S. HRG. 111–844

TARP AND EXECUTIVE COMPENSATION RESTRICTIONS

HEARING

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

OCTOBER 21, 2010

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CONGRESSIONAL OVERSIGHT PANEL

PANEL MEMBERS

THE HONORABLE TED KAUFMAN, *Chair*

KENNETH TROSKE

J. MARK MCWATTERS

RICHARD H. NEIMAN

DAMON SILVERS

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HEARING ON TARP AND EXECUTIVE COMPENSATION RESTRICTIONS

THURSDAY, OCTOBER 21, 2010

U.S. CONGRESS,
CONGRESSIONAL OVERSIGHT PANEL,
Washington, DC.

The panel met, pursuant to notice, at 11:00 a.m. in room SD–538, Dirksen Senate Office Building, Senator Ted Kaufman, chairman of the panel, presiding.

Present: Senator Ted Kaufman [presiding], Richard H. Neiman, Damon Silvers, J. Mark McWatters, and Kenneth R. Troske.

OPENING STATEMENT OF HON. TED KAUFMAN, U.S. SENATOR FROM DELAWARE

The CHAIRMAN. This hearing of the Congressional Oversight Panel will now come to order. Good morning.

My name's Ted Kaufman. I'm the chairman of the Congressional Oversight Panel for the Troubled Asset Relief Program.

This hearing is my first as the Panel's chairman, so I want to begin by thanking my fellow panelists and recognize their tremendous work to date. And I'm deadly serious about that. I'll tell you, they came into me the first day and they said, "Here, take a look at this." Twenty-four reports. What, 12 hearings? It's just—it is really remarkable what the Panel's work can do.

As we all know, the TARP has been among the most controversial government programs in recent memory; yet, month after month, this Panel has managed to cut through the noise and differing opinions to provide a perspective that is independent, fact-based, and consensus-driven. I hope to help carry our work forward in exactly that spirit.

We are here today to examine the executive compensation restrictions in the TARP. In 2008, Congress authorized $700 billion to bail out the financial system, but the money came with certain strings attached. As a condition of receiving taxpayer aid, the companies were required to align their executive pay practices with the public interest.

No one can argue against the "public interest," but in the context of executive pay, I think everyone would agree, it's very difficult to define or measure. After all, a paycheck represents many things. It represents the source of a family's livelihood. It represents an incentive to work hard and achieve results. It represents a tool for retaining workers. It represents the value that an employee adds to the workforce. It represents a cost to the employer's bottom line.

In the case of bailed-out financial institutions, a paycheck represents a transfer of wealth from taxpayers to corporate executives.

A paycheck that is too high is clearly out of step with the public interest. It risks rewarding executives whose mismanagement contributed to the financial crisis and potentially wasting taxpayer dollars. Yet, a paycheck that is too low creates problems, too. If a bailed-out bank cannot hold on to talented executives, it may struggle to stay afloat or to repay taxpayers.

Even a paycheck that is neither too high nor too low may still create perverse incentives. A CEO paid $10 million in company stock may take reckless risks to drive it to $20 million. A company can rein in this problem by requiring executives to hold their stock for several years. Yet, even then, executives may refuse to consider measures, such as bankruptcy, that would strengthen the public interest but diminish shareholder profits.

For all these reasons, executive pay is complicated and controversial, but it's also of profound importance. If Treasury, acting on its authority and leading by its example, can get executive pay right, it could help to lay the foundation for long-term financial stability. Any mistakes, on the other hand, could contribute to the next financial collapse.

Today, we will hear from witnesses—excellent witnesses—who have long practiced in navigating these turbulent waters. We thank you for your time and look forward to your testimony.

And now I'd like to turn to other colleagues in the Panel for their statement.

Mr. McWatters.

SEN. TED KAUFMAN, CHAIRMAN
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK MCWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOMS C-320
WASHINGTON, DC 20401

Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Ted Kaufman

Congressional Oversight Panel Hearing on the TARP and Executive Compensation Restrictions

October 21, 2010

Good morning. My name is Ted Kaufman, and I am the chairman of the Congressional Oversight Panel for the Troubled Asset Relief Program (TARP).

This hearing is my first as the Panel's chairman, so I want to begin by thanking my fellow panelists for their gracious welcome and by recognizing their tremendous work to date. As we all know, the TARP has been among the most controversial government programs in recent memory. Yet month after month this panel has managed to cut through the noise and differing opinions to provide a perspective that is independent, fact-based, and consensus-driven. I hope to help carry our work forward in exactly that spirit.

We are here today to examine executive compensation restrictions in the TARP. In 2008, Congress authorized $700 billion to bail out the financial system, but the money came with certain strings attached. As a condition of receiving taxpayer aid, companies were required to align their executive pay practices with the public interest.

No one can argue against the "public interest," but in the context of executive pay, it is very difficult to define or measure. After all, a paycheck represents many things. It represents the source of a family's livelihood. It represents an incentive to work hard and achieve results. It represents a tool for retaining workers. It represents the value that an employee adds to the workforce. It represents a cost to the employer's bottom line. And in the case of bailed-out financial institutions, a paycheck represents a transfer of wealth from taxpayers to corporate executives.

A paycheck that is too high is clearly out of step with the public interest. It risks rewarding executives whose mismanagement contributed to the financial crisis and potentially wasting taxpayer dollars. Yet a paycheck that is too low creates problems, too. If a bailed-out bank cannot hold onto talented executives, it may struggle to stay afloat or to repay taxpayers.

Even a paycheck that is neither too high nor too low may still create perverse incentives. A CEO paid $10 million in company stock may take reckless risks to drive its value to $20 million. A company can rein in this problem by requiring executives to hold their stock for several years, yet even then, executives may refuse to consider measures, such as bankruptcy, that would strengthen the public interest but diminish shareholder profits.

For all of these reasons, executive pay is complicated and controversial, but it is also of profound importance. If Treasury, acting under its authority and leading by its example, can get executive pay right, it could help to lay the foundation for long-term financial stability. Any mistakes, on the other hand, could contribute to the next financial collapse.

Today we will hear from witnesses who have long practice in navigating these turbulent waters. We thank you for your time and look forward to your testimony.

Before we proceed, I would like to offer my colleagues on the Panel an opportunity to make their own opening remarks.

STATEMENT OF J. MARK McWATTERS, ATTORNEY AND CERTIFIED PUBLIC ACCOUNTANT

Mr. MCWATTERS. Good morning, and thank you, Senator, and welcome to the panel.

The CHAIRMAN. Thank you.

Mr. MCWATTERS. Over the past 2 years, Members of Congress, policy wonks and academics, and private-sector participants have debated the existence of any linkage between the compensation structures employed by TARP recipients and other institutions and the financial contagion that erupted in the last quarter of 2008.

Some contend that the cause-and-effect relationship exists between the structure of an employee's compensation package and the amount of risk the employee's willing to undertake on behalf of his or her employer. I refer to this as the "show me the money" theory. Under this theory, some mortgage lenders, for example, may have originated residential mortgage loans without conducting prudent due diligence investigations of the borrowers. Likewise, some TARP recipients and other institutions may have packaged mortgage loans and securitization vehicles, without having properly vetted the underlying collateral, and sold the securitized tranches to investors who, themselves, may have elected to forgo any meaningful investigation of the legal and financial integrity of the transactions.

Other commentators, however, reject the "show me the money" theory and argue that the financial crisis of 2008 and beyond was not spawned by misdirected compensation policies, but instead arose from the failure of mortgage originators and securitization sponsors and investors to appreciate the magnitude of the risk inherent in the mortgage lending and pooling of loans into opaque securitization products. I refer to this as the "white heart, empty head" theory. Under this approach, directors, officers, and employees of TARP recipients and other institutions, from the perspective of pure self-interest, would not have knowingly taken any action that could have resulted in the loss of their employment, the material devaluation of their incentive stock options and grants, or the bankruptcy, takeover, or liquidation of their firms. That is, these individuals possess no desire for self-immolation, and they discharged their duties accordingly.

As in other instances, the solution to our inquiry may not reside solely within the domain of either theory or hybrid of the two. Although the "white heart, empty head" theory has a certain visceral appeal—and it is significant to note that relatively few investment professionals accurately foresaw the impending financial tsunami—those who dismiss the "show me the money" theory, however, may be disappointed as we discover more about how the sausage was actually made in the residential mortgage securitization factories.

In the final analysis, I suspect that both theories may help explain the genesis of the recent financial crisis. The compensation packages offered by some TARP recipients no doubt encouraged a certain amount of excessive and unnecessary risktaking, the consequences of which, unfortunately, were not fully appreciated by the TARP recipients themselves, their Federal and State regulators, or the capital markets.

The most challenging work remains ahead, however, as we struggle with the remaining fundamental inquiry: How does an employer structure a compensation program so as to identify and minimize unnecessary and excessive risktaking while encouraging managers to assume sufficient risk so as to assure the long-term profitability of their employer?

Thank you, and I look forward to our discussion.

The CHAIRMAN. Mr. Silvers.

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of J. Mark McWatters

Congressional Oversight Panel Hearing on the TARP and Executive Compensation Restrictions

October 21, 2010

Thank you Senator and welcome to the Panel.

Over the past two years members of Congress, policy wonks, academics and private sector participants have debated the existence of any linkage between the compensation structures employed by TARP recipients and other institutions and the financial contagion that erupted in the last quarter of 2008.

Some commentators contend that a cause and effect relationship exists between the structure of an employee's compensation package and the amount of risk the employee is willing to undertake on behalf of his or her employer, and that some compensation packages may directly encourage employees to undertake high risk investment strategies and business ventures. Followers of this school argue that both senior executives and junior employees will promptly respond to any financial incentives offered by their employers and modify their behavior so as to maximize their aggregate compensation. I refer to this as the "Show Me the Money Theory."

Under this theory, some mortgage lenders, for example, may have originated residential mortgage loans without having conducted prudent due diligence investigations of their borrowers. Likewise, some TARP recipients and other institutions may have packaged mortgage loans in securitization vehicles without having properly vetted the underlying collateral and sold the securitized tranches to investors who themselves may have elected to forgo any meaningful investigation of the legal and financial integrity of the transactions. The mortgage originators and securitization sponsors may have neglected their respective due diligence undertakings because they were in effect compensated *merely to close* mortgage loans and securitizations and to *pass the risks* associated with the investments downstream to the purchasers of the securitized tranches, regardless of the intermediate to long-term financial soundness of the underlying mortgages and securitized tranches. The end-user investors may have elected to forgo their independent investigations of the mortgage loans and securitized tranches in reliance upon the opinions of ratings agencies, legal counsel, accountants and other third-party advisors and experts. Some of these professionals may also have been financially motivated to facilitate the premature closing of the securitization transactions because the payment of their fees was often—at least in part—dependent upon a prompt and successful closing. Thus, under the Show

Me the Money Theory, the parties to a securitization transaction may have invested significant effort in ascertaining that each transaction closely paralleled the "form" of a text-book securitization transaction—with all the "i's" dotted and "t's" crossed—while allocating relatively less attention to the "substance" of the transactions and the intermediate to long-term prospects for the timely repayment of the securitized tranches.

