Occupy the SEC

http://www.occupythesec.org

July 22, 2016

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Re: Incentive-based Compensation Arrangements (RIN 1557-AD39, RIN 7100 AE-50, RIN 3064-AD86, RIN 2590-AA42, RIN 3133-AE48, RIN 3235-AL06)

Dear Sir or Madam:

Occupy the SEC[1] ("OSEC") submits this comment letter in response to the notice of proposed rulemaking[2] jointly issued by the above-captioned agencies ("Agencies") regarding the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act's (Dodd-Frank Act) Section 956,[3] which prohibits certain incentive-based compensation arrangements among financial institutions. Section 956 is premised on a laudable and vital objective: holding financial institutions accountable for producing the crisis of 2008 so that another such crisis may be avoided.

[1] Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.
[2] Incentive-based Compensation Arrangements, 81 Fed. Reg. 37670 (proposed June 10, 2016) [hereinafter Proposed Rule].
[3] 12 U.S.C. § 5641 (2016).

I. Introduction

Rampant speculation in the financial industry played a causative role in producing the financial crisis of 2008. The Financial Crisis Inquiry Council has determined that excessive risk-taking led to the gargantuan economic losses of that crisis, which devastated the economic position of multinational conglomerates and poor individuals alike, and extinguished nearly 40% of U.S. family wealth from 2007 to 2010.[4] Through the widespread usage of bonuses and other conditional compensation, financial institutions have encouraged a working culture that promotes short-termism and profiteering. In light of that culture, the catastrophe of 2008 was inevitable and should have come as no surprise.

Perhaps the best evidence that a culture of profiteering is an endemic feature of the financial industry is the fact that bonuses continued unabated even as large financials institutions remained on the public dole. Taxpayers bailed out many financial institutions to the tune of nearly a billion dollars under the Troubled Asset Relief Program (TARP). While that program is well-known in the public, relatively few people are aware that the Federal Reserve single-handedly buttressed the financial industry through *$16 trillion* in loan facilities to depository institutions.[5]

One might expect financial institutions to cut back on compensation out of some sense of compunction or shame over receiving such exorbitant government handouts. Not so. Much of Wall Street has continued to dissipate its capital through exorbitant bonuses, despite running gargantuan losses. For example, a 2009 report by the New York Attorney General found that Citigroup, Inc. paid over 738 people bonuses of over $1 million even though the company posted losses of $27.7 billion.[6] Similarly, Merrill Lynch paid over 696 employees bonuses of over $1 million despite suffering $27.6 billion in losses.[7] Executives at such institutions have had their cake and eaten it too. On the one hand, they have claimed billions in company losses and thereby evaded paying company taxes on earnings. On the other hand, they have paid themselves lavish bonuses (supposedly for a job well done), thereby diverting capital away from shareholders, taxpayers and the U.S. Treasury.

The American public has naturally been quite angry about this patently unfair situation. One refrain that was popular among Occupy Wall Street protesters lamented, “Banks got bailed out, we got sold out.” Section 956 of the Dodd-Frank Act was passed by Congress as a reflection of the public’s anger over the profiteering culture on Wall Street. As the Agencies implement Section 956 through the rulemaking process, they must vindicate the American public’s interest in a fair and just marketplace that is free of the self-interested profiteering that privileges the select few at the expense of the many.

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[4] Jesse Bricker, et al., Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances 17, Federal Reserve Bulletin (June 2012).

[5] A July 21, 2011 study by the Government Accountability Office indicated that the “total transaction amounts” for Federal Reserve lending totaled a staggering $16 trillion. U.S. Gov't Accountability Office, GAO-11-696, Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance Needed 131 (2011).

[6] Andrew M. Cuomo, No Rhyme or Reason: The Heads I Win, Tails You Lose Bank Bonus Culture 5 (July 30, 2009).

[7] *Id*.

