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Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

April 22, 2011

RE: RIN 3064 - AD56, "Incentive-based Compensation Arrangements"

Dear Secretary Feldman:

I would like to make several comments on the subject of possible prohibitions versus hedging of grants of employee stock options, restricted stock and hybrids of each.

First of all "hedging " is not defined clearly, although Congress has declared that selling certain at-the-money calls and out-of-the-money calls while holding the underlying stock is not considered a hedge but is merely an income producing trade which does not result in a substantial diminution of risk. See the 1984 Senate Finance Committee report which included the following language;

"The granting (selling) of a covered call does not substantially reduce a taxpayers risk of loss with respect to the underlying stock unless the option is deep-in-the-money."

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Also does "hedging" include selling calls or buying puts in correlated stocks. For example does buying out-of-the-money puts on Bear Stearns, Merril Lynch or Lehman Bros. stock while holding shares in my employer, J.P. Morgan constitute a "hedge" of my J.P. Morgan stock and employee stock options.

It seems that a definition of "hedging" should be decided on before any real discussion can be had.

Secondly, it can be demonstrated conclusively that selling calls and sometimes buying puts as "partial hedges" is the only efficient way to manage the risks of holding equity compensation grants for executives and employees, notwithstading what some agents for companies may claim. I personally can demonstrate it conclusively.

Selling calls moderates the risk to the executives holding equity compensation and reduces the executive's incentive to takes extreme risk with company assets. If that way becomes prohibited, the value of the grants (both perceived and real) are diminished to those holding equity grants, thereby requiring the companies to issue additional grants to make up for the diminished values, and thereby causing more costs to the company.

There are some who claim that hedging versus equity compensation voids the purpose of the equity compensation grants as it reduces the grantee/shareholder alignment by taking the "incentive" out of the equation. Unless the hedging is effectively a sale of the stock or a near sale of the stock (such as collars, pre-paid variable forwards, equity swaps and exchange trusts), much of the grantee/shareholder alignment is preserved by efficient hedging. In fact efficient hedging promotes longer alignment with the company because it reduces the risks and allows the grantee the ability to hold the alignment longer.

What reduces the alignment and the built in incentives is a prohibition against efficient hedging. Such a prohibition causes the grantee to have only one choice to reduce risk and that is to sell the stock, either stock that was granted or stock that he receives as a result of premature exercises of options. No informed person would claim that selling stock does not reduce the aligments and incentives. Hedging reduces the alignments less.

I notice that there is a letter written by three Senators on March 31, 2011 (attached) expressing views about the impact of hedging. A discussion of some of the claims in that letter is in order, The letter states in paragraph 3 page 1 that "Quite simply, the use of hedging takes the "incentive" out of incentive-based compensation".

Although hedging reduces risks, only sales of stock and near sales of stocks like collars, equity swaps and pre-paid forwards completely take the "incentive out of incentive-based compensation". So prohibitions of sales of stock should be made before any prohibitions against hedging should be contemplated if the "incentive" is to be preserved. But no one wants to prohibit sales of stock do they?

The letter further states in paragraph 4 page 1 that;

"There is ample evidence to suggest that this is not only a widespread problem, but also a problem that has serious implications for investors and the health of the companies that the executives work for".

The facts are that hedging is not widespread at all and that hedging is absolutely no problem at all and has no negative consequences for investors or the company.

A study by Carr Bettis is cited in the March 31, 2011 letter to support the idea that hedging is widespread. However during the 10 years period there were 2010 hedging transactions or 201 per year on average for 911 firms. That totals perhaps to less than 1/3 of one percent of all the transactions made by executives of the top 3000 firms. If we also considered the transactions of the non-officers and directors, the hedging total may be less than 1/10 of one percent. In other words one trade out of a thousand was a hedge over the 10 year period and most of those were near sales of stock type hedges.

Bettis is also cited for the idea that "the evidence is pretty compelling that hedges tend to be used before bad news hits the market". The suggestion is that executives over that period were trading with non public information, a felony under SEC Rule 10 b-5-1. But very few have been prosecuted. I would suggest that if the trading patterns in stock of those same executives were examined, we would probably find the same bad news hitting the market after their sale of stock. Perhaps sales of stock should also be prohibited.

In the Senators' letter in paragraph one on page two, a referrence to the fact that "in 2009 there was 107 instances of executive hedging were reported to the SEC": This illustrates that the number of instances are down by almost 50 percent compared to the preiod of 1996-2006.

Reference to Kenneth Feinberg's statement is un-impressive as is the chief-resourses officer at Pitney Bowes and persons at Procter & Gamble and Kellog. I would bet a $1000 to a donut that none of those "experts" ever hedged a position or traded options or ever analysed the consequences of doing so either to the executive or the company. They are 100% unqualified to express any opinions on hedging stock and options.

Betting against one's own company is prohibited by the 1934 Act and SEC Rule 16c-4. Reducing the risk of your equity exposure is legal and prudent and can not be accurately described as betting against the company. In fact advisers to persons holding large equity compensation position can be held civilly liable for not recommending hedging strategies and some have been held liable. And there is no competent person in the equity compensation arena or the derivative arena who holds a contrary view.