Other commentators, however, reject the Show Me the Money Theory and argue that the financial crisis of 2008 and beyond was not spawned by misdirected compensation policies, but, instead, arose from the failure of mortgage originators and securitization sponsors and investors to appreciate the magnitude of the risks inherent in mortgage lending and the pooling of loans into opaque securitization products. Followers of this school contend that—notwithstanding a few bad apples—mortgage loan originators and securitization sponsors and investors were not specifically motivated to forsake any of their legal or ethical duties and responsibilities based upon the structure of the compensation programs offered by their employers. To the contrary, these officers and employees—so the theory goes—undertook thorough and proper due diligence investigations of the collateral underlying each securitization transaction and, prior to making any investment decision, relied upon sophisticated stress tests and other econometric models; geographic and income diversification protocols; prepayment, default and collection metrics grounded in reasonable historic norms; and took great comfort in knowing that a material nationwide recession in residential real property had not occurred in approximately 80 years. I refer to this as the "White Heart, Empty Head Theory."

Under this theory, directors, officers and employees of TARP recipients and other institutions[1]—from the perspective of pure self-interest—would not have knowingly taken any action that could have resulted in the loss of their employment, the material devaluation of their incentive stock options and grants, or the bankruptcy, takeover or liquidation of their firms. That is, these individuals possessed no desire for self-immolation and they discharged their duties accordingly.[2] A few years ago it was all but conventional wisdom that the mortgage loan securitization process represented modern day alchemy where brilliant investment bankers mysteriously transformed billions of dollars of illiquid, risky mortgage loans into readily marketable, investment grade securitized instruments. Many of the alchemists—notwithstanding their business acumen and enviable track records—were dead wrong with respect to the mortgage loan securitization implosion, yet, if the White Heart, Empty Head Theory prevails, they were not motivated in any manner to game the system based upon the structure of their employer's compensation program.

[1] These other institutions include commercial banks, investment banks, hedge funds, private equity firms, sovereign wealth funds, endowments and pension plans.

[2] Most investment professionals—understandably—take occasional comfort in following the "herd" and few truly relish outlier status. As such, the handful of senior managers and investment advisors who accurately foresaw the brewing financial crisis would have faced—and in fact did face—incredible peer and market pressure to "get with the program" and adhere to the seemingly well vetted conventional norms of the day.

As in other instances, the solution to our vexing inquiry may not reside solely within the domain of either theory or even a hybrid of the two. Although the White Heart, Empty Head Theory has a certain visceral appeal and it is significant to note that relatively few investment professionals accurately foresaw the impending financial tsunami, those who dismiss the Show Me the Money Theory may be disappointed as we discover more about how the sausage was actually made in the residential mortgage securitization factories. To the extent it is ultimately determined that the White Heart, Empty-Head Theory presents the more compelling view, we should remain cautious so as not to misallocate effort and expense to the structuring of compensation programs directed at addressing the putative harm presented by the Show Me the Money Theory. In the final analysis, I suspect that both theories may help explain the genesis of the recent financial crisis. The compensation packages offered by some TARP recipients most likely encouraged a certain amount of excessive and unnecessary risk taking, the consequences of which, unfortunately, were not fully appreciated by the TARP recipients themselves, their federal and state regulators or the capital markets.

The most challenging work remains, however, as we continue to struggle with the fundamental issue: How does a too-big-to-fail TARP recipient employer structure a compensation program so as to identify and minimize in a timely manner unnecessary and excessive risk-taking while encouraging senior executives and other managers to assume sufficient risk so as to assure the long-term profitability of the employer?

Regardless of which theory prevails, regulators should remain mindful that ill-conceived efforts to deter certain behavior may have unintended consequences and cast a chilling effect throughout the financial services community and capital markets.[3] For example, the recently enacted Dodd-Frank Act requires certain employers to disclose the ratio of the median annual total compensation of a company's employees (excluding its chief executive officer (CEO)) to the total annual compensation of its CEO, a requirement that could have the unintended consequence of encouraging the outsourcing of lower wage jobs.[4]

I hope that we are able to explore these two theories and the executive compensation provisions of the Dodd-Frank Act today.

Thank you and I look forward to our discussion.

[3] Although, understandably, some may feel envy towards those senior executives who receive substantial compensation packages, it remains problematic that such emotions alone should serve as the basis for sound public policy initiatives.

[4] Internal Revenue Code Section 162(m) as originally enacted provides that annual compensation – other than performance-based compensation – over $1 million is not deductible if paid to certain key employees of a publicly-traded corporation. Although section 162(m) was arguably enacted so as to reduce aggregate executive compensation, it may have had the opposite effect by encouraging employers to grant significant performance-based compensation awards to their key employees.

STATEMENT OF DAMON SILVERS, DIRECTOR OF POLICY AND SPECIAL COUNSEL, AFL–CIO

Mr. SILVERS. Thank you, Mr. Chairman.

Good morning. Let me first say what a pleasure and honor it is to be with our new chairman, Senator Ted Kaufman. Secondly, I would like to express my appreciation to all our witnesses, and in particular to Kenneth Feinberg, for appearing before us today, for being open to our views in the course of his work, and for his strenuous efforts in so many difficult circumstances on behalf of the American public.

Now, TARP is a program which uses public funds to subsidize private businesses and, in the process, extends to those private businesses implicit, and in some cases explicit, guarantees. Now, while there is extensive debate about executive pay in private companies subject to market discipline, that debate is of limited relevance to companies that have capital at below-market cost or have escaped bankruptcy due to the generosity of the American public.

So, we are here to ask, today, What compensation practices at TARP recipient institutions were and are in the public interest? I believe there are three dimensions to this question. The first is: Compensation practices under TARP should have contributed, and should contribute, to a sense among the American public that TARP's purpose was public-spirited and not designed or managed to maintain the incomes or assets of the executives of the businesses that caused the financial crisis. This issue is critical to the very legitimacy of our national government and our capacity, as a Nation, to address the ongoing economic crisis and to engage in national economic policymaking in the future.

Now, in this context, I am particularly curious about the somewhat peculiar conclusion drawn by the special master, that billions of dollars of executive pay was, quote, "not appropriate," but was nonetheless in the public interest. I look forward to learning how that could be.

Second, compensation practices under TARP should have led to economic and career consequences for executives of failed firms. There was and is a profound public interest in mitigating the moral hazard created when executives of too-big-to-fail institutions learn that, in the words of the New York attorney general, "Heads, I win; tails, you lose." Unfortunately, one of the effects of TARP appears to have been to perpetuate the accumulation of wealth by the very people and institutions that seem to have been responsible for our Nation's economic catastrophe.

Last week, the Wall Street Journal reported that overall compensation at six of the largest TARP recipients, including Bank of America and Citigroup that were recipients of exceptional aid, was higher in 2009 and in 2010 than it had been in 2007, and, during the 4-year period of the continuing financial crisis, amounted to over $430 billion; this, during a period when the real wages of Americans fell and returns to long-term investors in these very firms were catastrophic.

Now, finally and thirdly, compensation practices under TARP should be aligned with the public's interest both as investor and as implicit guarantor, both of individual firms and of the financial system as a whole. In pursuing this goal, TARP has faced a problem of equity prices in a number of TARP recipients that were so low as to be, effectively, options. Executives with equity-based compensation thus faced little real downside exposure and every reason to not restructure bank balance sheets, as my fellow panelists have alluded to. This situation would seem to encourage reckless risktaking, like, say, pursuing foreclosures without having the proper documents by means of faked affidavits.

So, I hope, today, that we can learn how TARP measures up against these objectives and what approaches to executive pay make the most sense, in light of them.

Thank you.

The CHAIRMAN. Mr.—Dr. Troske.

SEN. TED KAUFMAN, CHAIRMAN
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK MCWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

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CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Damon Silvers

Congressional Oversight Panel Hearing
on the TARP and Executive Compensation Restrictions

October 21, 2010

Good morning. Let me first say what a pleasure and honor it is to be with our new Chairman, Senator Ted Kaufman. Second, I would like to express my appreciation to all our witnesses and in particular to Kenneth Feinberg for appearing before us today, for being open to our views in the course of his work, and for his strenuous efforts in so many difficult circumstances on behalf of the American public.

Today our Panel holds its first hearing focused on issues of executive pay at companies that have received TARP funds.

TARP is a program which uses public funds to subsidize private businesses, and in the process extends to those private businesses implicit, and in some cases, explicit guarantees.

While there is an extensive debate about executive pay in private companies subject to market discipline, that debate is of limited relevance to companies that have capital at below market cost or have escaped bankruptcy due to the generosity of the American public.

We are here today to ask, what compensation practices at TARP recipient institutions were and are in the public interest.

I believe there are three dimensions to this question.

The first is, compensation practices under TARP should have contributed to a sense among the American public that TARP's purpose was public spirited, and not designed or managed to maintain the incomes or assets of the executives of the businesses that caused the financial crisis. This issue is critical to the very legitimacy of our national government and our capacity as a nation to address the ongoing economic crisis and to engage in national economic policy making in the future.

In this context, I am particularly curious about the somewhat peculiar conclusion drawn by the Special Master that billions of dollars of executive pay was "not appropriate," but was nonetheless in the public interest. I look forward to learning how that could be.

Second, compensation practices under TARP should have led to economic and career consequences for executives of failed firms. There was and is a profound public interest in mitigating the moral hazard created when executives of too big to fail institutions learn that in the words of the New York Attorney General, Heads I Win, Tails You Lose.

Unfortunately, one of the effects of TARP appears to have been to perpetuate the accumulation of wealth by the very people and institutions that seem to have been responsible for our nation's economic catastrophe. Last week, the Wall Street Journal reported that overall compensation at six of the largest TARP recipients was higher in 2009 and in 2010 than it had been in 2007—and during the four year period of the continuing financial crisis amounted to over $430 billion. This during a period when the real wages of Americans fell and returns to long term investors in these firms were catastrophic.

Finally, compensation practices under TARP should be aligned with the public's interest both as investor and as implicit guarantor, both of individual firms and of the financial system as a whole. In pursuing this goal, TARP has faced the problem of equity prices in a number of TARP recipients that were so low as to be effectively options. Executives with equity based compensation thus faced little real downside exposure and every reason to not restructure bank balance sheets. This situation would seem to encourage reckless risk taking like, say, pursuing foreclosures without having the proper documents by means of faked affidavits.

I hope today we can learn how TARP measures up against these objectives, and what approaches to executive pay make the most sense in light of these objectives.

Thank you.

STATEMENT OF KENNETH TROSKE, WILLIAM B. STURGILL PROFESSOR OF ECONOMICS, UNIVERSITY OF KENTUCKY

Dr. TROSKE. Thank you, Senator Kaufman.