II. The Proposed Rule Established a System of Self-Monitoring that Flouts Congressional Intent and that has Proven to be Ineffective

While the Proposed Rule established various rules and thresholds for incentive-based compensation, it falls short in the area of actual monitoring and compliance. Congress passed Section 956 with the express expectation that the Agencies would take an *active role* in monitoring compliance with the incentive-based compensation rules established under that Section.

> "This subtitle . . . **requires federal financial regulators to monitor** incentive-based payment arrangements of federally regulated financial institutions . . . larger than $1 billion and prohibit incentive-based payment arrangements that the regulators determine jointly could threaten financial institutions' safety and soundness or could have serious adverse effects on economic conditions or financial stability."[8]

Unfortunately, the Agencies have failed to heed this Congressional mandate. The Proposed Rule adopts an excessively deferential approach to monitoring compliance with incentive-based restrictions. Instead of delineating a regulatory mechanism by which regulators oversee institutional compliance with compensation restrictions, the Agencies have essentially delegated the task of actual compliance to covered institutions themselves. The fox is left to guard the hen-house.

The above-cited passage from a House Report describing the intent behind the Dodd-Frank Act demonstrates that Congress expected the Agencies to take on an *active* role in monitoring compliance. Instead, the Agencies have proposed a framework under which covered institutions essentially monitor themselves as part of their normal corporate governance procedures and policies.

Aside from being contrary to Congressional intent, this *laissez-faire* approach has shown to be ineffective in the past. Banks and their risk control procedures cannot be trusted to unearth or correct dangerous incentive-based compensation. There is no doubt that covered institutions spent billions of dollars on compliance and self-monitoring efforts in the run-up to the 2008 crisis. Yet those efforts seemed to yield little benefit as the global economy teetered on the verge of collapse. It is highly questionable for the Agencies to blithely expect that internal risk control procedures will be more effective this time around.

It could be argued that incentive-based restrictions are themselves not new. Fiduciary law has always restrained the ability of corporate officers to enrich themselves at the expense of shareholders and other stakeholders.[9] Covered institutions have long utilized internal corporate governance procedures as a means to uphold their fiduciary responsibilities. Still, it is quite

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[8] H.R. Rep. No. 111-517, Joint Explanatory Statement of the Committee of Conference, Title IX, Subtitle E "Accountability and Executive Compensation" 873 (Conf. Rep.) (June 29, 2010).

[9] *See generally* J. Robert Brown, Returning Fairness to Executive Compensation, 84 N.D. Law Rev. 1141 (2009).

apparent that these internal procedures failed in 2008 (despite their ostensible and asserted robustness[10]).

Internal risk control procedures failed to stop covered institutions from endowing key employees with exorbitant compensation schemes that created perverse incentives for mismanagement and profiteering. Those very incentives contributed to the financial crisis,[11] which in turn led Congress to pass Section 956.

If internal procedures proved to be ineffective in 2007, why should we expect them to be more effective now? Admittedly, the Proposed Rule establishes specific restrictions on executive compensation that have not existed before, but the mere existence of those restrictions will not serve the purposes that Congress intended without the addition of an effective, external monitoring mechanism.

Indeed, many covered institutions have already been voluntarily imposing compensation restrictions on key employees, and in some cases those restrictions are near-approximations of the frameworks established in the Proposed Rule. Thus, in many areas the Proposed Rule provides little benefit in terms of expanding *de facto* restrictions. The Proposed Rule could have a much more meaningful impact were it to actually impose a framework for active monitoring and enforcement of those restrictions.

III. Proposals for Improvement to the Proposed Rule

The Agencies can strengthen the Proposed Rule by reducing the ability of covered institutions to self-police their compliance with the incentive-based compensation restrictions. We certainly understand that the Agencies suffer from limited budgets and manpower, not to mention a burgeoning regulatory imprint pursuant to the Dodd-Frank Act. Nevertheless, the Proposed Rule could implement numerous cost-effective requirements that would ensure effective compliance without overburdening the Agencies with additional responsibilities.

a. The Agencies Should Mandate External Audits to Augment Existing Independent Compliance Monitoring Requirements

