greatest risk to the financial system—executive officers make up a small

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[9] Raghuram Rajan, "Bankers' Pay is Deeply Flawed," FT.com, Jan. 8, 2008) (available at http://www.ft.com/cms/s/0/18895dea-be06-11dc-8bc9-0000779fd2ac.html#axzz1N5ryAT1n)

proportion of employees who receive high levels of incentive-based compensation and whose decisions may create substantial risk for the institution. We urge the Agencies to require deferral for employees who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance, who are discussed in the following section.

Special Review and Approval Requirement for Other Designated Individuals

The Proposed Rule would mandate that the board of a covered financial institution identify those covered persons other than executive officers who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance. The board or a committee of the board would be required to approve those individuals' compensation and maintain documentation of approval.

We support the elements of review and board approval contained in this section of the Proposed Rule. We are concerned, however, that this provision gives boards very little guidance and near-total discretion in identifying the employees who will be included. The Proposed Rule provides only one example—that of traders with large position limits relative to the institution's overall risk tolerance. Many covered institutions are extremely large and complex organizations. For example, data provided by The Corporate Library's Board Analyst database indicate that Bank of America has 288,000 employees; Citigroup employs 260,000 people; and JPMorgan Chase has 239,831 employees. As a result, we believe that identifying employees who have the ability to expose the institution to substantial losses will be a daunting task for boards of larger institutions.

Accordingly, we urge the Agencies to provide some non-exclusive bright-line standards to guide this inquiry. Functional standards would, we think, be more useful than standards focusing on particular job titles. For example, the Agencies might stipulate that anyone who serves on a committee (not a board committee) or similar body at a covered institution that has input into, administers or allows exceptions to the institution's risk tolerance should be identified in connection with this requirement.

Reporting Requirement

The Proposed Rule would require larger covered financial institutions to submit annual reports to their regulator disclosing the structure of its incentive-based compensation arrangements, including descriptions of policies and procedures, material changes to compensation arrangements since the last annual report and the "specific reasons why the covered financial institution believes the structure of its incentive-based compensation plan does not encourage appropriate risks by the covered financial institution . . . ."

In our view, narrative disclosures like those set forth in the Proposed Rule are of limited utility in evaluating the level of risk created by compensation arrangements. Our experience with the narrative Compensation Discussion and Analysis section of the proxy statement, which requires some disclosures that are similar to those contained in the Proposed Rule, is that such descriptions tend to be heavily lawyered and convey little meaningful information.

To effectively carry out the purpose of the Proposed Rule, the Agencies need to be able to monitor the risk created by compensation arrangements on an institution-by-institution basis and across regulated institutions; in both cases, the Agencies also need to be able to track trends over time. To do so, the Agencies need specific structural data from covered financial institutions, in a uniform format to allow data aggregation and analysis, about specific compensation arrangements. We suggest that the Agencies should receive data on median stock option grants, stock awards and stock/option holdings to allow the Agencies to calculate measures of the sensitivity of pay to risk and performance at covered institutions. Data on the median amount of compensation paid under short-term incentive plans, as well as the median amount of compensation subject to deferral, would also be useful.

The data should cover a group of employees beyond executive officers in order to provide a full picture of compensation arrangements at an institution. We recognize that even larger financial institutions have widely varying numbers of employees, making it difficult to select a single number of employees for all covered institutions. Accordingly, we suggest that structural data be required about a specified percentage of employees.

One possibility is to focus on the most highly compensated employees at a financial firm (outside of executive officers) or those who receive the largest amounts under short-term incentive plans. Our calculations indicate that, based on data from the 2008 Cuomo Report on financial firm bonuses, the median TARP financial firm recipient paid bonuses of $1 million or more to approximately .2% of its employees in 2008. It seems likely that financial institutions are already generating data on highly compensated employees as part of their own analyses of compensation and risk, if not for more generic human resources purposes. Accordingly, we urge the Agencies to specify a percentage of employees and require detailed structural data on compensation arrangements within that group.

Hedging Transactions

The Agencies ask for comment on whether covered financial institutions' policies and procedures should be required to include limits on personal hedging strategies. We believe that allowing hedging subverts the measures prescribed in the Proposed Rule, which are intended to align compensation with risk. Hedging sharply limits the ability of incentive compensation to shape behavior, such as the promotion of a longer-term outlook intended by the Proposed Rule's mandatory deferral. For that reason, Kenneth Feinberg, the U.S. Treasury Special Master for TARP Executive Compensation banned the practice among top executives at TARP companies.

A study of hedging transactions reported in SEC filings from 1996 through 2006 found an increase in financial restatements and shareholder lawsuits during the year after executives and directors had engaged in hedging. Thus, we are concerned that executives of financial institutions might engage in hedging to counter losses they think might occur as a result of excessive risk-taking. The Agencies should include in the final rule a provision prohibiting hedging by executive officers and other employees who have the ability to expose financial institutions to substantial losses.

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We appreciate the opportunity to share our views with the Agencies on this important issue. If you have any questions, or need additional information, please so not hesitate to contact Lisa Lindsley at (202) 429-1275.

Sincerely,

Gerald W McEntee

GERALD W. McENTEE
International President

cc: Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Office of Thrift Supervision
National Credit Union Administration
Federal Housing Finance Agency