I would like—also like to start by thanking all of the witnesses for appearing before our panel today. I recognize that all of you are very busy people with a number of other responsibilities, so I appreciate you taking your time to travel here and to help us with our oversight responsibilities.

As we are all aware, the issue before us today—examining the government's efforts to regulate how firms compensate executives, particularly firms who have received bailout money—remains one of the more controversial issues to arise out of the recent financial crisis. Taxpayers remain incensed about the large bonuses received by executives at firms that received enormous government bailouts.

Much of the recent discussion of executive compensation on these issues has focused on several issues about executives: Should executives of bailed-out financial firms receive bonuses? Do bonuses cause managers to focus on short-term gains as opposed to the long-term growth of a company? And have boards of directors of large financial firms been captured by management so that they simply rubberstamp managerial decisions instead of engaging in the appropriate amount of oversight?

While I recognize that there can be instances in which the way firms compensate executives is not always perfectly in line with the interests of shareholders, I believe that, in a free market, these problems can and will be corrected. However, in my opinion, the fact that for the past 40 years the Federal Government has made it clear that it would use taxpayer money to insure large financial firms against failure creates a distortion that actually exacerbates the problems mentioned above—mentioned previously. In other words, the financial sector is not a free market, and if we could simply return it to a free market—that is, if we could simply get rid of all of the government guarantee that has created too-big-to-fail firms—then many, if not most, of these problems would largely disappear or would no longer be of concern to taxpayers. It also means that by focusing on these ancillary problems, we fail to fix the true problem that is producing so much anger.

In regard to the specific issue of executive compensation, recent research from the Federal Reserve Bank of Minneapolis shows that, in almost every setting, shareholders of firms will choose to pay workers in an efficient manner. The one exception to this rule is when the government provides an implicit or explicit guarantee of the firm's debt and does not charge the firm for this guarantee. In this case, shareholders will choose to incentivize workers in ways that encourage them to take an excessive amount of risk. After all, if the risky investment pays off, shareholders reap all the rewards, but if the investment bankrupts the company, then it is the taxpayers who are left holding the bag.

One obvious solution to this problem is to simply let firms fail, in the too-big-to-fail phenomena, or at least charge firms for the insurance that they're being provided by the taxpayers.

Regardless of what one thinks is the optimal solution, I think we can all agree that these issues remain important, and I am interested in hearing what the witnesses have to tell us about the challenges involved in having the government regulate how firms pay their employees.

So, once again, I would like to thank all of the witnesses for agreeing to appear before our panel today.

Finally, I would like to extend a special welcome to our new chair, Senator Kaufman. For me, having Senator Kaufman join us is especially exciting, since I am no longer the newest member of the Congressional Oversight Panel. And, Senator, I want to assure you that I empathize with what you have been going through during the past few weeks, trying to catch up on all of the fine work that the Panel has completed. However, burdensome as your work has been, I want you to know that you're getting off easier than me, since the first hearing I participated in was the Panel's marathon hearing on AIG which lasted for 6 hours.

The CHAIRMAN. Oh, God.

Dr. TROSKE. I am fairly confident that our hearing today will be much shorter.

The CHAIRMAN. Thank you.

Superintendent Neiman.

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Kenneth Troske

Congressional Oversight Panel Hearing on the TARP and Executive Compensation Restrictions

October 21, 2010

Thank you, Chairman Kaufman.

I would like to start by thanking all of the witnesses for appearing before the panel today. I recognize that all of you are very busy people with a number of other responsibilities, so I appreciate you taking time to travel here and help us with our oversight responsibilities.

As we are all aware, the issue before us today—examining the government's efforts to regulate how firms compensate executives—remains one of the more controversial issues to arise out of the recent financial crisis. Taxpayers remain incensed about the large bonuses received by executives at firms that received enormous government bailouts. Much of the recent discussion of executive compensation has focused on several issues: should executives of bailed out financial firms receive bonuses; do bonuses cause managers to focus on short-term gains as opposed to the long-term growth of a company; and have boards of directors of large financial firms been captured by management so that they simply rubber stamp managerial decisions instead of engaging in the appropriate amount of oversight? While I recognize that there can be instances in which the way firms compensate executives is not always perfectly in line with the interests of shareholders, I believe that the market can and will correct most inefficiencies. However, in my opinion the fact that for the past forty years the Federal Government has made it clear that it would use taxpayer money to insure large financial firms against failure creates a distortion that actually exacerbates the problems mentioned above. This means that if we could simply get rid of the government guarantee that has created "too big to fail firms," then many if not most of these problems would largely disappear. It also means that by focusing on these ancillary problems we fail to fix the true problem that is producing so much anger.

In regards to the specific issue of executive compensation, recent research from the Federal Reserve Bank of Minneapolis shows that, in almost every setting, shareholders of firms will choose to pay workers in an efficient manner. In other words, workers will be paid in a way that maximizes shareholder wealth without imposing costs on the rest of society. The one exception to this rule is when the government provides an implicit or explicit guarantee of the firm's debt and does not charge the firm for this guarantee. In this case shareholders will chose to incentivize workers in ways that encourage them to take an excessive amount of risk. After all, if the risky investment pays off the shareholders reap all the rewards; but if the investment bankrupts the company it is the taxpayers who are left holding the bag.

There are three obvious solutions to the current state of executive compensation: have the government undertake the difficult job of regulating how too big to fail firms pay their workers, end the practice of insuring large firms against failure, or charge firms for the insurance they are being provided. To my way of thinking one of the latter two solutions—ending the government's too big to fail guarantee or charging firms for the insurance—is the preferred solution, because either is the simplest solution and imposes the least cost on taxpayers. I am well aware that others disagree with my assessment.

Regardless of what one thinks is the optimal solution, I think we can all agree that these issues remain important, and I am interested in hearing what the witnesses have to tell us about the challenges involved in having the government regulate how firms pay their employees, what impact various pay plans could have on employee turnover and the ability of firms to hire skilled workers, and what was accomplished through the efforts of the Special Paymaster. So once again I would like to thank all of the witnesses for agreeing to appear before our panel.

Finally I would like to extend a special welcome to our new chair, Senator Ted Kaufman. For me having Senator Kaufman join us is especially exciting since I am no longer the newest member of the Congressional Oversight Panel. Senator, I want to assure you that I empathize with what you have been going through during the past few weeks trying to catch up on all the fine work the panel has completed. However, burdensome as your work has been, I want know that you are getting off easier than me since the first hearing I participated in was the Panel's marathon hearing on AIG which lasted for six hours. I am fairly confident that our hearing today will be much shorter.

STATEMENT OF RICHARD NEIMAN, SUPERINTENDENT OF BANKS, NEW YORK STATE BANKING DEPARTMENT

Mr. NEIMAN. Thank you.

I, also, want to start by welcoming Senator Kaufman. I'm thrilled that you have been able to join us, and I want to congratulate Majority Leader Reid for such an exceptional appointment.

When I first started as a bank regulator, almost 4 years ago in New York, one of the first things that became clear was that the misaligned compensation incentives in the mortgage origination process, particularly of those around mortgage brokers, was harming consumers and poisoning the mortgage market. As my colleagues on the Panel and our witnesses know, too many new homeowners were steered into inappropriate subprime products because of the higher profits those products provided to loan originators. Worse, such misaligned compensation incentives permeated throughout the entire securitization process as the default risk of these products was consistently offloaded onto others.

The entire financial system is rife with potential for similar conflicts between short-term profits and long-term sustainability. I hope to focus, this morning, on the best ways we have, collectively, learned to align risk with compensation so that we do not again need another TARP, or possibly yet another special master position, for Mr. Feinberg. [Laughter.]

The guidance issued by the Federal regulators, in June, takes a principle-based approach to assuring that insured institutions and their holding companies appropriately balance risks and rewards and do not encourage imprudent risk taking.

I hope to draw on Mr. Feinberg's experience with TARP, and the other witnesses' experience, to explore the pros and cons of a rules-based versus principle-based approach to compensation. It seems to me that it is clearly difficult to draw effective rules for all situations before the fact, but, at the same time, the enforcement of principles requires vigilance and discretion.

An additional area worth considering is if compensation and misaligned pay incentives are not just a concern for those generating revenue within institutions. The independence and incentives of those whose job it is to manage risk and assure legal compliance is arguably just as important. The mindset that considers risk managers as merely a cost of doing business is one we can no longer afford.

I am pleased that the Panel is exploring this topic of executive compensation. And I do very much appreciate Mr. Feinberg's attendance with us today, as well as the other experts. Compensation issues are an unfinished business in building a more resilient financial sector, and this is an important hearing for our Panel.

Thank you.

The CHAIRMAN. Thank you.

I'm pleased to welcome our first witness, Kenneth Feinberg, who served as special master for TARP Executive Compensation from June 2009 to December 2010 and who has demonstrated his support for tough assignments and for—as a great public servant. And Ken and I go way back when we both were—he was involved with Senator Kennedy and I was involved with Senator Biden, primarily on the Judiciary Committee. So, I want to thank you for your service and I want to thank you for joining us.

We ask that you keep your oral testimony to 3 minutes so there will be adequate time for questioning, but, as you well know, your written statement will be printed in the official record for the hearing. Please proceed.

SEN. TED KAUFMAN, CHAIRMAN
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK MCWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States

CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Richard Neiman

Congressional Oversight Panel Hearing on the TARP and Executive Compensation Restrictions

October 21, 2010

Good Morning. Thank you to Special Master Feinberg and to our four other knowledgeable witnesses for sharing your depth of experience this morning.

When I first started as a bank regulator in New York almost four years ago, one of the first things that became clear was that misaligned compensation incentives in the mortgage origination process were harming consumers and poisoning the mortgage market. As my Panel colleagues and our witnesses know, too many new homeowners were steered into inappropriate subprime products because of the higher profits those products provided to loan originators. Worse, such misaligned compensation incentives permeated throughout the entire securitization process, as the default risk of these products was consistently offloaded onto others.

The entire financial system is rife with potential for similar conflicts between short-term profits and long-term sustainability. I hope to focus this morning on the best ways we have collectively learned to align risk with compensation so that we do not again need another TARP.

The guidance issued by the federal bank regulators takes a principles-based approach to assuring that institutions appropriately balance risks and rewards and do not encourage imprudent risk-taking. I hope to draw on the witnesses' expertise to explore the pros and cons of a rules-based vs. principles-based approach to compensation. It seems to me that it is clearly difficult to draw effective rules for all situations before the fact, but at the same time the enforcement of principles requires vigilance and discretion.

An additional area worth considering is if compensation and pay incentives are not just a concern for those generating revenue within institutions. The incentives of those whose job it is to manage risk and assure legal compliance is arguably as important. The mindset that considers risk managers as merely a cost of doing business is one we can no longer afford.

I am pleased that the Panel is exploring the topic of executive compensation today. Compensation issues are an unfinished business in building a more resilient financial sector.

