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

Reference: RIN 3064-AD86

Dear Mr. Feldman:

This letter is in response to the request by the Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Federal Housing Finance Agency (FHFA); National Credit Union Administration (NCUA); and U.S. Securities and Exchange Commission (SEC) for comments on their joint proposed release entitled "Incentive-based Compensation Arrangements" published on April 21, 2016 (the proposed rule; https://www.sec.gov/rules/proposed/2016/34-77776.pdf). These comments are based on my research published in several papers in scholarly journals with Professor Roberta Romano (Yale Law School). These published papers are cited and discussed in the attached book, "Financial Crisis, Corporate Governance, and Bank Capital" (Cambridge University Press, forthcoming 2016).

The new proposed rule takes a tiered approach; more stringent regulations for banks with assets more than $250 billion, somewhat less stringent regulations for banks with assets between $50 billion and $250 billion, and even less stringent regulations for banks with assets in the $1 billion to $50 billion range. The proposed rule covers bonuses; specifically, *it does not cover compensation derived from the sale of stock*.[1] Besides the senior bank executives, the new proposed rule covers "significant risk-takers in the bank" defined as employees with a third of their compensation based on incentive-compensation and among the top 5% salary-earners in the bank, or those who can commit 0.5% or more of the net worth or bank assets. The proposed rule requires deferral of at least 60% of the incentive-compensation for a period of at least four years, and forfeiture of all unvested deferred incentive-based compensation. The deferral and forfeiture can be triggered by poor financial or non-financial performance due to "inappropriate" risk taking, among other events.[2] The April 2016 regulations also require clawback provisions that allow a bank to recover incentive-based compensation from the manager for a period of seven years following the incentive compensation vesting date. The clawback can be triggered by (i) misconduct that resulted in significant financial or reputational harm to the bank; (ii) fraud; or (iii) intentional misrepresentation of information used to determine the manager's incentive-based compensation.

We support the essence of the April 2016 "Incentive-based Compensation Arrangements," proposed by the six U.S. agencies. These agencies have done an impressive amount of analysis and used the theoretical and empirical financial economics literature to motivate their proposed regulations. The deferral, forfeiture, and clawback provisions are focused on discouraging "inappropriate" risk taking by banks. A critical question: What is "inappropriate" risk taking by banks? From a financial viewpoint the risk of a project or trading

[1] Page 136 in (https://www.sec.gov/rules/proposed/2016/34-77776.pdf).: "Neither would the proposed definition include dividends paid and appreciation realized on stock or other equity-like instruments that are owned outright by a covered person."

[2] Page 49 in (https://www.sec.gov/rules/proposed/2016/34-77776.pdf).

strategy would be inappropriate if the net present value of the project or trading strategy is negative. However, the measurement of such risk (and associated cash flows) are subject to both manager biases and estimation errors as discussed in chapter 3 of the attached book. Enforcing deferral, forfeiture, and clawback provisions can lead to very large potential losses on managers (see Table 5.3, Panels A, B, and C in the attached book). Given the potential losses of tens or hundreds of millions of dollars, affected managers are likely to *litigate* the occurrence of a particular trigger event or the measurement of the "inappropriate" risk. Given the inherent uncertain outcome of any litigation, the disciplining effect of the April 2016 proposed rule on bank manager inappropriate risk-taking behavior would be muted.

We suggest an alternative executive incentive compensation reform proposal that addresses the concerns with and drawbacks of the proposed rule. We suggest three criteria for evaluating executive compensation reform policies : i) simplicity, ii) transparency, and iii) focus on creating and sustaining long-term shareholder value. A simple and transparent incentive compensation structure is desirable for at least three reasons. First, the financial sector is particularly fast-moving, rendering it difficult to predict what risks may emerge as products and markets develop, and how individuals respond to regulatory and contractual incentives can alter risk in unanticipated ways that can evolve in complicated ways. Moreover, in today's context of large and interconnected financial institutions and complex financial instruments, banks must grapple with unknown and unknowable risks. As a consequence, the more complicated and opaque incentive package, the more difficult it will be to determine how individuals will respond, and what risks will or will not be incurred. Second, as shareholders are now required to vote on CEO compensation packages, a simple incentive structure is easier for them to understand and evaluate, reducing the need to rely on third-party vendors of proxy voting advice, the value of which has been the subject of considerable controversy. Third, simplicity and transparency in incentive compensation packages mitigate public skepticism toward high levels of executive pay in conjunction with poor performance, particularly when a firm's failure implicates the public fisc. Finally, the focus on creating and sustaining long-term shareholder value would channel management's attention to the longer term profitability of an investment or trading strategy. Business and legal scholars posit that managers should act in the best interest of long-term shareholders – what better way to do this than tie management incentive compensation to long-term share price!

We propose that the incentive compensation of bank executives should consist only of restricted equity (restricted stock and restricted stock option) – restricted in the sense that the individual cannot sell the shares or exercise the options for one to three years after their last day in office. We refer to this as the *Restricted Equity proposal*.

