COMMENTS

of

THE WASHINGTON LEGAL FOUNDATION

to the

SECURITIES AND EXCHANGE COMMISSION

concerning

PROPOSED RULES FOR IMPLEMENTING THE
ENHANCED COMPENSATION STRUCTURE REPORTING REQUIREMENTS OF SECTION 956 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT
(RELEASE NO. 34-64140; FILE NO. S7-12-11)

In Response To The Commission's Invitation
To Submit Written Comments

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<u>Via Email and U.S. Mail</u>
Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Incentive-based Compensation Arrangements
File Number: S7-12-11

Dear Ms. Murphy,

The Washington Legal Foundation (WLF) submits these comments in response to the Securities and Exchange Commission's (SEC) proposed implementation of Section 956 of the Dodd-Frank Act regarding "Enhanced Compensation Structure Reporting." WLF appreciates the need for greater financial stability; however, WLF urges caution in the implementation of Section 956 lest it weaken the country's economy. WLF is particularly concerned with the absence of data linking incentive-based compensation to financial risk, as well as the unintended consequences of artificially altering executive compensation. Therefore, WLF recommends that the final regulation only curtail extreme measures of incentive-based compensation that blatantly bifurcate the financial interests of the individual executive and the interests of the firm.

I. Interests of WLF

The Washington Legal Foundation (WLF) is a non-profit, public interest law and policy center based in Washington, D.C., with supporters nationwide. Founded 34 years ago, WLF regularly appears before federal and state courts and administrative agencies to promote economic liberty, free enterprise, and a limited and accountable government. WLF has a longstanding interest in the work of the SEC, especially as it relates to several of WLF's comprehensive goals. These include protecting the stock markets from manipulation; protecting employees, consumers, pensioners, and investors from stock losses caused by abusive securities and class action litigation practices; encouraging congressional and regulatory oversight of the conduct of the plaintiffs' bar with respect to the securities industry; and restoring investor confidence in the financial markets through regulatory and judicial reform measures. Additional background information on WLF is available on our website at *<u>www.wlf.org</u>*.

WLF has filed a number of comments with the SEC on matters of public interest. For example, on September 18, 2006, WLF filed comments in File No. S7-11-06: Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting Under Sarbanes-Oxley. WLF also filed comments on May 20, 2008 in File no. S7-08-08: SEC's Proposed "Naked" Short Selling Anti-Fraud Rule, 73 Fed. Reg. 15376 (March 21, 2008). Most recently, WLF filed comments on December 17, 2010, on proposed rules and forms for implementing the whistleblower provisions entitled "Securities Whistleblower Incentives and Protection," which are contained in Section 21F of the Securities and Exchange Act of 1934, as amended by Title IX of the Dodd-Frank Act.

WLF also litigates and appears as *amicus curiae* before federal courts in cases involving securities litigation. *See, e.g., Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869 (2010); *Merck & Co. v. Reynolds*, 129 S. Ct. 2432 (2009); *Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006); *Dura Pharm, Inc. v. Broudo*, 544 U.S. 336 (2005).

Similarly, WLF's Legal Studies Division has produced and distributed timely publications on securities regulations and the SEC. WLF's most recently published works in this area include: William G. Lawlor and Michael L. Kichline, *Federalizing Fiduciary Duties Through Shareholder Lawsuits: Three Reasons for Court Scrutiny* (WLF Working Paper, July 23, 2010); Tammy Albarran, *Court Reins In SEC's Expansive "Primary Liability" Theory* (WLF Legal Opinion Letter, June 18, 2010); and, Laura L. Flippin and Morgan J. Miller, *Double Teamed: Defending Parallel Investigations Under SEC's New Cooperation Initiative* (WLF Legal Backgrounder, April 23, 2010).

II. Section 956 of the Dodd-Frank Act

President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173) on July 21, 2010 in response to the financial crisis that began in 2007. The Act represents the greatest reform of financial markets since the Great Depression.

Section 956 addresses executive compensation, with particular emphasis on incentive-based compensation. Specifically, Section 956 requires the disclosure and regulation of incentive-based compensation. "Not later than 9 months after the date of enactment of this title, the appropriate Federal regulators shall jointly prescribe regulations or guidelines that prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions—

(A) By providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or

(B) That could lead to material financial loss to the covered financial institution."