STATEMENT OF KENNETH R. FEINBERG, SPECIAL MASTER FOR TARP EXECUTIVE COMPENSATION, JUNE 2009 THROUGH SEPTEMBER 2010

Mr. FEINBERG. Thank you. It is an honor to be here, Mr. Chairman. It's been about 30 years since we first met, and it's great to be back here again, with you on that side and I'm the witness this time.

I want to emphasize I'm the "former" special master. The acting special master, Patricia Geoghegan, is right here, along with deputy special master Kirk Slawson. He is still on the front lines doing this. I also note the presence of Professor Murphy, who was of great assistance to us as a consultant during our work.

I just want to emphasize a couple of points. This whole issue of causation was sort of preempted by Congress, when it came to my role. Congress delegated, to the Secretary of the Treasury, who delegated to me, the legal responsibility for linking executive compensation to regulation. Professor Murphy and others can talk about whether it's a good idea for government to get involved in this.

I've emphasized, repeatedly, that my role was very limited to just seven top recipients. That's all the statute conveyed to me. Even as to those seven, my role in actually regulating pay was limited to the top 25 officials, as a mandatory matter. I had other voluntary discretionary regulatory authority, limited somewhat by the statute and by the regulations. So, in effect, to some extent—to some extent—my role is a sideshow, as the New York Times pointed out, because if you really want to get answers to questions of causation, linkage, executive pay, what is appropriate regulation, look to the Federal Reserve, the SEC, the FDIC, the G20, the new Dodd-Frank legislation that's now the law of the land. My role was rather limited.

Now, within that context, we did find some prescriptions that we invoked and implemented tying pay to performance. Very limited guaranteed compensation. Cash. Very limited guaranteed cash compensation. Tie the rest of an executive's compensation to stock in the company for which she or he works. Do not allow that stock to be easily transferred too early. Compel the executive to keep that compensation in the form of equity. Nontransferable, except over a period as long as 4 years, a third after 2 years, a third transferable after 3, a third transferable after 4.

The law required the statute immediate vesting of that compensation, but we decided, in a move that I think was important, that the long-term compensation of any individual top official in these seven companies should be deferred, as much as possible, so that the long-term success or failure of that company will be tied to the long-term compensation of the executive. I think it's sort of elementary. I'm not sure everybody agrees with me on this, but this is what we concluded.

We wanted to try and minimize risk. We wanted to maximize taxpayer return. We wanted to make sure that there was an appropriate allocation between cash and equity. We wanted compensation tied to performance. We wanted to look to the compensation of these seven companies and see how competitive our pay packages would be, relative to other companies that are in the marketplace that we had no authority to regulate. And, finally, we wanted to make sure that, as I say, the top officials were paid based on what they contributed to the overall performance of the company and its shareholders.

Finally——

The CHAIRMAN. Can you wrap up?

Mr. FEINBERG [continuing]. Finally, two quick points. We heard, over and over again, that if we didn't provide competitive pay packages, those top officials would leave and go elsewhere. And we were told by these companies, they would go elsewhere, they might even go to China. Everybody was going to go to China to work if these companies lost these officials. They're still there. Eighty-five percent of the specific individuals whose pay, by statute, we regulated are still there.

The second final point is in response to panelist Silvers. Why did the special master conclude, at the end of his tenure, that—as to officials at 17 top recipients—not just the 7, but as to 17 top recipients—why did I conclude, at the end of my tenure, that, although certain compensation practices led to compensation that was inappropriate and not justified—why didn't I demand—even though I had no enforcement authority—why didn't I demand that that money be returned to the taxpayer?

Answer?

The CHAIRMAN. No, let's hold the answer, when Mr. Silvers asks the question, because you're——

Mr. FEINBERG. I'm done.

The CHAIRMAN [continuing]. Out of time.

Mr. FEINBERG. Thank you, Mr. Chairman. You wield a tough gavel.

The CHAIRMAN. Oh, yeah, right. [Laughter.]

[The prepared statement of Mr. Feinberg follows:]

TESTIMONY OF
KENNETH R. FEINBERG
Former Special Master for TARP Executive Compensation

CONGRESSIONAL OVERSIGHT PANEL
OCTOBER 21, 2010

Mr. Chairman and Members of the Panel:

I thank you for the opportunity to testify today and share with you my experiences as the Special Master for TARP Executive Compensation. In June of 2009, I was asked to serve in that position by Secretary Geithner, and I continued to do so until September of this year. Patricia Geoghegan, a Treasury attorney with whom I worked closely during my tenure as Special Master, currently serves as Acting Special Master.

The Panel has asked me to provide an overview of my statutory and regulatory authority as Special Master and the actions I performed pursuant to those authorities. On September 10, 2010, I submitted a final report detailing those authorities and the actions taken by the Office of the Special Master during my tenure.[1] I have included a copy of the final report with my prepared testimony.

Under the relevant statutory[2] and regulatory[3] authority, I had a number of responsibilities as Special Master related to the oversight and review of executive compensation. My primary responsibilities included making determinations regarding the compensation of certain employees of TARP recipients that received exceptional financial assistance. There were originally seven recipients of exceptional financial assistance: AIG, Ally Financial (formerly known as GMAC), Bank of America, Chrysler, Chrysler Financial, Citigroup and GM. Three of those institutions—Bank of America, Citigroup, and Chrysler Financial—are no longer subject to the jurisdiction of the Special Master, although Citigroup will continue to be subject to the rules applicable to all TARP recipients until it completes its repayment of all TARP obligations.

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[1] This final report is available to the public on the Office of Financial Stability's website at http://www.financialstability.gov/docs/Final%20Report%20of%20Kenneth%20Feinberg%20-%20FINAL.PDF.

[2] See Section 111 of the Emergency Economic Stabilization Act of 2008, as amended by the American Recovery and Reinvestment Act of 2009 (EESA).

[3] See TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30.1 et seq.

Under pertinent Treasury regulations, I was required to determine individual compensation for the "top 25" executives at these companies, and to make determinations on compensation structures—but not individual payments—for executive officers and 75 additional employees who are not in the "top 25" group.[4] This mandatory jurisdiction applied only to the "exceptional assistance" recipients and did not extend to employees of any other financial institutions or corporations. Although I had discretion to make recommendations and render nonbinding determinations concerning other TARP recipients, this jurisdiction was purely advisory and not mandatory, and I had no legal authority to make binding determinations pertaining to executive compensation for any companies other than the exceptional assistance recipients.

The Panel has asked me to describe the process and criteria that I employed to make compensation determinations. Under Treasury regulations, my primary directive in overseeing compensation structures and payments within my jurisdiction was to determine whether the structures or payments in question were, are, or may be "inconsistent with the purposes of section 111 of EESA or TARP, or ... otherwise contrary to the public interest." In my determinations, I referred to this directive as the Public Interest Standard.

The Treasury regulations require that the Special Master consider the following six principles when determining whether a payment or compensation structure meets the Public Interest Standard:[5]

(1) *Risk.* The compensation structure should avoid incentives that encourage employees to take unnecessary or excessive risks that could threaten the value of the company.

(2) *Taxpayer return.* The compensation structure and amount payable should reflect the need for the company to remain a competitive enterprise, to retain and recruit talented employees who will contribute to the recipient's future success, so that the company will ultimately be able to repay its TARP obligations.

(3) *Appropriate allocation.* The compensation structure should appropriately allocate the components of compensation such as salary and short-term and long-term performance incentives, as well as the extent to which compensation is provided in cash, equity, or other types of compensation.

[4] Because Bank of America repaid its TARP obligations in early December 2009, the compensation structures for the company's "next 75" employees were not subject to my review.

[5] *See* 31 C.F.R. § 30.16(b)(i-vi).

(4) *Performance-based compensation.* An appropriate portion of the compensation should be performance-based over a relevant performance period. Performance-based compensation should be determined through tailored metrics that encompass individual performance and/or the performance of the company or a relevant business unit taking into consideration specific business objectives.

(5) *Comparable structures and payments.* The compensation structure, and amounts payable where applicable, should be consistent with, and not excessive taking into account, compensation structures and amounts for persons in similar positions or roles at similar entities that are similarly situated.

(6) *Employee contribution to TARP recipient value.* The compensation structure and amount payable should reflect the current or prospective contributions of an employee to the value of the company.

Under the regulations, I had discretion to determine the appropriate weight or relevance of a particular principle depending on the facts and circumstances surrounding the compensation structure or payment for a particular executive, which I often exercised when two or more principles were in conflict in a particular situation.

When making compensation determinations, these principles demanded that I strike a balance between prohibiting excessive compensation and permitting the appropriate competitive compensation to attract talented executives capable of maximizing shareholder value. Only time will tell if I was successful in achieving the right balance, but the initial indications are positive. A large marjority—84%—of "top 25" executives covered by my 2009 determinations remained with the companies through the 2010 determinations. Also, two of the original seven exceptional assistance recipients under my jurisdiction have completed repayment to the taxpayers and three more have begun to do so—in the case of Citigroup fully returning the "exceptional" assistance that invoked my purview.

Finally, the Panel asked me to highlight the aspects of the approach I took in evaluating compensation structures that I believe would serve as useful models for the future. By application of the principles described above to the facts and circumstances underlying my determinations, I developed the following key standards that are outlined in my final report of September 10, 2010: limit guaranteed cash; demand a performance component for most compensation; focus on long-term value creation; and stop excessive perquisites and other giveaways. I believe that these standards could help lay the groundwork for appropriate compensation structures at all financial institutions, regardless of whether those institutions are receiving financial assistance from the government.

Aside from the standards I developed while serving as the Special Master, the Federal Reserve and other federal banking regulators have issued guiding principles on how incentive compensation at banks should be designed to protect safety and soundness. In addition, the recently-enacted Dodd-Frank Wall Street Reform law includes several new restrictions on executive compensation that generally apply to all public companies, including increased independence for compensation committees and a requirement for public companies to give shareholders a "say on pay." These new requirements necessarily will guide the development of executive compensation structures in the future.

Mr. Chairman, I thank you and the other members of the Panel. This statement constitutes my formal testimony.

The CHAIRMAN. How did you—overall, how did you evaluate your success? I know it was kind of inside, and it was internal, but how did you judge your success as special master?

Mr. FEINBERG. I think, I would view, if I must say so—Ms. Geoghegan might have a different view, but I don't think so—I think we did exactly what the statute, Congress, and the Treasury regulations asked us to do. We were confined by those legal regulations in the statute. And I think, overall, in a very limited way—seven companies we did exactly what we were trying to do. And frankly, Mr. Chairman, we now see other Federal agencies adopting many of the prescriptions I've mentioned in their own effort to rein in executive pay.

The CHAIRMAN. Well, you stated that 85 percent of the people are still there. Are there other numbers you use? In other words, at the end of the thing, you looked at it, and you said, "There are some numbers here, some metrics that I feel good about or I feel bad about"?