In Summary:

The idea that banning hedging for executives or employees will improve the situatio for the shareholders, the executives or the employees is far fetched. There is not one bit of proof, circumstantial or otherwise that it will. It will, in fact, harm all three. If there is a ban on hedging unexercised employee stock options, where the case is strongest to allow it, it will harm the employees and the executives and the companies moreso.

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http://www.wiley.com/WileyCDA/WileyTitle/productCd-0470471921.html

P.S. I have invented a new type of employee stock option called Multiple Choice Employee Stock Options, which in most cases eliminates the need for executives or employees to ever hedge their positions while at the same time benefitting the shareholders, the executives and the employees. Its linked below. I would be happy to explain it to anyone who wishes.

https://docs.google.com/present/edit?id=0AdBngJz5Vy2WZGduNTI2NHhfNzU5ZHR4bmp4ZGc&hl=en&authkey=CPOhiO0F

United States Senate

WASHINGTON, DC 20510

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OFFICE OF THE SECRETARY

March 31, 2011

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

RE: RIN 3064 – AD56, "Incentive-based Compensation Arrangements"

Dear Secretary Feldman:

We write today to comment on a rule jointly prescribed by federal regulators to implement Section 956(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), concerning the prohibition of certain compensation arrangements to deter excessive risk-taking at major financial institutions.

On page 49 of the proposed rule, the agencies questioned if the use of personal hedging strategies – such as financial derivatives, insurance contracts, etc. – on incentive-based compensation arrangements for highly-paid executives would make many of the provisions prescribed by the agencies less effective. The agencies invited comments as to whether limits should be placed on these personal hedging strategies.

We strongly believe that hedging strategies used by highly-paid executives on their own incentive-based compensation should be prohibited. Quite simply, the use of hedging takes the "incentive" out of incentive-based compensation, undermining accountability of the executives who engage in these tactics.

There is ample evidence to suggest that this is not only a widespread problem, but also a problem that has serious implications for investors and for the health of the companies that the executives work for.

Carr Bettis, the co-founder of the forensic accounting firm Gradient Analytics and co-author of a recent study on hedging found 2,010 hedging transactions reported in filings by 1,181 executives at 911 firms over a ten-year period from 1996 to 2006.[1] A recent article in Bloomberg Businessweek describes the potential impact these transactions may have on investors:

> "There is no question these transactions should be a red flag for investors," says Carr Bettis. "The evidence is pretty compelling that hedges tend to be used before bad news hits the market." Bettis' research found that in the year after executives and directors had engaged in hedging, their company's stock often dropped markedly. He also found evidence of an increase in financial

[1] http://www.businessweek.com/magazine/content/10_10/b4169044647894.htm

restatements and shareholder lawsuits during the same period. Executives at MCI, Enron, ImClone, Krispy Kreme – companies that suffered some of the great stock melt-downs of the last decade – hedged their shares.[2]

In 2009 alone, 107 instances of executive hedging were reported to the SEC.[3]

Other governmental offices have taken exception with the tactic. Kenneth Feinberg, the U.S. Treasury Special Master for TARP Executive Compensation, who was responsible for overseeing the distribution of compensation to top executives at companies that received federal bailout assistance, banned executives under his jurisdiction from this practice. He said, "We wanted to make sure they couldn't undercut the links we created between compensation and long-term performance."[4]

And many companies, perhaps realizing the hypocrisy in this practice, have banned it themselves. Johnna Torsone, the chief human-resources officer at Pitney Bowes Inc. has said, "We think it is inappropriate for senior employees to, in effect, bet against the company."[5] Procter & Gamble and Kellogg have reportedly banned these tactics.[6] However, many large banks such as JPMorgan Chase, Morgan Stanley and Goldman Sachs ban only their highest-ranking executives.[7]

During debate of the Dodd-Frank Act, we offered Senate Amendment #3818 to prohibit exactly this type of behavior. The amendment would have banned executives and other highly-compensated employees – those making more than $1 million – from engaging in trades that would bet against their own company's stock. While the amendment was not voted on, it was supported by several advocacy groups and prominent figures, including Americans for Financial Reform, the Council of Institutional Investors, and former SEC Chief Accountant Lynn Turner.

We continue to stand by this legislation. Stock hedging significantly undermines the purpose of incentive-based compensation. Executives should benefit when their company does well. If allowed to hedge, it takes their company out of the equation, allowing them to profit regardless, and further encourages excessive risk-taking.

In short, we would strongly urge the agencies to consider including prohibitions preventing highly-paid executives from hedging in any way on incentive-based compensation arrangements. We thank you for the opportunity to comment.

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[2] http://www.businessweek.com/magazine/content/10_10/b4169044647894.htm
[3] http://www.businessweek.com/magazine/content/10_10/b4169044647894.htm
[4] http://www.businessweek.com/magazine/content/10_10/b4169044647894.htm
[5] http://online.wsj.com/article/SB124407837568483691.html
[6] http://www.businessweek.com/magazine/content/10_10/b4169044647894.htm
[7] http://dealbook.nytimes.com/2011/02/05/stock-hedging-lets-bankers-skirt-efforts-to-overhaul-pay/

Sincerely,

Robert Menendez
United States Senator

Jeff Merkley
United States Senator

Frank Lautenberg
United States Senator

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