The Proposed Rule should require mandatory *external* audits. While the Proposed Rules contains requirements for "independent" compliance monitoring, it appears that such compliance monitoring can still occur from within the very financial institution being monitored. The Rule only requires that the monitoring arm be independent of the monitored business unit. However, so-called "Chinese walls" and other intra-company restrictions have been standard operating

[10] ISDA, SIFMA *et al.*, Comment Letter to European Commissioner for Internal Markets and Services (July 16, 2008) ("It is also important to highlight that risk control procedures at the regulatory level have already been improved. Investors among our members in the many forms of tranched products are in the process of ensuring that sufficient internal and regulatory capital is allocated to these exposures."), *available at* https://circabc.europa.eu/sd/a/ed8f231a-d2ca-4237-a5f9-9524147b8a81/Joint%20Association.pdf.

[11] Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations, Board of Governors of the Federal Reserve System 1 (Oct. 2011) ("Risk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007.").

procedure in the financial industry for decades -- well before the passage of the Dodd-Frank Act. Those restrictions did little to avert the catastrophe of 2008, and the public has little confidence that similar measures will be effective in reducing perverse incentives in executive compensation in the future. The Dodd-Frank Act generally (and Section 956 specifically) was passed to institute actual changes in the way that financial institutions comply with the law. The Agencies should establish a framework under which covered financial institutions are required to conduct external audits to ensure compliance with Section 956.

b. The Agencies have Failed to Consider the Interplay of Section 956 with Related Statutes in Dodd-Frank

Section 952 of the Dodd-Frank Act specifically references the utilization of truly "independent" compensation consultants and other advisors. In contrast, the Proposed Rule is virtually silent on the role that outside companies might play in assisting financial institutions in their compliance with Section 956. Both Sections 952 and 956 are part of the same subtitle, Subtitle E of Title IX of the Dodd-Frank Act, and both were passed as part of the same act ("H.R. 3269 - Corporate and Financial Institution Compensation Fairness Act of 2009"). This common origin suggests that Congress passed both statutes with the intention of requiring financial institutions to increase their reliance on truly external compensation consultants in both contexts.

Similarly, the Proposed Rule fails to address the potential interplay between Sections 951 and 956 of the Dodd-Frank Act. The legislative intent behind Section 951 was to augment the role of shareholders in setting executive compensation rates for executive officers and significant risk-takers. While the Agencies need not set absolute dollar limitations on incentive-based compensation, they should nevertheless subject any such compensation arrangement to a shareholder vote. While this idea may seem extreme at first blush, the Agencies should be aware that a similar provision already exists in Britain.[12] Any incentive-based compensation scheme falling under the purview of Section 956 should be *automatically* invalid in cases where executive compensation does not receive majority support from shareholders under the Say-on-Pay rules.

As the owners of the covered institutions, shareholders have a legitimate right to veto excessive compensation that dissipates their capital and impedes their ability to receive proper dividends. Again, Section 951 and 956 were passed as part of H.R. 3269 and share a commonality of purpose. The Proposed Rule fails to consider the interplay between these statutes. The Proposed Rule is seven hundred pages long, yet utterly fails to mention Sections 951 and 952, which are clearly related to Section 956 in origin and purpose.

[12] UK Dept. for Business Innovation & Skills, Government Announces Far-reaching Reforms for Directors' Pay (June 20, 2012), *available at* https://www.gov.uk/government/news/government-announces-far-reaching-reform-of-directors-pay.

c. The Agencies Should Restrict Incentive-Based Compensation Where a Covered Financial Institution Suffers Losses

On a very basic level, executives who run financial institutions into the ground should not be rewarded for doing so. Section 956 is based on that simple premise. A natural corollary of that premise is that *covered financial institutions that report negative earnings should be prohibited from providing any incentive-based compensation to senior executive officers and significant risk-takers*.