Mr. FEINBERG. Well, that's the most important. I also look at the metrics that demonstrate that we did—if you look at the statistics, we substantially reduced what we thought was inappropriate largesse on the part of these top 25 officials. I think the executive pay that we set, mostly consensual with the companies, demonstrates a drop in that overall executive pay, something that I think was important to do.

The CHAIRMAN. Well, how much of it, do you think, though, people stay because they thought, when you were gone, it was going to go back to what it was before?

Mr. FEINBERG. Oh, I think there's something to that. Now, whether or not that will happen, I don't know.

The CHAIRMAN. Oh.

Mr. FEINBERG. I draw two conclusions from that question. One, it's a bit premature to say whether companies will go back to business as usual. I've only left a couple of months ago. The 2010 prescriptions and pay prescriptions, we'll watch, I think, and this panel and the Congress will watch and see. Second thing I would say is, don't paint with too broad a brush. I think what I've learned is, you've got to look at each individual company and see how that company reacts to criticism, when it comes to pay. I don't think you can just assume all companies adopt these prescriptions, all companies don't adopt these prescriptions. You got to go case by case by case.

The CHAIRMAN. But you do have some views about whether, in fact, that worked. You do have views about specifically what happened, and—in terms of the metrics, in terms of the math—of what happened, case by case. And the other thing that you were looking for, you were looking for long-term effect.

Mr. FEINBERG. That's right.

The CHAIRMAN. So, it isn't just—looking at the seven companies really will not tell us what happened with that, right?

Mr. FEINBERG. That's right.

The CHAIRMAN. We're looking for something broader than that, right?

Mr. FEINBERG. That's right. And the two ways you'll find out about a broader impact is, one, what the agencies are doing with a much broader cohort of companies than what I would—dealt with; and, secondly, it'll be interesting, in the next few years, to see whether companies that weren't under my jurisdiction voluntarily, on their own, adopted the prescriptions. Many did, right now. We'll see, over the next few years, whether they adhere to those prescriptions.

The CHAIRMAN. Right. And you used—you kept track of what the pay was before you got involved, and when you got involved. Do you have that? Can we have a chance to view——

Mr. FEINBERG. Final report.

The CHAIRMAN. Final report.

Mr. FEINBERG. If you look at our final report and the accompanying materials that are submitted that are part of the public record, you will see: what the companies submitted; how we responded; how we engaged that data and companies, anecdotally and empirically; and how we disagreed with those companies.

The CHAIRMAN. Okay.

Mr. McWatters.

Mr. MCWATTERS. Thank you.

Mr. Feinberg, you were charged with the interpretation and implementation of certain statutory and regulatory provisions regarding executive compensation. What's your assessment of those statutory and regulatory provisions?

Mr. FEINBERG. I think that it—they worked. It was a very limited role. I doubt that Congress or the Treasury want any expansion of that role. I think, in the limited area that I was asked to regulate, we did it, we did it pursuant to law, we did it effectively. I do not hear, anywhere, in Congress or in this administration, suggesting that the degree of micro management that I was obligated to be engaged in should be replicated or expanded.

Mr. MCWATTERS. Okay. If you were presented with the opportunity—asked to draw these provisions again, de novo, how would they differ?

Mr. FEINBERG. Well, clearly we would want to change some of the language of the statute that prevented—that required that compensation, in an annual year, vest immediately—the so-called Dodd Amendment. I think that the problem we ran into is that, for the top 25 officials, vesting was required immediately, cash bonuses were severely curtailed—cash compensation was severely curtailed. I think that we would want to tinker with the—some of those incentives—or, some of those requirements. But, I think, overall, those were the major areas of tinkering.

Mr. MCWATTERS. Okay. I'll ask the same question I asked in my opening statement. And, again, in answering the question, don't be constrained by the current rules, okay? This is just, again, de novo question. And that is: How does an employer structure a compensation program so as to identify risk, but also minimize any unnecessary and excessive risk, but still permitting the executive to take sufficient risk so the company prospers? How do you balance that?

Mr. FEINBERG. Very, very difficult. My first answer is a hedge by saying: every company has a culture and a environment that is different. I'm not sure you can answer that very legitimate question by saying that GM and automobile companies should invoke the same prescriptions as AIG or Bank of America. I think they're very different.

But, I would say that the fundamental conclusion we drew is that you want to set up a compensation package that provides competitive cash to that employee, but in a limited amount—a competitive amount—we said, under $500,000 annually—and that the appropriate balance should be struck by giving the remaining compensation in a given year in stock in that company, but over a relatively lengthy period of time so that you are undercutting any incentive for quick turnaround, quick flip, making the stock, in effect, cash. And, instead, you've got to hold a—as nontransferable, a good share of that stock, over as long as 4 years.

Mr. MCWATTERS. Okay, thank you. My time's up.

The CHAIRMAN. Mr. Silvers.

Mr. SILVERS. Mr. Feinberg, before I let you continue in what you were about to say before, let me express my view that I think that your work has undoubtedly significantly improved compensation practices in the financial sector and in the specific companies that you were—that you had authority over.

Mr. FEINBERG. You're setting me up, Mr. Silvers. [Laughter.]

Mr. SILVERS. I am, indeed, but I'm trying to be nice first. And I want to express the absolute sincerity of my—of what I've just said, before I get to the tougher part of it.

Now, I'd like you to tell me why you found, in your final report, that a significant amount of the compensation paid to the 17 firms you referred to who were TARP recipients that were paying, I believe, over half a million dollars to their executives—why you found a significant amount of that compensation during the period after the enactment of TARP, during a 4-month period after the enactment of TARP, to be inappropriate. Why was that?

Mr. FEINBERG. It was inappropriate because they were taking taxpayer money and feathering their own nest.

Mr. SILVERS. Well, that's an extraordinarily helpful lead-in to where you left off, because what I want to know is, not the question of how much or should you have clawed it back—all right?—but, How do you reconcile that finding with your statutory obligation around the notion of the public interest?

Mr. FEINBERG. Well, it's a very close question, I admit. I debated this for many, many weeks. And I concluded, for the following couple of reasons, that it would be inappropriate to claw back the—or seek to claw back the money.

First, 90 percent of that money that was inappropriately paid to those executives on those 17–90 percent of it was paid to companies, like Citigroup, that had already repaid the taxpayer every dime of TARP. We——

Mr. SILVERS. Now——

Mr. FEINBERG. We found——

Mr. SILVERS. Mr. Feinberg, Citigroup has not repaid every dime of TARP——

Mr. FEINBERG. Under my jurisdiction—they were out from under my jurisdiction—they had repaid——

Mr. SILVERS. But, they have not repaid every dime of TARP, as we sit here today.

Mr. FEINBERG. That is correct. But, under my statutory——

Mr. SILVERS. I——

Mr. FEINBERG [continuing]. Jurisdiction over Citigroup——

Mr. SILVERS. I—yes. No, I understand that. But, the public-interest mandate was not confined to special aid.

Mr. FEINBERG. I understand. I——

Mr. SILVERS. It seems—Mr. Feinberg, it seems to me that what you were really—what you really did—and I would like you to deny—if it's not true, if I have—misunderstand what you were doing, then tell me—but, what you really did was, you concluded that—I—it can't be true that feathering your own nest, when you're a—when you're holding the public's money, is in the public's interest. That can't be true. It seems to me, what you just said is the key thing, that you felt that it was not in the public's interest to have an accurate finding here, because it would trigger a process of recapture that you felt was not in the public interest to trigger.

Mr. FEINBERG. You——

Mr. SILVERS. Is that——

Mr. FEINBERG. You say it well. You say it well. But, let me go on and remind me you, as you well know, better than anybody, I also recognized I had no authority to force that money back. All I could do under the statute was seek, beseech, request, urge. I couldn't guarantee that that money would be repaid, in any event.

Mr. SILVERS. Right.

Mr. FEINBERG. And, my final point, at the time that that money was inappropriately paid to those executives, as you well know, they violated no law at the time, they hadn't violated any regulation at the time. I thought it was overkill.

Mr. SILVERS. But, that wasn't your standard. Your standard was not, "Did they break the law?" Your standard was "the public interest." And I understand that you made a judgment about what was in the public interest, in terms of the consequences; but, that was also not your mandate. Your mandate was—and I think you've determined it—I think the irony here is that, in your own way, you have determined that that compensation violated the public interest. And, it was Congress's determination that, if it did, it should be—every effort should be made, within the fact that you didn't have the power, to claw it back.

Mr. FEINBERG. Don't——

Mr. SILVERS. My time is expired.

Mr. FEINBERG. Don't pooh-pooh that fact, that I didn't have the power to claw it back.

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you.

Mr. Feinberg, I thought you made a very good point about the limited role that you had—Congress—and it's something that we should all keep in mind. Having said that, you've got a lot—gained a lot of experience in this issue, so, you know, we would like to draw on some of your broader experience.

One question I have is, in some such—you—as you correctly said, you're supposed to look at what would be competitive and, you know, what are comparable firms and what you'd expect these executives to get paid. Of course, many of these executives that you were dealing with were executives that—at firms that, in the absence of a government bailout, would have been bankrupt. And I don't think CEOs of bankrupt firms get paid a lot. So, I mean, did you take that into account? Is that something that you considered when—you thought, What would these people have been paid, had they been out looking for a job, having been just the CEO of a firm that they drove into bankruptcy?

Mr. FEINBERG. Yes, we looked at any and all of these variables to try and come up with a pay package that we thought was appropriate, in light of competitive pressures.

Dr. TROSKE: Okay. You mentioned that 85 percent of executives were still there. What would we have expected? I mean, what was the—I guess, in some sense, I'm trying to get a sense of what a competitive pay package would have been. And you would expect a normal amount of turnover at these firms. Did you investigate what turnover was like before they implemented TARP and sort of—in some sense, maybe you paid them too much; maybe the turnover—you know, saying that 85 percent of them are still there, I—that seems like a high number to me. So, can you—do you have a sense of what that is? Did you do any looking at that?

Mr. FEINBERG. Yes, we looked at that. I must say, I always viewed this whole issue of pay as only one variable as to why people stay where they are. This argument that was presented to us, that pay, and pay alone, is "the" variable that will determine whether we're competitive or not, I found it dubious at the time, and I still find it dubious, and I think that the statistics bear me out on this. People stay at jobs for a lot of reasons, only one of which—important, but one of many reasons—is their pay.

Dr. TROSKE. As a college professor who probably—you get paid more, as a consultant—I'm certainly going to agree with you, because I—and you're right that that is a common finding, is that pay is not the sole determinant of whether people are happy and stay at their job.

Talk a little bit about AIG. I guess it's—it was reported, or at least I've read reports in the New York Times, that AIG received some sort of special consideration, in terms of the value, you know, that they were not—their compensation—the executives—they were not based on the value of their—the stock—AIG stock—but of some derivative of that stock. Is that the case? And, if so, why?

Mr. FEINBERG. I don't believe that is the case. That was the case—that was proposed.

Dr. TROSKE. Okay.