III. WLF'S Understanding of Section 956

The guiding philosophy of these two Dodd-Frank requirements – as elaborated in the Proposed Rules – is to curb excessive risk-taking at large U.S. financial institutions that could lead to a future nation-wide, economic depression. "Improperly structured compensation arrangements can provide executives with incentives to take *imprudent risks* that are not consistent with the long-term health of the organization. The Agencies believe that *flawed incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007*." (Emphasis added).

The Proposed Rules apply only to institutions with total assets over $1 billion and excessive risk is defined under Section 39 of the Federal Deposit Insurance Act (FDIA).

Given the flexible definition of risk (actions that "lead to material financial loss to the covered institution") as outlined in Section 956, WLF recommends that incentive-based compensation be restricted only at the most egregious levels when the interests of the executive and the firm are truly divergent. This recommendation is made because WLF questions the link between incentive-based compensation and risk, and WLF fears the unintended consequences of restricting incentive-based pay. The rest of document provides reasoning for this question and concern.

IV. No Link Between Financial Risk and Total Executive Compensation

WLF salutes the Proposed Rules' decision to call merely for the reporting of large executive compensation – not for its regulation. The purported goal of Section 956 of the Dodd-Frank Act is to limit financial risk. However, there is no significant body of literature that links the risk assumed by large individual institutions and baseline (as opposed to incentive-based) executive compensation. On the other hand, studies from the Watson Wyatt Worldwide executive compensation consulting company show no correlation between the two variables.[1] This seems logical. After all, if there is no incentive to take a risk, the risk-index of a company is unlikely to be different whether the CEO makes $500,000, $5 million, or $50 million.

Nor is large compensation inherently risky just as a function of its being large. Even very large compensation packages represent only a small fraction of a company's total business. Ira T. Kay and Steven Van Putten found that in a sample of 1,398 U.S. corporations, "total CEO pay in 2004 was just 0.09 percent of sales, 0.06 percent of market capitalization, and 1.3 percent of net income for the companies."[2] A study by Brian Hall and Jeffrey Liebman substantiates that CEO pay is a miniscule amount of the average company's total budget.[3] This will especially be true for institutions with assets over $1 billion – the institutions that are the subject of these Proposed Rules.

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[1] Watson Wyatt Worldwide data, "Realizable Pay for CEOs and Company Performance."
[2] Ira T. Kay and Steven Van Putten, "Executive Pay Regulation vs. Market Competition." Policy Analysis. Cato Institute, September 10, 2008.
[3] Brian J. Hall and Jeffrey B. Liebman, "Are CEOs Really Paid Like Bureaucrats?" *Quarterly Journal of Economics* 113, no.3 (August 1998): 653—91.

a) Unintended consequences of limiting executive compensation

Not only is no evidence offered to suggest that limiting executive pay will reduce general societal risk, there is good reason to think that artificially capping executive pay will adversely affect the economy.

i) *Limiting pay could drive out top executives*. As noted by Commissioner Troy Paredes before the SEC, "Larger broker dealers and investment advisers may find it more difficult to recruit and retain quality personnel. It is potentially compromising the competitiveness and capability of these financial institutions."[4] With compensation caps on the financial industry, talented executives might depart for other industries where their compensation is unlimited. Instead of limiting risk, capping executive pay could increase risk to the financial market by depriving it of some of its best talent. In a similar proposal of an artificial limitation on salary, Megan Barnett of Port*f*olio.com wrote, "That means Wall Street is going to be run by executives with subpar experience and drive. Money … is what motivates people to come to Wall Street."[5]

ii) *Limiting pay could send top executives abroad.* Similarly, a pay limitation could send America's top financial minds to other countries. Currently, America's labor practices are quite free when compared with Europe. But the free-market practices of many Asian countries are starting to draw more top talent—talent that used to remain in the United States. In 2007, 18 percent of Harvard Business School graduates left the country. Limiting potential compensation of these high-level business leaders could drive away more talent.[6]

iii) *The market will correct itself by less-efficient means*. If executive pay is limited, firms will likely retain executives through other perks such as golf trips or an increased number of personal assistants. In such an example, a firm might have to reduce the CEO's pay by $50,000. The firm would then try to retain the CEO by promising to allocate the $50,000 to another personal assistant. Because this assistant was not demanded by the market in normal circumstances, however, the assistant is likely to be used at less than maximum efficiency (say $30,000), and there will therefore be economic deadweight loss ($20,000 in this case).

