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May 31, 2011

Via Electronic Filing

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

Re: File Number S7-12-11 (Incentive-Based Compensation Arrangements)

Dear Secretary Murphy:

The Cornell Securities Law Clinic ("the Clinic") welcomes the opportunity to comment on the Securities and Exchange Commission's ("the Commission") Rule Proposal for Incentive-Based Compensation Arrangements, File Number S7-12-11 ("Rule Proposal"). The Clinic is a Cornell Law School curricular offering in which law students provide representation to investors and provide public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see http://securities.lawschool.cornell.edu.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1] signed into law July 21, 2010, requires the Commission to prescribe regulations or guidelines on incentive-based compensation practices at covered financial institutions.[2] Specifically, section 956 of the Dodd-Frank Act,[3] requires that the Commission prohibit incentive-based payment arrangements at a covered financial institutions if the Commission determines those arrangements encourage inappropriate risks or lead to material financial loss.[4] For the Commission's purposes, the Act defines "covered financial institution" to include any broker-dealer registered under section 15 of the Securities Exchange Act of 1934 at a firm that has over $50 billion in assets.[5]

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[1] *See* The Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter Dodd-Frank Act), page 1841, *available at* http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.
[2] Incentive-Based Compensation Arrangements; Proposed Rule, 76 Fed. Reg. 21170, 21172, *available at* http://www.sec.gov/rules/proposed/2011/34-64140fr.pdf (hereafter Rule Proposal).
[3] *See* Dodd Frank Act, *supra* note 1, at 1905.
[4] *See* Rule Proposal, *supra* note 2, at 21772.
[5] *Id.* at 21188.

Introduction

Incentive-based compensation arrangements implicate two major issues related to the separation of ownership and control of a firm. First, managers have incentives to neglect the effective management of corporate resources insofar as those resources belong to shareholders, not managers.[6] Therefore, managers have the incentive to indulge in resources that come at no cost to them. Properly structured compensation packages may be able to better align managerial incentives with those of shareholders.[7] Secondly, the design of compensation packages for high-level managers is typically left to directors, who themselves act on behalf of shareholders.[8] The Commission's position is that flawed incentive compensation practices in the financial industry were a contributing factor to the financial crisis and that aligning the interests of shareholders and employees is not always sufficient to deter behavior that can lead to material financial losses.[9] As a result, the Commission is introducing a regulatory regime that would monitor incentive-based arrangements at financial institutions and invalidate arrangements that encourage inappropriate risks or would otherwise lead to material financial losses for the firm.

1. **The Commission Should**
   Clarify Key Portions of the Rule Proposal

   a. ***The Commission's Compensation Review Process Appears Contrary to the Aim of Dodd-Frank***

The Commission proposes that a covered financial institution be required to disclose the structure of its incentive compensation arrangements so that the Commission can determine whether the structure provides "excessive compensation, fees, or benefits" or has potential to "lead to material financial loss" for the institution and if so, to prohibit it.[10] According to the Commission, the Dodd-Frank Act does not require a covered financial institution to report individuals' actual compensation.[11] In explaining how the Commission will implement a review process for excessive compensation arrangements, however, the Commission says it will consider the "compensation history of the covered person relative to other individuals with similar expertise."[12] This allows the Commission to determine whether compensation for the covered person is excessive.[13] Logically, however, the Commission cannot compare compensation levels unless the firm to reveals individuals' actual compensation. Therefore, what the Commission is proposing seems contrary to the intent of the Dodd-Frank Act. The Clinic asks that the Commission clarify this provision.

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[6] *See* THOMAS CHOO, CORPORATE GOVERNANCE: LAW, THEORY AND POLICY 471 (2010).
[7] *Id.*
[8] *Id.*
[9] *See* Rule Proposal at 21772.
[10] *Id.*
[11] *Id.*
[12] *See* Rule Proposal, *supra* note 2, at 21178.
[13] *Id.*

b. The Clinic Urges the Commission to Define "Material Financial Loss"

Section 956 of the Dodd-Frank Act requires that the Commission prohibit compensation arrangements that would lead to "material financial loss." This term functions as the basis for several key aspects of, if not the entire, Rule Proposal. Thus, the phrase "material financial loss," itself unclear, is a highly significant term. Where Congress has delegated to an agency, such as the Commission, the power to speak with the force of law and the agency has interpreted a statute that it administers, courts must afford deference to the agency's reasonable statutory interpretations.[14] Deference by courts is especially fitting where, such as here, the statutory meaning is unclear.[15] Furthermore, because the Dodd-Frank Act mentions "material financial loss" only in Section 956 but does not define it, this strongly suggests that Congress intended the Commission to interpret the meaning of the statute. Therefore, the Clinic believes that Congress delegated to the Commission the responsibility of defining "material financial loss."