Mr. FEINBERG. And we tried to work something out, in conjunction with AIG's suggestion that the stock—the common stock wasn't worth enough to appropriately compensate top officials. But, we worked out a compromise with the Federal Reserve, with AIG, with the Office of Financial Stability. It turned out, at the end of the day—I believe—that, at the end of the day, AIG did agree that its common stock, under our formula, would be appropriately used as a compensation device.

Dr. TROSKE. Your 500—again, your $500,000, you know, seemingly, line in the sand of—that's what they should get as cash—I—you said that you tried to come up with a competitive amount. How did you come up—where did the $500,000 come from?

Mr. FEINBERG. First, it wasn't a line in the sand. We allowed variations from the 500,000. And, in some cases, there were quite a few variations from the 500,000. We concluded, based on the packages that were submitted to us, based on evidence that we took on our own, anecdotally—empirical evidence that we got on our own—and also based on our sense of what Congress and Treasury intended in their statute and regulations—at the end of the day, we exercised our discretion and came up with that number, based on these variables.

Dr. TROSKE. Thank you.

The CHAIRMAN. Superintendent Neiman.

Mr. NEIMAN. Yes, thank you.

Just, really, following up on that, because, you know, it's clear there's—a fundamental question and debate on executive comp is: What is the proper role of government insuring that incentive comp arrangements don't encourage excessive risktaking? And, as I mentioned in my opening statement and you referenced in yours, there's a lot of work already being done by Federal bank regulators. The guidance put out by the bank regulators, as you know, in June, took a principle-based approach. I'd be interested in your experience. And, you certainly set out, in your opening, that—the six principles that guided you. Do you see the proper role for government in a principle-based or in a rule-setting framework, or a combination of the two?

Mr. FEINBERG. Combination of the two. The one thing I had to do, that nobody else had to do, of course, was actually put pencil to paper and come up with the dollars. And coming up with the dollars, I would have thought, at the outset of this assignment, it wouldn't have been—there wouldn't have been much interest. Only 175 people I'm dealing with, here. Turns out that principles plus rulemaking—that's fine; but asking government to then translate that into, "You will make 1 million or 800,000 or 5 million," that is government intervention, which I think should be very, very limited and should not be expanded upon.

Mr. NEIMAN. So, what are the specific pay issues that are more susceptible to principle-based versus rules? I mean, you said one clear rule, with respect to the 500,000, and now we're hearing it's—it clearly wasn't a line in the sand. Are there other specific pay issues that you think a rule-based is appropriate?

Mr. FEINBERG. Very important that compensation be spread and not be guaranteed and be tied to the overall performance of the company where the official works. We made sure—I think perhaps our most important prescription—and Professor Murphy and others can comment on this—is, we concluded that compensation should be in the form of stock, but stock which cannot be transferred. It may vest, by law, but it should not be transferable, except over a lengthy period of time, so that long-term performance of the company will determine the total pay package of the corporate official.

Mr. NEIMAN. So, that, let me understand, is a principle as opposed to——

Mr. FEINBERG. A rule.

Mr. NEIMAN [continuing]. A rule of mandating a——

Mr. FEINBERG. Right.

Mr. NEIMAN [continuing]. Specific vesting period.

Mr. FEINBERG. A rule might be: you should transfer, over a lengthy period of time. The principle is: a third, a third, a third—2 years, 3 years, 4 years.

Mr. NEIMAN. So, now, what—we hear one of the—some—many of the commentators to the Fed's guidance said, principle-based are—give rise to vagueness, ambiguity with respect to compliance. And I think it's also clearly tied to enforcement. What is the enforcement regime on a principle-based?

Mr. FEINBERG. I'm—I'd want to debate the Federal Reserve more on that. It seems to me that what we found is that the rule delegated to the special master the ability to provide more detailed principles that would be used to effectuate the rule. The danger, I think, with pay is that you'll come up with vanilla rules: Pay should be performance-based. Well, I mean, who will disagree with that? But, what's the underlying detail behind that rule that is a principle that will be adopted? And I think—I'd debate—maybe it's semantic, but I think it's an important difference.

Mr. NEIMAN. Before my time runs out, I would like your view on the guidance put out by the Federal bank regulators as getting at the issue of misaligned incentives.

Mr. FEINBERG. Again, it remains to be seen. I want to—to me, the only test here, with these rules put out by the agencies, What impact do they have in practice? And I think it's too early to comment, other than to say that vigorous enforcement—your point, Mr. Neiman—vigorous enforcement, I think, will determine the effectiveness of these rules or principles.

Mr. NEIMAN. Thank you.

The CHAIRMAN. Useful—when you talk about a "useful model" and "for reasonable pay," do you think your work has led to more—an idea of what "reasonable pay" is?

Mr. FEINBERG. Yes, I do.

The CHAIRMAN. And what were the main elements of it?

Mr. FEINBERG. The main elements, as I said—and I think the agencies are adopting some of what we prescribed the main elements of pay should be, without mentioning numbers: Low guaranteed base-cash salary; the remaining compensation in X stock, in that company, which cannot be transferred, except over a lengthy period of time; and, I should point out, more effective corporate—corporate regulation of golden parachutes, perks, end-of-career severance payments and pension plans. I think our final report pretty much lays out the blueprint that we think is a pretty good model.

The CHAIRMAN. Can you comment on—and this goes beyond your—you know, specifically this thing, but I think it has real impact, especially when you're talking about a reasonable model. My experience has been, over the years, that using stock as an incentive—and the price of stock has—you know, sometimes it works, sometimes it doesn't. I mean, you're executive, you got a good market going, Dow Jones goes up 3,000 points, you're king, and you're making a fortune, and you had nothing at all to do with that; you just happened to be there when the wind was blowing. And then, conversely, what we see, time and time again, when the market turns down, the compensation committees say, "Well, wait a minute, we didn't cause the downturn. We shouldn't be taking the hit on that. Our company's doing just what it was doing the last 3 years."

And therefore, they don't get the reduction in compensation. Can you comment on that?

Mr. FEINBERG. Well, that's the argument. My response will be a couple of things. Two points.

One, there's got to be some diversity in compensation. I agree with that.

The CHAIRMAN. Right.

Mr. FEINBERG. It can't be all stock. It can't be all cash. We went back and forth on this discussion. Frankly, we concluded that if the market improves and corporate officials get a windfall because the stock soared: win-win. I mean, if the corporate—if the corporation benefits to that extent, so its shareholders benefit, hopefully the country benefits, that's the free market. That's all right.

The CHAIRMAN. Except that, in order to do that, then when it goes down, they should take the hit for that.

Mr. FEINBERG. They should take the hit.

The CHAIRMAN. And you do agree that, in most cases, they don't. And then, for this—in many, many cases——

Mr. FEINBERG. I——

The CHAIRMAN [continuing]. The compensation committee meets, and they say, "Well, you know, it wasn't our fault, let's—we're not going to reduce that. We'll give more stock or we'll change the stock options, or whatever."

Mr. FEINBERG. That's right. Now, that's a corporate governance issue, too.

The CHAIRMAN. No, no, I got it. I understand it. But, I'm saying—but, I'm just to get—again, I understand it's a corporate governance issue, but when you're dealing with the issue of, you know, what is reasonable pay, then that's clear—you know, a clear concern.

Mr. FEINBERG. Mr. Chairman, I agree completely that, in a vacuum, what I'm suggesting as principles might work just fine. But, if you're not going to have enforcement, and you're not going to have the type of corporate—internal corporate regulation to make the principles meaningful——

The CHAIRMAN. Right.

Mr. FEINBERG [continuing]. It's all about enforcement in the corporate culture.

The CHAIRMAN. But, it would be fair to say that, in a reasonable model—a reasonable pay model, it would be incentives—stock can be one of those incentives, but it should be taken into account that stock is not the only determinant of whether an executive does a good job.

Mr. FEINBERG. Absolutely.

The CHAIRMAN. Good. And I know you said that the school's not out yet on how Wall Street's going to pay, but I think—again, it's always risky to refer to newspapers, but the Wall Street Journal says, "Wall Street pay is on a pace to reach a record high in 2010." William Cohan, writing in the New York Times, October 7, 2010, said, "The incentives on Wall Street have not been changed one iota." Now, if that, in fact, is the case, how do you feel about your tenure and the ability to actually change cultures?

Mr. FEINBERG. Hey, if that's the fact, and it's broad brush across Wall Street and includes not only Bank of America and Citigroup, companies that were under my jurisdiction, but also includes Goldman, who professed to follow the prescriptions last year that we had imposed, voluntarily, then I think that our work has not been successful and it's not being followed and it is a problem.

The CHAIRMAN. Thank you.

Mr. FEINBERG. But, I think that, if that's the case, there are other agencies that profess to rein in executive pay, like the SEC and the Federal Reserve—I think that the mandate falls to them to pick up the slack.

The CHAIRMAN. Although, I really do think everyone agrees that it would be better if we didn't turn to that. It would be better if we could come up a reasonable pay package, if we did have incentives, if we did have a model, if people did go ahead and control it. And it's very disturbing, if, in fact, given the opportunity to do this, that—an opportunity that, as bad as this financial crisis is, people don't take advantage of it, you've got to wonder about where the answer is.

Mr. FEINBERG. Right. I think that's right.

The CHAIRMAN. Mr. McWatters.

Mr. MCWATTERS. Thank you, Senator.

Mr. Feinberg, if a company pays a portion of the compensation in the form of stock—okay?—at a point when the stock prices are at historic lows, will executives have an incentive to engage in risky behavior, due to the potential for large upside gains and the limited downside loss?

Mr. FEINBERG. Well, that—we had to debate that. That's the argument. Now, we concluded that the way to minimize that likelihood—two ways: One, diverse pay packages that include cash, to a certain extent. And, secondly, have that stock transferable only over a relatively lengthy period, so that whatever short-term gain that corporate official might try and be incentivized to do—over the long-term life of that company, we thought it less likely that that type of risky behavior would be maximized, because over the long-term, especially with corporate governance in place, we thought that that would make it more likely that the long-term interest of the company would be aligned with the corporate official.

Mr. MCWATTERS. Sure. I mean, if you talk to employees of Merrill, Lehman, Bear—Citi, I think, is trading around $4 a share—B of A, and a number of others, who had incentive stock—a lot of incentive stock, coming into the fall of 2008, and—I can't say they were all wiped out, but they lost a lot. But, nonetheless, they created this mess with those compensation programs in place. So, if we now have these new and improved compensation programs that are dependent upon long-term incentive comp, aren't we, in effect, copying what was in existence in '05, with the exception, perhaps, of a meaningful clawback?

Mr. FEINBERG. I'm not sure about that. I tend not to agree with that. I tend to look at Lehman and the debacle of the last few years—and I'm not an expert on this, I have a statute to enforce—but, to what extent would those executive pay packages, the cause of that debacle, as opposed to capitalization requirements and other institutional flaws in these companies—I think that, by requiring that compensation in the form of stock be transferable only over a number of years, you minimize, somewhat, the likelihood of that type of risktaking. May be wrong about that, but that's the conclusion we reached.