Under Section 956, a covered financial institution's incentive-based payment arrangements cannot reward risk-taking that could lead to material financial loss.[13] For this restriction to apply, the offending bonus arrangement must have a causal relationship with the company's losses. The mere fact that a company suffers losses does not mean that the bonus had anything to do with producing that loss. Even so, one much recognize that a senior-level officer or other significant risk-taking employee is likely to have meaningful control over the profitability of her employer. Thus, when that employer suffers losses, those losses can legitimately be attributed, at least in part, to that employee. Therefore, the Agencies would be well-justified in imposing a bright-line restriction on executive bonuses where the covered financial institution reports losses. Section 956 grants the Agencies the authority to demand that senior-level bonuses be paid only for a job well done. We urge the Agencies to exercise that authority and revise the Proposed Rule accordingly.

Permitting senior employees to reap heady bonuses even when the company suffers losses creates a serious moral hazard problem. Where company losses have no *automatic* impact on bonuses, employees are incentivized to continue with risk-taking behavior. In contrast, the imposition of a bright-line rule, such as the one proposed above, eliminates this moral hazard because employees will know that loss-producing risk would necessarily lead to forfeiture or clawback.

Moreover, the payout of bonuses to covered persons despite company losses constitutes the unfair dissipation of capital that rightly belongs to others. Agency law has long held that executives and officers cannot enrich themselves at the expense of shareholders. When executives and officers pay themselves exorbitant bonuses despite company losses, they are unjustly extracting value from the company. As the owners of the company, shareholders are entitled to be free such undue dissipation of capital.[14] Such dissipation of capital also diverts money away from the Treasury and the public coffers. Bankers have proven adept at utilizing the money-generating capacity of the Federal Reserve (such as the above-mentioned $16 trillion in loan facilities) to enrich themselves. They should, at the very least, compensate the public by

[13] 12 U.S.C. § 5641(a)(1).

[14] The payment of excessive compensation puts a strain on the finances of a company, thereby decreasing the likelihood that it will have enough profits to issue dividends to shareholders. This kind of capital dissipation also harms the long-term profitability of the company by diverting funding away from necessary investments in employee training, research and development. *See Center for American Progress, Workers or Waste?: How Companies Disclose – or Do Not Disclose – Human Capital Investments and What to Do About It*, June 2016, *available at* https://cdn.americanprogress.org/wp-content/uploads/2016/06/03042031/HumanCapital.pdf. Such dissipation also hurts non-executive employees. Research shows that the wages and benefits of non-executive employees has stagnated over the past few decades. *See id*. at 8.

paying their fair share in taxes, instead of gorging on excess capital through incentive-based compensation arrangements.

d. Covered Financial Institutions Should be Required to Hold Incentive-Based Payment in Escrow

One of the chief failings of the Proposed Rule is that it does not establish a realistic mechanism whereby financial institutions can claw back ill-gotten gains. While we commend the Agencies for proposing a seven-year duration for the clawback period, we nevertheless have reservations about the practicality of that provision. By the time a covered financial institution realizes that it must claw back compensation from a former employee, that employee may:

a) not have enough money to pay the institution back,
b) be deceased,
c) be untraceable or living in another country

We therefore urge the Agencies to require executive compensation to be held in escrow for the duration of the seven-year clawback period. At the very least, a certain portion of executive compensation should be held in escrow even after the expiration of the various holding periods defined in the Proposed Rule. This approach would greatly improve the ability of affected financial institutions to enjoy something more than nominal restitution in cases where clawbacks are needed. Moreover, the usage of an escrow would facilitate the collection of government penalties. Even if the Agencies decline to apply an escrow requirement to all covered persons, the Agencies should at least apply the requirement to top-level executive officers who have far-reaching control over profitability and to others who are able to commit the highest levels of firm capital.