Additionally, to ensure that the Commission is not behaving arbitrarily or capriciously in implementing the Rule Proposal, courts evaluate whether the agency reasoned from statutory premises in a well-considered fashion.[16] This may require that the interpretation be supported by a reasonable explanation that is logically coherent.[17] The Clinic believes the Commission has not presented its interpretation, or provided a reasonable explanation, for the phrase "material financial loss."

After review, the Clinic was unable find a clear definition for the term "material financial loss" in the Rule Proposal. The closest attempt to define it is found in a section entitled "Inappropriate Risks that May Lead to Material Financial Loss."[18] However, this section merely explains the obvious, which is that section 956 of the Dodd-Frank Act applies to compensation arrangements. The need to define "material loss" is heightened by the fact that, according to the Commission, no other guidance exists to clarify its meaning.[19] Without a clear understanding of "material financial loss," the Commission does not provide an effective understanding of every provision that depends on the term for its enactment.

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[14] *See* Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).
[15] This is known as "step two" of the *Chevron Doctrine*.
[16] *See Chevron*, *supra* note 14.
[17] *Id.*
[18] *See* Rule Proposal at 21178.
[19] The Commission states that "Section 39 of the FDIA does not include standards for determining whether compensation arrangements may encourage inappropriate risks that could lead to material financial loss." *Id.*

2. **Incentive Arrangements for <u>Executives May Be Difficult to Compare</u>**

As part of compensation arrangement comparisons, the Commission asks whether it should include additional factors, such as the "nature of a firm's operations."[20] The Clinic believes the Commission should include such factors. Doing so ensures that compensation arrangements are compared to similar jobs at similar firms. The Commission will be using at least six defined criteria to determine whether compensation is unreasonable or disproportionate to the nature, quality, and scope of services performed by the executive.[21] Still, this may not fully ensure that comparisons are between individuals in the same class of employment. While the Commission appears to recognize that executive compensation may not be easy to compare, the Clinic would like to express additional concern.

The complexity of each firm, and the differences between them, give rise to wide variation in the responsibilities of executives, which may preclude the comparative analysis that the Commission appears to adopt in the Rule Proposal. Talent is not a fungible product. Varied jobs in a complex industry are not fungible than, say, products like corrugated containers.[22] Services generally tend not be susceptible to standardization.[23] Thus, the Clinic supports including as an additional factor the "nature of a firm's operations" to ensure that compensation arrangements are fairly compared between equivalent firms; this ensures that the arrangement of the covered person is compared with benchmark jobs that are most nearly comparable to the class of employment of the covered person in the industry.

3. **The Clinic Supports Strong <u>Corporate Governance Controls for Boards</u>**

The Commission argues that covered financial institutions should have a strong and effective corporate governance structure to help ensure sound compensation practices, including active and effective oversight by the board of directors.[24] The Commission also believes that the board of directors is ultimately responsible for a covered institution's incentive-based compensation arrangements, which should appropriately balance risk and rewards, and further ensures that those arrangements are consistent with the institution's overall risk tolerance.[25] Indeed, because of a collective action problem, shareholders face the difficulty of being unable to effectively monitor and control incentive-based compensation.[26] The Clinic agrees that shareholders must rely on the board of directors to accomplish this task due to a collective action problem on the part of shareholders. Therefore, the Clinic supports the Commission in requiring

[20] *See* Rule Proposal, *supra* note 2, at 21178.
[21] *Id.*
[22] Todd v. Exxon Corp., 275 F.3d 191, 210 (2d Cir. 2001).
[23] *Id.*
[24] *See* Rule Proposal at 21180.
[25] *Id.*
[26] *Id.* at 21173.

the board to a) review and approve the firm's incentive-based compensation arrangement; b) ensure that the arrangement is consistent with the firm's overall risk tolerance; and c) review relevant data and analysis to assess whether the overall design, as well as the performance, of the institution's incentive compensation arrangements is consistent with section 956 of the Act.[27]

4. There are Policy Concerns with Involving Risk-Management Personnel in Decisions <u>That Have Typically Been the Province of the Board</u>

The Commission states that risk management personnel should periodically assess incentive-based compensation policies to help ensure that such policies remain current and effective, as well as to ensure that risks are properly understood and evaluated, as such risks change over time in light of a continuously changing business environment.[28] Accordingly, the Rule Proposal would obligate firms to hire risk management personnel or, if risk-management personnel already exist, to expand their scope of responsibilities to help with everything from designing incentive-based compensation arrangements to verifying the firm's compliance with federal mandates.