Mr. MCWATTERS. No, I understand. As I said in my opening statements, I'm not necessarily wedded to the idea of compensation packages causing the problem. In other words, the "show me the money" theory, as I called it, I'm not confident that works. But, a lot of people are. And so, they're proposing deferred comp, incentive comp as a way to solve the problem. But, my fear is—I mean, we may be solving the wrong problem, or at least not solving the correct problem.

Mr. FEINBERG. Yeah. What is the alternative? We concluded that, if you really want to promote risky behavior, tell a corporate official that he or she is guaranteed 5 million in cash—win, lose, or draw, in terms of the future performance of the company. And we concluded that that, as a relative matter, would be more risky, in terms of the company's long-term growth and success, than the method that we adopted.

Mr. MCWATTERS. See, I would think to the contrary. I would think, "If someone's going to pay me $5 million cash a year, I want to keep this gig going." That's a good one. It's hard to come by, unless you can play first base for the Yankees or something like that, which I can't. So, I'm just not sure.

Okay, my time's up.

The CHAIRMAN. Mr. Silvers.

Mr. SILVERS. Yeah.

Mr. Feinberg, I'm—in a way, I want to continue Mr. McWatters's line of questioning, but in a somewhat—maybe from a somewhat—a little different angle. Although, let me just take one case study, in what Mr. McWatters is talking about, that haunts me, which is: Angelo Mozilo. All right? $400 million-plus in comp taken out of Countrywide during, essentially, one leg of the business cycle. The up leg. All right? Securities fraud settlement, giant headlines. So, he paid—he had to pay back, I think, 67 million of the 400. What's the externalities of that little adventure? Seven million foreclosed families, a destroyed—apparently, a deeply damaged property-loss system that's been a foundation of our economy for 300 years. The—all of them—all of the work of this panel and the TARP and all that sort of thing—seems to have been substantially—Countrywide seems to have been a substantial contributor to it. And the net of that circumstance is—well, let's say he had to pay his lawyers $30 million. The net of that circumstance is a pretax income of $300 million to Mr. Mozilo. That would appear to speak very strongly to executive pay as a contributing factor, would it not?

Mr. FEINBERG. Oh, I think so. I mean, it gets to the point—you're using a summa cum laude example. Don't forget that, as to the 175 officials that we dealt with——

Mr. SILVERS. Right.

Mr. FEINBERG [continuing]. We did—by statute, legally obligated—we did cap everybody's packages. All of the compensation. I don't think that we approved—I could be wrong; Patricia would know—but, I don't think we approved anybody's pay package—maybe one or two people—that were $10 million.

Mr. SILVERS. The Mozilo example, though, goes to the time horizons issue. Right? If you—you've got pay set up so you can take out $400 million—right?—in one leg of the business cycle. The incentives are obvious.

I want to come, then, to the—to, sort of, the big question here. We, as a—we—this panel has found, repeatedly, that TARP functions as an implicit guarantee of the major financial institutions. And it's my opinion that there's kind of a linger—it's kind of always been an implicit guarantee of the very largest financial institutions. And the certainty of that guarantee has grown with the—with their size. Why does it make sense, if the—if that's the truth of the matter, to have incentive pay be equity-based, for those institutions?

Mr. FEINBERG. What's the alternative?

Mr. SILVERS. I mean——

Mr. FEINBERG. I mean, in—you talk about what's implicit. What is the alternative? I mean, I guess one alternative is: don't bail out these companies. If—let the free market really control——

Mr. SILVERS. Well, I mean, I know that my fellow panelist, Professor Troske, would like to have that happen. I think history suggests that, with these very large financial institutions, despite all of our desires, it doesn't, that there is an implicit guarantee operating, and as long as we have institutions of that size, it will operate. And so, the question is—I mean, this is not a—I'm not being critical of your work in—in a respect, because you applied, I think, very—you know, in a very thoughtful way, the prevalent thinking around long-term equity-based compensation. But, if these institutions have a government guarantee behind them, doesn't that suggest that we ought to be looking at measures of performance that are: (a) more risk-based; and (b) maybe tied more to debtholders, as I think we're going to hear from witnesses, following you.

Mr. FEINBERG. You may be right. I think, really, your question is better directed to the Chairman and the Congress, in terms of an overview as to what the appropriate role of government is. Congress had already spoken and delegated to me, through the Treasury, certain limited function and——

Mr. SILVERS. But, Mr. Feinberg, they didn't delegate to you, specifically, equity-based pay.

Mr. FEINBERG. I understand that. But, I don't really think—when you talk about the type of meltdown you're discussing, Mr. Silvers, I'm not sure what the pay package would be that would minimize the likelihood of that type of meltdown. You're talking about a meltdown that maybe should have resulted in these seven companies not being protected by the government.

Mr. SILVERS. Well, a larger question. My time's expired.

The CHAIRMAN. Since I've been asked, I have spoken: I think "too-big-to-fail" should not be too big to fail. And I've worked mightily to do it. I didn't succeed in all the things I wanted to, but I'm very interested to hear Dr. Troske's questions.

Dr. TROSKE. Thank you. And I do—you know, as Mr. Silvers has indicated, I do have somewhat of a preference for that, but I do recognize the problems of allowing large financial firms to fail in the midst of a financial crisis. But—and it does bring up the issue, I think—and maybe you can talk a little bit about that—is—I mean, is—when you have these guarantees, you really don't—there aren't a lot of people around, involved with the company. In some sense, it allows them to ignore really bad risk, right? Large level—what's known as black swans, now. The—just—you don't have to worry about it. If—once it gets so bad, after a certain point, well, the government's going to step in. And so, given that, it's hard for me to imagine an incentive-based compensation structure that is going to be created that gives an executive a lot of incentive to worry about that.

Mr. FEINBERG. Well, you may say that. I must say, one thing I learned in this job is the desire of these companies to get out from under any government regulation. I mean, Citigroup and Bank of America, as I understand it, borrowed money to get out from under TARP and my restrictions.

Again, I go back, I guess, to the question that—my role was so limited, all I could do, under the statute and regs—and Mr. Silvers thinks maybe I could have done more—but, all I could do was try and tinker with ways that might be a model to deal with these seven companies. And I think, within that limited framework, we did what we were supposed to do.

Dr. TROSKE. So, let me ask you a little bit about that, because I think, while you are right—your description is, obviously, correct, that your—you were limited in what you could do. You clearly scared these people. And it is the case—I mean, I think, you have described it as—that in order to get out from under you, they paid back TARP funds quickly. Do you think that's a good thing?

Mr. FEINBERG. Congress certainly did. Congress felt that the single most important thing I could do is get those seven companies to repay the taxpayer. That was the number—Secretary Geithner made that clear, Congress made that clear, the administration made that clear; and we succeeded, with three of those companies already repaying.

Dr. TROSKE. And so, let me ask—build on that again a little. And I want to be clear, I—you know, the companies that went bankrupt, I think, deserve almost anything they got, and then took the money. I'm not a big sympathy—I'm not very sympathetic. But, there were companies that were requested to take TARP funds, that were not in the same financial situation, and yet they came under your purview. And it also does seem to be the case that the rules of the game changed over—I mean, I think, the final rules regarding what you were allowed to do, many of them were adopted after the original TARP legislation, in October of 2008.

Do you think that they were aware—many of the executives were aware, when they took the original TARP money, what they were agreeing to? And——

Mr. FEINBERG. No.

Dr. TROSKE. And do you think it's, in some sense, fair to them to change the rules of the game in the midst of it? And I know I'm asking you to expand on what—that's not part of your——

Mr. FEINBERG. It really isn't part of my mandate.

Dr. TROSKE. Yeah.

Mr. FEINBERG. I—you'd have to ask each company, and each corporate official who made these decisions, what they knew and when they knew it. But, I do agree with the argument that, once Congress provided substantial taxpayer assistance to these companies, I was, in effect, a surrogate creditor for the taxpayer. And I'm hard-pressed to accept the argument that it was inappropriate for us to change the rules or to modify the rules. The taxpayers were creditors, the government had a right, I think, especially under the congressional legislation, to influence pay practices, at least to a limited extent, with those companies. And I think we did that—exactly what Congress wanted us to do.

Dr. TROSKE. Okay. I would agree with you. I think they learned a valuable lesson about what comes with taking money from the public trough.

The CHAIRMAN. Superintendent Neiman.

Mr. NEIMAN. Thanks.

Well, we talked about what should be the regulatory governmental regime principle, versus rules, regarding incentive comp. But, another key question is the scope of the institutions that should be subject to these standards. My question is: Where should we draw the line? Your line was pretty clearly drawn, with respect to TARP recipients, the seven you referenced. But, I'd be interested in your views as to—in expanding that out. Should it be—should it cover only insured banks? What about other financial institutions, like security firms and insurance companies? Should we only be focusing on those systemically significant institutions; you know, beyond the explicit guarantees of insured banks, but to those with implicit guarantees?

Mr. FEINBERG. I'm not the expert, there. I mean, I must say, you're asking a very legitimate question to somebody who had just seven institutions to worry about, and we worried, at 3 a.m., what to do with those seven. Whether or not the Federal Reserve and the FDIC should expand their authority to encompass prescriptions on pay for others and other agencies, you're asking the wrong witness, on that.

Mr. NEIMAN. Well, you know, maybe I'll take it—you know, I'll come at it a different way, because I think your experience and learnings are helpful. What should be the principles that we should be guided by in determining the scope? Is it simply protecting the taxpayers, whether through explicit—as a result of explicit guarantees or implicit guarantees? Is it financial stability?

Mr. FEINBERG. Well, financial stability protects the taxpayers. I think that—in my situation, I had—you're right, I had a rather explicit mandate tied to the fact that the taxpayer cut a check to each of these seven companies, and that made us a creditor. I'm not suggesting that that's the way to do it next time, but I do think that, in terms of prescriptions, there ought to be some rule tied to taxpayer protection and financial stability in the marketplace. So, how that translates, you'll have to ask others.

Mr. NEIMAN. Okay. And—also, in your experience—you know, we're talking about—to the extent it even should extend to the shadow banking system, to the extent that controls that we put in place in regulated entities may shift some of these riskier activities and compensation programs into less regulated entities.

Mr. FEINBERG. I think that's right. I also think—be careful about—in my experience, be careful about looking only at the issue of scope, because I think what we learned, in the special master's office, is: every bit as important, if not more important, than scope is enforcement. And, at the end of the day, who are in the front line enforcing these regulations and the scope of regulatory effort is every bit as critical as what, on paper, looks to be a fairly sensible regulatory regime.

Mr. NEIMAN. Yeah. And, I—you know, where we left off, in principle versus rules—I think the first time a regulator takes a significant enforcement action under a principle-based regime, the industry will first say, "Give me the rules. We can't live with this ambiguity. Give us the rules and we will comply." So, it—there really is the balance.

