July 19, 2016

Re: Incentive-based Compensation Arrangements

Ladies and Gentlemen of the supervisory Agencies,

Thank you for receiving the public's comments on the Proposed Rule on incentive-based compensation. Please allow me to express my whole-hearted support for the work of the Agencies. In circumstances in which democracies are voicing protest at the status quo, and populist fomenting appears to have few concrete plans, I believe that the work of professional policy-makers and regulators is more important than ever.

I would therefore like to both iterate my strong support for the rule as a matter of principle, as well as offer some input on the "mechanics" of the claw-back element of the Rule.

The Agencies' intervention to prohibit features of incentive-based compensation that encourage inappropriate risk-taking is absolutely essential. It cannot be reasonably disputed that 1) managers and "risk-takers" are solely accountable to shareholders; and 2) notwithstanding this accountability, their actions affect a far broader constituency than just the company's shareholders.

The undertakings to improve governance by shareholders in recent years, or to seek to consider corporate operational impact on other constituencies (i.e., "green" or ecological initiatives) have not changed the accountability of managers under the law. Indeed, it is not only the economist Milton Friedman's opinion that "[t]here is one and only one social responsibility of business–to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud." Corporate law also provides this – at least according to certain notable legal experts, such as former Chancellor Strine of the Delaware Chancery Court, as well as Professor David G. Yosifon of Berkeley University[1].

Consequently, we should not, as Chancellor Strine says "anguish when the board of a venerable homeland corporate icon reacts receptively to a premium takeover bid from a foreign acquirer" of be surprised that "the board sell out and undermine the traditional values the firm stands for?" *Our*

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[1] Prof. Yosifon states:

> *While I am a critic of the "shareholder primacy norm" in corporate governance, I am nevertheless convinced that shareholder primacy is the law. In fact, the critical vantage and reformative program that I have pursued in other writing presupposes that shareholder primacy is currently the law. This Article is therefore dedicated both to providing doctrinal clarification on the law of corporate purpose and to vindicating a key presumption in a broader normative agenda.*

See, e.g., "*The Law of Corporate Purpose*," *Berkeley Business Law Journal*, D. Yosifon, Vol. 10, p. 181 (2014).

continuing struggle with the idea that for-profit corporations seek profit, L. Strine, *Wake Forest Law Review*, Vol. 47, p. 135 (2012).

Chancellor Strine continues to explain evoke the danger of not being clear on the role of for-profit corporations.

> "Although I am sympathetic to many of the sentiments and policy concerns that motivate these dismayed reactions, I confess to being weary of the naïveté they manifest. More importantly, the continued failure of our societies to be clear-eyed about the role of the for-profit corporation endangers the public interest. *Instead of recognizing that for-profit corporations will seek profit for their stockholders using all legal means available, we imbue these corporations with a personality and assume they are moral beings capable of being "better" in the long-run than the lowest common denominator.* We act as if entities in which only capital has a vote will somehow be able to deny the stockholders their desires, when a choice has to be made between profit for those who control the board's reelection prospects and positive outcomes for the employees and communities who do not."

Id. at p. 135-136 (emphasis added).

In other words, we cannot rely on corporate governance in order to promote and enforce actions by corporations that benefit anyone other than its shareholders. This does not mean that no "good" actions have ever been undertaken by corporations, or that all "green" initiatives amount to window dressing. But it does mean that the expectation of higher morality is unrealistic and unreasonable and that regulations to compel a particular behavior is necessary.

It may be worth recalling that during the Industrial Revolution, it took the Factory Acts to enjoin companies from using child labor, which was less costly. It took regulation to impose a mode of conduct that would be beneficial to society at large – not only the shareholders of the company whose profit margin increased through lower labor costs. This example also raises two other issues: the perception of the labor force, as distinct from working managers, and the perception of the burden and cost of compliance – or rather, the perception of the restriction on commerce that government and regulation thrusts on business.

There is a certain amount of irony when it comes to the view of wages for labor vs. executive compensation. First of all, the labor force is at best seen as a necessary evil and an expense that, if possible, should always be cut. Indeed, jobs are outsourced out of the country; and when a company faces difficult economic times, there are often lay-offs, rather than salary reductions for executives. Similarly, the justification of high executive salaries that are needed to "attract talent" seldom applies to lower echelons. Understanding that "fairness" of the system is not the debate at hand, it is nevertheless worthwhile to extrapolate how this mode of thinking plays out in reality. As a society, we seem to have tolerated the fact that decisions that adversely affect a greater population than the body of shareholders is acceptable – as in the case of mass lay-offs. The debate at hand is essentially asking "at what point do we determine that the decisions of a very few, that affect far more than just shareholders, must be regulated in order to render some accountability to this now *very* broad constituency?"