If a bank CEO is offered incentive compensation contracts consistent with the Restricted Equity proposal, then she would have more high-powered incentives not to invest in the high-risk but unprofitable (over the long-term) projects and trading strategies. Not only would the CEO be required to hold these shares and options for the duration of her employment in the bank, but for one to three years subsequent to her retirement or resignation. If the trading strategy resulted in an unexpected positive cash flow in a certain year prior to their retirement or resignation, the bank's share price would go up, the CEO's net worth would go up on paper, but the CEO would not be able to liquidate her stockholdings. The CEO would have to make an assessment of the likelihood of the large negative cash flow outcome during the years she continued to be employed at the bank, plus one to three additional years. After making such an assessment, a CEO would presumably be less likely to authorize or encourage the high-risk but unprofitable (over the long-term) projects and trading strategies in the first place. The long-term feature of the Restricted Equity proposal's compensation package would operate to curb optimistic estimates of a project's long-term profitability by using high-powered financial incentives to prod the executive to attend to, and hence estimate more assiduously, all of a project's cash flows, rather than solely those in the near term. If a bank does not engage in the long-term unprofitable investment project or trading strategy, then this would, of course, also serve the interests of the long-term shareholders.

We have suggested that the time frame extend one to three years after retirement, but we would leave the specific horizon to the board compensation committee, to whom the proposal is addressed. The rationale for this extended time frame is to maintain incentives for an executive in an "end-game" situation, i.e., an individual making decisions when he or she is reaching retirement. At the shorter end of our proposal, management's discretionary authority to manage earnings under current U.S. accounting conventions unravels within a one-to-two year period, while at the longer end we think three years is a reasonable period in which at least the intermediate-term results of executives' decisions will be realized.

We note three important caveats to the Restricted Equity proposal . First, if executives are required to hold restricted shares and options, they would most likely be under-diversified. Second, if executives are required to hold restricted shares and options post-retirement, they may be concerned with lack of liquidity. Third, the proposal could lead to early management departures, as executives seek to convert illiquid shares and options into more liquid assets (after the one to three year waiting period). We address these caveats by recommending to the board of directors a best practice that allows executives to annually liquidate a small amount to meet legitimate cash flow needs; please see pages 56-80 in the attached book. Such a best practice will provide managers stronger incentives to work in the interests of long-term shareholders, and avoid excessive risk-taking. Importantly, the above compensation structure is simple, transparent, and focused on creating and sustaining long-term shareholder value.

The clawback triggers in the proposed rule (noted above) are subjective, hence, will entail significant litigation costs which will limit their effectiveness. The Restricted Equity proposal has an inherent *clawback* (and, deferral and forfeiture) feature that renders unnecessary intricate mechanisms requiring repayments (forfeiture) of bonuses on income from transactions whose value proved illusory. Because executives are compensated in equity that is not received until years after it is earned – one to three years after they leave the firm – they cannot capture short-lived share price gains from transactions whose value is not long-lasting. The compensation will be dissipated as the value of the firm's shares decline upon the realization of the project's or investment strategy's losses. In other words, executives will receive less in value than the originally granted incentive stock compensation if the stock price drops thereafter. This automatic clawback is, accordingly, simpler to administer than the specified regulatory clawbacks, avoiding definitional, and consequently litigation, pitfalls.

We note a second concern with the April 2016 proposed rule which cover bonuses, but do not cover compensation derived from the sale of stock. Big bank executive compensation derived from sale of their bank's stock is usually *twice* as large, or greater, than their compensation from salary and bonus; see Table 5.3, Panels A, B, and C in the attached book. Hence, even if the April 2016 proposed rule is successful in discouraging some inappropriate risk taking by banks, the adverse incentives from compensation derived from the sale of stock remains a potent problem. Our Restricted Equity proposal would address this problem as well.

Who will implement the Restricted Equity Proposal? Our proposal is directed at bank compensation committees, who, we urge, should voluntarily adopt a Restricted Equity plan as the preferred mechanism for aligning management's incentives to long-term shareholder wealth creation and to mitigate the taking of excessive risk. In implementing the proposal, we think corporate boards should be the principal decision-makers regarding:

a) The mix of restricted stock and restricted stock options a manager is awarded.
b) The amount of restricted stock and restricted stock options the manager is awarded.
c) The maximum percentage of holdings the manager can liquidate annually.
d) Number of years post retirement/resignation for the stock and options to vest.

Director compensation typically consists of a cash component (called the retainer), smaller cash amounts paid for attendance at board and committee meetings, and incentive compensation in the form of stock and stock option grants which vest over a period of time of a few years. While the theoretical and empirical literature on executive compensation is extensive, the literature on director compensation is relatively modest. We think that it is plausible to assume that incentives operate similarly in both employment positions. If, for example, directors can liquidate their vested stock and options, and a director feels the need to liquidate the position in the near future, then the director may focus on short-term performance that may be to the detriment of long-term shareholder value and the public fisc.

We propose that director compensation for banks (and non-financial companies) be structured along the lines of the Restricted Equity proposal. Our proposal is based on the following empirical findings:

- Companies in which directors own more stock performed better in the future years.

- Directors who own more stock are more likely to discipline or fire the CEO when the stock price performance of their company has been sub-par in the previous two years.

We propose that all compensation (including incentive compensation) of corporate directors should consist only of restricted equity (restricted stock and restricted stock option) – restricted in the sense that the director cannot sell the shares or exercise the options for one to three years after their last board meeting. With regard to cash compensation – we are recommending corporate directors not be paid any retainer fees or other cash compensation. We discuss and address several important caveats of this director compensation policy in the attached book (pages 81-90).

We appreciate this opportunity to comment on the proposed rule.

Yours sincerely,

Sanjai Bhagat