Caps that limit executive baseline pay will not reduce systemic risk, and they will adversely affect the economy. As such, the Proposed Rules are correct to leave baseline compensation unregulated.

[4] "SEC Proposes Curbing Wall Street Bonuses." *Reuters.* March 2, 2011.
[5] Megan Barnett, "Banker Pay Caps, Bad Idea." *Portfolio.com*. February 4, 2009.
[6] Kay and Putten, p.6.

V. Incentive-based compensation

As noted at the beginning of Section IV of these comments (previous section), there is no demonstrated link between systemic or corporate risk and baseline executive compensation. We now ask whether systemic or corporate risk is induced by incentive-based compensation—a theory that is at least plausible. Yet the connection here also fails. As noted in a research paper by Rüdiger Fahlenbrach and René M. Stulz, "There is no evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis and some evidence that these banks actually performed worse…"[7]

In fact, there is a significant body of literature that suggests that incentive-based pay actually *improves* company performance. Based on a report conducted on February 28, 2008, titled, "Report on Directors' and Investors' Views on Executive Pay and Corporate Governance," Kay and Putten conclude that "We found that board members believe that the pay-for-performance model directly contributes to *improved* corporate performance." (emphasis added)

Kay and Putten then offer a review of the largest 1,088 companies and show that the higher-performing companies provided larger stock option profits to executives and the largest increase in stock option profits over the prior year.[8] A number of other academic studies confirm this *positive* link between the use of incentive-based compensation and corporate performance.

Accordingly, limiting incentive-based executive compensation may actually reduce company performance and increase company risk as the result of the loss of incentive. Additionally, the company may suffer from the same unintended consequences detailed in Section IV if the restriction of incentive-based compensation leads to an overall decline in compensation.

For these reason, WLF recommends that the Proposed Rules adopt a reading of Section 39 of the FDIA that only limits incentive-based compensation practices at their most extreme, when the interests of the executive and the company follow divergent paths.

VI. Recommendations

WLF appreciates the acknowledgement in the Proposed Rules of the importance of compensation in a vibrant American economy: "Compensation arrangements are critical tools in the successful management of financial institutions. These arrangements serve several important objectives, including attracting and retaining skilled staff, promoting better organization and individual employee performance, and providing retirement security to employees."

[7] Rüdiger Fahlenbrach and René M. Stulz, "Bank CEO Incentives and the Credit Crises." The National Bureau of Economic Research. Working Paper No. 151212. August 2009. http://www.nber.org/papers/w15212
[8] Kay and Putten, p.3.

Given compensation's importance, WLF cautions the SEC against overregulating the compensation practices of private firms. As noted above, the link between executive compensation (baseline and incentive-based) and corporate risk is tenuous, and limitations on executive compensation could produce unintended negative consequences.

However, WLF also appreciates the SEC's obligation to comply with Section 956 of the Dodd-Frank Act and limit economic risk to the fullest extent possible. We suggest that truly egregious incentive-based pay structures can be improved through clawbacks. Clawbacks are contracts that allow for some of the benefits of incentive-based executive compensation while minimizing risk. They operate by giving executives immediate incentive-based pay, while stipulating that if the company's future performance drastically declines as a result of the executive's past decisions, then a percentage of the executive's former compensation must be returned to the company. This clawback method recently won endorsement from Barry Ritholtz in an article in *The Washington Post* titled "Putting an end to Wall Street's 'I'll be gone, you'll be gone' bonuses," and it is also discussed in the Proposed Rules. The three-year clawback assessment period as suggested in the Proposed Rules seems reasonable to WLF.

Any regulatory reports requirements outlining clawback programs should be as minimal as possible so as to not further encumber American businesses in paperwork. WLF commends the language in the Proposed Rules in this instance: "The Agencies note that they have intentionally chosen phrases like 'clear narrative description' and 'succinct description' to describe the disclosures being sought."

VII. Conclusion

It is said that "faint heart never won fair maiden." Risk-taking has long been part of the American economic ethos, and it has contributed to making this country truly great. We hope that through these recommendations, the American economy can retain the freedom and dynamism it has gained through entrepreneurial risk while also significantly curtailing the chance of a future economic crisis.

Respectfully submitted,

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Daniel J. Popeo
Chairman and General Counsel

/s/ Stephen I. Richer
Stephen I. Richer
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