Secondly, the argument often resorted to that regulation is costly and will deter investment should be closely examined. Certainly, a climate of uncertainty can hamper the decision to allocate significant, long-term funds to a project. But there are two key elements that need to be parsed. The first is whether "costly" means that a transaction will not be profitable – e.g., break even or lose money -- meaning that there is no point in undertaking it? Or does it mean that investors are not interested because they will not be able to make the desired level of return? The second element is something of a corollary to the first: if the desired return on investment is not achievable by one transaction, will investors turn it away altogether, or will they steer their investment funds elsewhere? The level playing field that regulation seeks to advance cannot be discounted in answering the question. If regulation seeks to de-risk in order to create stability, then it will be more difficult across the board to find higher risk and higher reward investments. Further, the experiment of Economics 101 classes to demonstrate how "efficiency" works is telling: any allocation of $10 between groups A and B is efficient, except of one side having the entire sum of $10. The example is overly simplistic because the question often devolves into "which is 'better', a 7-3 split, or a 6-4 split?" But it is worthwhile to raise this issue because the opportunities for investment will not dissolve entirely but may instead have a lesser ranger of projected returns. The key term is "projected": the notion of having diminished expectations of return on investment but leaving intact the theoretical right to earn unlimited returns should not seem so unreasonable. Usury laws that apply to lending have been limited without necessarily diminishing the availability of credit or the appetite of financial institutions to lend money. Is it so far-fetched to promote a similar mindset when it comes to equity investments?

Finally, I would also note that the initiatives with respect to bankruptcy reform (Chapter 14) and the efforts to make equity holders and long-term debt holders carry the loss-bearing load is coherent with making those who ensure shareholder satisfaction accountable.

As to the claw-back provisions, there are several reasons for which these are sound:

1) They promote a longer-term vision of success and a notion of sustainability of results. Manipulating parameters to achieve a favorable quarterly perspective puts the focus on manipulating performance indicators – not on building a business. A case could be made to say that at the strategic levels of a company, the business is of managing the company's capital, while it is only at the tactical level that there is concern about making viable product that achieves sales. And if that is the case, then regulation should aim to take the focus off corporate "wealth management" and more closely examine the impacts of "corporate citizens" on society at large.
2) Their measurement is quantifiable and consistent with the basis for determining bonuses within a company. Key performance indicators for managers tend to be quantitative. Indeed, the doctrine tends to be that if it's not measurable or quantifiable, then it never registers as a criterion of assessment.
    a. Qualitative evaluation within financial institutions for production-side staff and managers is hardly existent. Even if notions of profitability are brought into the equation, the focus is on the amount of business brought in and the impact on return on investment.
    b. While introducing qualitative evaluation criteria could be a way of promoting a different course of conduct, the difficulty of establishing such criteria is surpassed only by the difficulty of enforcing what amounts to a subjective standard. Further, while this role is

also challenging enough for a company's executive's and supervisory bodies, it is hardly feasible or appropriate for a governmental entity to intervene in this way.

Consequently, the claw-back provisions are likely the most effective way of promoting individual decision-making that favors a sustainable view of profitability.

Finally, while I believe that advantage of the Agencies' review of the Proposed Rule is their technical and un-politicized evaluation, I also believe it is impossible not to bring both historical and philosophical perspective into the analysis. The way of the world is a question of balance of power, not of fairness and equity. Consciously or not, we tolerate unfairness within a certain spectrum as long as some balance of power exists, as long as one side believes it still has *some* leverage in the decision-making process. But when the perception of potential influence is gone, then discontent and irrationality govern human behavior.

Following the disclosure of the Panama Papers, corruption has become a hot topic, although the focus has been on specific acts of corruption, such as tax avoidance. There has been little discussion to define corruption or recognizing it as conduct that seeks to shift balances of power. And yet, corruption does just that: corruption is the concentration of wealth and coercive power in too few hands. Hence, the balance of power interrelationships within societal groups, seeking the sufficient influence to maintain the upper hand, without disrupting social peace.

In evaluating the efficacy of the proposed measures in promoting stability of the financial system, I would urge the Agencies to also ask the question of whether the status quo allows too few to both amass more influence and enforce the outcomes of that influence through the legal system.

Thank you most sincerely for your efforts and attention to this issue.

G. Sirot