The Clinic is concerned that the authority of risk-management personnel will exceed the board's authority. The Commission has previously stated that the board is responsible for reviewing and approving incentive-based compensation arrangements and for ensuring that the arrangement is consistent with the firm's overall risk tolerance. For example, by requiring risk-management personnel to assume a significant role in creating incentive-based arrangements, this could encourage the board to rely exclusively on the recommendations of expert personnel. This may encourage the board to skirt its duty to closely monitor and deliberate compensation arrangements. Therefore, the Clinic encourages the Commission to provide additional guidance explaining how the role of risk-management personnel will affect the board.

5. The Clinic Supports the Prohibition of Hedging Mechanisms for <u>Incentive-Based Compensation Arrangements</u>

The Commission asks whether prohibiting the use of financial derivatives, insurance contracts or other similar mechanisms to hedge against the market risk of equity-based, incentive compensation is an effective means to ensure that incentive compensation arrangements remain aligned with the risk assumed by covered persons.[29] Hedges are a way to contain losses if a stock declines, while retaining some upside potential if the price continues rising.[30] Anyone in the

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[27] *Id.* at 21180.
[28] *See* Rule Proposal, *supra* 2, at 21182.
[29] *Id.* at 21183.
[30] Jane Sasseen, *Some CEOs Are Selling Their Companies Short*, Bloomberg BusinessWeek, Feb. 25, 2010, available at:

market can employ this strategy.[31] As a general matter, the Clinic believes that prohibiting hedging for equity-based incentive compensation is good policy.

Allowing equity-compensated executives to hedge against the risks associated with their business decisions eliminates much of the incentive provided by linking compensation to stock performance. It benefits shareholders to link the interests of executives with that of shareholders. Incentive compensation is an effective way to accomplish this. If a firm performs well because of good management, both the executive and shareholders benefit from the increase in the value of the stock, which is the intended effect. Hedging allows executives to recover their compensation regardless of how the firm performs, much like insurance against the firm's poor results. Thus, hedging directly undermines the concept of incentive compensation because it nullifies the vital link between the interests of the executive and that of shareholders. Indeed, it is the risk of loss that equity-based compensation uses to encourage the executive to perform well.

Compensation schemes in the last twenty years have tended to tie a large share of an executive's wealth to the firm using deferred compensation in the form of equity. Executives, however, have a predilection for diversifying their holdings.[32] This behavior is rational where the valuation of the firm's stock is a function of both performance, which the executive is able to control, and exogenous effects, which are beyond the executive's control.[33] While hedging is justified on the argument that it minimizes the impact of external effects on the stock's valuation, it nonetheless curtails the consequences of poor performance as well. Lucian Bebchuk, head of Harvard Law School's Program on Corporate Governance agrees that hedging defeats the purpose of equity compensation and says that the only solution might be an outright ban against hedging on incentive-compensation.[34] In fact, some companies, such as Procter & Gamble and Kellogg, already forbid executive hedging.[35]

As for non-incentive compensation, the Clinic strongly believes that hedging for these sources should be permitted because hedging on this compensation does not implicate the same alignment-of-interests concerns that underpin incentive compensation arrangements.

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http://www.businessweek.com/magazine/content/10_10/b4169044647894.htm?campaign_id=rss_null.

[31] *Id.*

[32] Carr Bettis, EIA on Hedging Activity, 3 (Equity Incentive Analytics, Gradient) (2009), available at http://www.gradientanalytics.com/commentary.do?action=ReportSelect&reportIndex=0.

[33] *Id.*

[34] *See* Sasseen, *supra* note 29.

[35] *Id.*

Conclusion

The Clinic appreciates the opportunity to provide our comments to the Commission. The Clinic generally supports the Rule Proposal and offers the suggestions and considerations detailed above.

Respectfully Submitted,

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