Council of Institutional Investors
The Voice of Corporate Governance

Via Email

May 19, 2011

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. R–1410 and RIN No. 7100–AD69, Incentive-based Compensation Arrangements

Dear Ms. Johnson:

I am writing on behalf of the Council of Institutional Investors (Council), a nonprofit association of public, union and corporate pension funds with combined assets exceeding $3 trillion.[1] Council members are large, long-term investors responsible for protecting the retirement savings of millions of American workers. The purpose of this letter is to respond to your request for feedback on the Board of Governors of the Federal Reserve System's (Federal Reserve Board) proposed rules on incentive-based compensation arrangements.

Per the Financial Crisis Inquiry Commission's recent report, executive compensation at financial institutions, "often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences." This theme was also raised in the Council's November 2010 white paper entitled "Wall Street Pay: Size, Structure and Significance for Shareowners," authored by pay expert Paul Hodgson of GovernanceMetrics International, which stated, "the lack of long-term performance measurement on Wall Street…likely helped to fuel excessive risk-taking."[2]

Badly-structured incentives can promote the get-rich-quick mindset and overly risky behavior that caused the recent financial crisis. As described in the July 2009 report of the Investors' Working Group (IWG), a blue ribbon panel of industry and market experts, "Poorly structured pay plans that rewarded short-term but unsustainable performance encouraged CEOs to pursue risky strategies that hobbled one financial institution after another and tarnished the credibility of U.S. financial markets. To remedy this situation, stronger governance checks on runaway pay are needed."[3]

[1] For more information about the Council and its members, please visit our Web site at http://www.cii.org.
[2] The Council's white paper on Wall Street pay can be found online at http://www.cii.org/CouncilPublications.
[3] The IWG was an independent, nonpartisan commission sponsored by the CFA Institute and the Council to provide an investor perspective on ways to improve, in an efficient and cost-effective manner, the regulation of the U.S. financial markets. The IWG's full report and recommendations are available at http://www.cii.org/iwgInfo.

Therefore, the Council applauds the Dodd-Frank Wall Street Reform and Consumer Protection Act's (Dodd-Frank Act) provisions requiring covered financial institutions to report their incentive-based compensation arrangements to regulators and prohibiting incentive-based compensation arrangements at a covered financial institution that could expose the institution to inappropriate risks that could lead to material financial loss.

The Council has many executive pay policies relevant to the Dodd-Frank Act's provisions on incentive-based compensation arrangements. Several of these Council guidelines are included below as core reforms we believe should be incorporated in the Federal Reserve Board's final rules for the benefit of all stakeholders:

- Compensation committees should *cap incentive awards at a reasonable maximum level*, since an unlimited potential upside promotes excessive risk-taking. These caps should not be calculated as percentages of accounting or other financial measures (such as revenue, operating income or net profit), since these figures may change drastically due to mergers, acquisitions and other non-performance-related strategic or accounting decisions. Caps based on accounting or other financial measures could incentivize executives to make myopic decisions that lift the numbers and boost their incentive pay but ultimately hurt long-term shareowner returns.

- Pay should incorporate *company-wide performance metrics*, not just business unit performance criteria. This should deter executives from increasing business unit performance in risky ways that might harm the company as a whole.

- Executives should own, after a reasonable period of time, a *meaningful position in the company's common stock, and hold a significant portion of their equity-based compensation* for a period beyond their tenure. These measures should help rein in excessive risk-taking by encouraging executives to act in ways that create sustainable shareowner value over the long run. The Council believes a meaningful proportion of executive pay should be in an equity-based form.

- Executives should be prohibited from *hedging* equity-based awards granted as long-term incentive compensation or other stock holdings in the company. As Lucian Bebchuk and Jesse Fried point out in their book <u>Pay without Performance</u>, hedging transactions, "weaken the link between executives' wealth and shareholder value, diminishing their incentives to increase this value."

In addition, the Council believes the Federal Reserve Board should require covered financial institutions to update their incentive-based compensation disclosures between annual disclosure cycles if any material changes to their incentive plans occur. Expeditious disclosure of material changes, especially those with the potential to encourage excessive risk-taking, should help the Federal Reserve Board to timely identify and address potentially dangerous incentive plans before harm arises.

If you have any questions or need any additional information, please feel free to contact me at (202) 261-7088 or justin@cii.org.

Sincerely,

Justin Levis
Senior Research Associate

cc: Mr. John Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency, Department of the Treasury
Mr. Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation
Mr. John E. Bowman, Acting Director, Office of Thrift Supervision, Department of the Treasury
Ms. Mary Rupp, Secretary of the Board, National Credit Union Administration
Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission
Mr. Alfred M. Pollard, General Counsel, Federal Housing Finance Agency