In addition, we suggest that the Agencies establish an online, publicly-accessible database (similar to FINRA's BrokerCheck) that lists all employees whose compensation has been clawed back pursuant to Section 956. The disclosure of this information would serve as an additional deterrent against irresponsible risk-taking among employees of covered financial institutions.

e. The Agencies Should Enhance the Disclosure Requiremetns in the Proposed Rule

We recognize that Section 956 contains a presumption against the disclosure of actual compensation of particular individuals.[15] Still, we believe that the Proposed Rule should be revised to require every covered financial institution to disclose the number of its employee that earn incentive-based compensation above $1 million. Similarly, each institution should be required to report aggregated incentive-based compensation by department, sub-department and function. The disclosure of such information will provide shareholders and prospective investors with important information about a company's internal allocation of capital resources. Such information will also make it easier for regulators to monitor compliance with the applicable regulations.

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[15] 12 U.S.C. § 5641(a)(2).

f. The Agencies Should Disregard Commenters' Calls for Deregulation

Various industry lobbyists have proclaimed that a vigorously enforced Section 956 would cause talented financial professionals to "flee" the United States.[16] The Agencies must disregard these proclamations.

First of all, there is no evidence that Congress intended the Agencies to take that kind of potential impact into consideration. The rules of construction listed in the statute only seem to concern themselves with excessive disclosure of payment arrangements.[17] There is simply no statutory mandate for the Agencies to consider the Rule's impact on retention of talent.

In any case, there is no credible evidence that the Proposed Rule will actually cause the financial markets to suffer from a dearth of talented financial professionals. The only financial professionals who might flee from the American financial industry by virtue of Section 956 would be those individuals with an outsized appetite for risk. And even if such individuals were to flee, the United States markets would be more stable without them.

Furthermore, the "flight" argument rings hollow when one considers the fact that compensation regulations are actually more burdensome in comparative jurisdictions.[18] Unlike those comparative jurisdictions, the United States currently suffers from the absence of meaningful restrictions on risk-promoting compensation. This imbalance creates incentives for dangerous risk-taking in the American financial markets. By failing to meet the stringent compensation standards set in Europe, American regulators are setting the stage for the next financial disaster.

IV. Conclusion

Section 956 mandates that the provisions of that section be enforced under Section 505 of the Gramm-Leach-Bliley Act.[19] The Proposed Rule essentially restates that fact, without delving into much depth about exactly how the Agencies plan to enforce the Rule.

At least one of the Agencies, the SEC, was provided with a similar opportunity to punish improper compensation, under Section 304 of the Sarbanes-Oxley Act. Unfortunately, history has shown that that section has been rarely enforced.[20] We urge the Agencies not to repeat history when it comes to enforcing Section 956.

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[16] *See, e.g.*, American Bankers Association *et al*., Comment Letter to the Agencies on the Proposed Rule (June 1, 2016), *available at* https://www.sec.gov/comments/s7-07-16/s70716-4.pdf.
[17] 12 U.S.C. § 5641(a)(2).
[18] *See* Press Release, European Commission, Commission Adopts New Standard to Increase Transparency over Bankers' Pay and Risk Profiles (Mar. 4, 2014), *available at* http://europa.eu/rapid/press-release_IP-14-210_en.htm; Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act, No. 42 (2011) (Australia); Raphael Minder, *Swiss Voters Approve a Plan to Severely Limit Executive Compensation*, N.Y. Times, Mar. 3, 2013, *available at* http://www.nytimes.com/2013/03/04/business/global/swiss-voters-tighten-countrys-limits-on-executive-pay.html?_r=0.
[19] 12 U.S.C. § 5641(d).
[20] *See SEC v. Baker*, 2012 WL 5499497 (WD Tex. Nov. 13, 2012) ("For reasons best known to the SEC, the Commission has been historically reluctant to utilize § 304 in the ten years since Sarbanes-Oxley was enacted.").

In crafting regulations implementing Section 956, the Agencies have been given an historic opportunity to reorient the nation's financial industry towards stability and growth and away from the kind of self-interested profiteering that produced the Great Recession of 2008.
It is vital that the Agencies avail of this opportunity by producing tough, bright-line regulations that help restore the public's confidence in the nation's financial system.

Thank you for your attention to this matter of great public interest.

Sincerely,
/s/
Occupy the SEC

Akshat Tewary
Neil Taylor
Josh Snodgrass
et al.