I'm also interested in your views on culture, because you've seen very different institutions and—with the large investment banks converting to bank holding companies, with trading mentalities. I'd be interested in your views as to how much culture really plays in——

Mr. FEINBERG. Oh.

Mr. NEIMAN [continuing]. These kinds of organizations.

Mr. FEINBERG. We found cultures critical. Goldman, Morgan—they're different. One fascinating aspect of what I learned in this is the relative lack of interest in the public when it came to GM and Chrysler. I mean, almost all of the media and public attention was addressed to Bank of America, Citigroup, and AIG. There was, relatively speaking, much, much less interest in General Motors and in Chrysler, in GMAC and Chrysler Financial. Part of that, I think, was driven that—if you look at the pay packages of these Wall Street firms, relative to GM and Chrysler, it was like Earth and Mars. I mean, I think, if I remember correctly, the top three people of the 25 at Citigroup got more compensation before we arrived than all 25 people at GM, which was, to me, a little bit astounding.

Mr. NEIMAN. Thank you.

The CHAIRMAN. I think, I can answer that question. I think that people in America believe that they were the people that brought this thing down, they're the people that caused the unemployment, they're the people that caused foreclosure, they're the people that did all that, number one.

Number two is, they came through this thing and started making money faster than any other economic entity in the country, and got back to where they were, when all the others were floundering. So, I think—it's very obvious to me that that was the cause-effect.

I want to thank you for your testimony. Illuminating, as usual. And thank you for your public service.

Mr. FEINBERG. I just want to thank the Panel for—this is the third opportunity I've had to meet, formally or informally, with the panel, although not with the distinguished Chairman. And I want the panel to be—rest assured that the acting special master, Patricia Geoghegan, who's right here, will continue the fine work of the special master's office. So, thank you very much.

The CHAIRMAN. Great. Thank you.

And can the second panel come forward? [Pause.]

Very good.

I'm pleased to welcome our second panel, a truly distinguished group of academics and industry experts who will help us evaluate the TARP's executive compensation restrictions and the work of the special master, Feinberg.

We are joined by Professor Kevin Murphy, from University South Carolina's Marshall School of Business; Professor Frederick Tung, from Boston University School of Law; Rose Marie Orens, a senior partner at Compensation Advisory Partners; and Ted White, strategic advisor from Knight Vinke Asset Management and the co-chair of the International Corporate Governance Network, Executives Remuneration Committee.

We'll believe with—we'll begin with Professor Murphy. Please keep your oral testimony to 3 minutes, as we know, and we'll put the whole record—everything you—your total testimony in the record.

Thank you.

STATEMENT OF KEVIN MURPHY, KENNETH L. TREFFTZ CHAIR IN FINANCE, UNIVERSITY OF SOUTHERN CALIFORNIA, MARSHALL SCHOOL OF BUSINESS

Mr. MURPHY. Good afternoon, Chairman Kaufman and Panel members.

I have been asked to address a set of 11 very provocative questions, and I want to begin by commending the Panel for asking exactly the right questions, even though they are very hard questions.

I have 3 minutes to summarize my responses, so my challenge is to figure out what to do with my remaining time. [Laughter.]

Seriously, I've offered a 25-page report detailing my responses to these questions and could spend the full semester talking about these issues; and, in fact, intend to, when I get back to Southern California. I'll refer you, in part, to my report and wait for the Q-and-A for specific responses to specific questions, but I would like to summarize several general themes and conclusions emerging from my responses.

First, when the pay restrictions were enacted in February 2009, Congress was angry at Wall Street and its bonus culture, and suspicious that this culture was the root cause of the financial crisis. By limiting compensation to uncapped base salaries, coupled with modest amounts of restricted stock, Congress completely upended the traditional Wall Street model characterized by low base salaries coupled with high bonuses paid in a combination of cash, stock, and stock options. One interpretation of Congress's intentions was to punish the executives at firms alleged to be responsible for the crisis. More charitably, Congress may have decided that banking compensation was sufficiently out of control that the only way to save Wall Street was to destroy its bonus culture. Whatever the intent, it is my opinion that the restrictions were misguided and not in the interest of protecting taxpayers.

Second, while ostensibly designed to implement the pay restrictions, Treasury's interim final rule circumvented Congress by blending the enacted restrictions with the, frankly, more sensible restrictions proposed earlier by the Obama administration but dismissed by Congress. In particular, Treasury circumvented the intentions of Congress by allowing salaries to be paid in the form of nontransferable stock and by imposing more severe pay restrictions on firms requiring exceptional government assistance. In my opinion, these changes benefited taxpayers, relative to the strict adherence of TARP.

Third, the special master, guided by a well-intentioned but ill-defined public-interest standard, was forced to navigate between the conflicting demands of politicians, who insisted on punishments, and taxpayers and shareholders, who were legitimately concerned about attracting, retaining, and motivating executives and employees. Too often, the politicians won.

Overall, the pay restrictions for TARP recipients were value-destroying. Ultimately, the most productive aspect of the restrictions was the pressure they put on TARP recipients to escape the restrictions by repaying the government sooner than most anticipated. In retrospect, the TARP experience is a case study in why the government should not get involved in regulating executive compensation within the financial sector or more broadly.

Thank you.

[The prepared statement of Mr. Murphy follows:]

Congressional Oversight Panel

Hearing

"Executive Pay Restrictions for TARP Recipients: An Assessment"

Testimony of

Kevin J. Murphy

Kenneth L. Trefftzs Chair in Finance
University of Southern California
Marshall School of Business

Washington, DC

October 21, 2010

(revised Oct. 27, 2010)

Testimony of Kevin J. Murphy

I. Introduction and Summary

Between October 2008 and December 2009, the U.S. Government invested nearly $400 billion into financial services and automotive firms through the Troubled Asset Relief Program (TARP), established under the Emergency Economic Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA). As a consequence of these cash infusions – typically made in the form of investments in preferred stock and warrants – U.S. taxpayers became major stakeholders in hundreds of bailed-out organizations, and were legitimately concerned that the interests of the executives of these organizations be aligned with those of taxpayers. Section 111 of EESA (as amended), imposed significant restrictions on executive pay for TARP recipients. The Act delegated to the U.S. Treasury the task of interpreting the details and implementing the pay restrictions; Treasury in turn established the Office of the Special Master of Compensation to address these issues.

I have been asked to provide my opinion on several issues related to the executive pay restrictions under the EESA (as amended), including:

1. *What was the intent of the legislation?*
2. *Did Treasury's regulations provide the Special Master with the appropriate guidance to achieve that purpose?*
3. *Were the Special Master's compensation determinations generally consistent with the intent of the statutory and regulatory authorities and the goals of the TARP?*
4. *Was the Special Master's "Public Interest Standard" the appropriate analytical framework for his compensation determinations?*
5. *Did the Special Master strike the appropriate balance between prohibiting excessive compensation and permitting the appropriate competitive compensation necessary to attract talented executives capable of maximizing shareholder value?*
6. *Did the determinations effectively discourage excessive risk-taking by executives?*

7. *Did the determinations provide any incentives for executives to make decisions that were not in the best interest of taxpayers, for example, prolonging a company's dependence on the government rather than taking it into bankruptcy?*
8. *What is your general view of the role of government in regulating executive compensation at financial institutions?*
9. *What lessons from the TARP experience with regulating executive compensation might be applicable to all financial institutions?*
10. *Are the Special Master's determinations a useful model for corporate executive compensation structures in the future?*
11. *Is there any evidence that the Special Master's determinations have been adopted by companies that were not subject to his oversight?*

I provide detailed responses to each of these questions in Section III below. Several themes and conclusions emerge from my responses, summarized briefly as follows:

- The apparent intent of the pay restrictions in EESA was to punish executives and companies perceived as being responsible for the financial crisis and to upend the Wall Street bonus culture, and not to protect taxpayers or to maximize the return on taxpayers' investments.

- While ostensibly designed to implement the EESA restrictions, Treasury's Interim Final Rule (IRM) "blended" the EESA restrictions with the more-sensible restrictions proposed earlier by the Obama administration (but rejected by Congress).

- In particular, Treasury circumvented the intentions of Congress by allowing salaries to be paid in the form of non-transferable stock, and by imposing more severe pay restrictions on firms requiring exceptional government assistance. These changes benefited taxpayers (relative to strict adherence to EESA).

- The Special Master – guided by an ill-defined "Public Interest Standard" – was forced to navigate between the conflicting demands of politicians (insisting on punishments) and taxpayer/shareholders (concerned with attracting, retaining, and motivating executives and employees).

- Ultimately, the most productive aspect of the restrictions was the pressure they put on TARP recipients to escape the restrictions by repaying the government sooner than most anticipated.

- In retrospect, the TARP experience is a case study in why the government should not get involved in regulating executive compensation.

My report proceeds as follows. Section II chronicles the evolution of the pay restrictions in the EESA (as amended), focusing on the restrictions in the original October 2008 legislation, the February 2009 Treasury guidance proposed by the Obama administration, the pay amendments introduced in conference as part of the February 2009 American Recovery and Reinvestment Act, and Treasury's interim final rule issued in June 2009. In addition, to provide context for this evolution I describe the "current events" influencing the evolving restrictions. In Section III, I offer my detailed responses to each of the eleven questions. Finally, Section IV describes my qualifications and discusses my advisory role with the Office of the Special Master during 2009 through early 2010.

II. The Evolution of the EESA Pay Restrictions

Pay Restrictions in the October 2008 Bailout

On September 19, 2008 – at the end of a tumultuous week on Wall Street that included the Lehman Brothers bankruptcy and the hastily arranged marriage of Bank of America and Merrill Lynch – Treasury Secretary Paulson asked Congress to approve the Administration's plan to use taxpayers' money to purchase "hundreds of billions" in illiquid assets from U.S. financial institutions.[1] Paulson's proposal contained no constraints on executive compensation, fearing that restrictions would discourage firms from selling potentially valuable assets to the government at relatively bargain prices.[2] Limiting executive pay, however, was a long-time top priority for Democrats and some Republican congressmen,

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1 Solomon and Paletta, "U.S. Bailout Plan Calms Markets, But Struggle Looms Over Details," *Wall Street Journal* (September 20, 2008), p. A1.

2 Hulse and Herszenhorn, "Bailout Plan Is Set; House Braces for Tough Vote," *New York Times* (September 29, 2008), p. 1.

who viewed the "Wall Street bonus culture" as a root cause of the financial crisis. Congress rejected the bailout bill on September 30, but reconsidered three days later after a record one-day point loss in the Dow Jones Industrial Average and strong bipartisan Senate support. The Emergency Economic Stabilization Act (EESA) was passed by Congress on October 3rd, and signed into law by President Bush on the same day.

The EESA enacted in October 2008 included what at the time seemed like serious restrictions on executive pay. For example, while Section 304 of the 2002 Sarbanes-Oxley Act required "clawbacks" of certain executive ill-gotten incentive payments, Sarbanes-Oxley only covered the chief executive officer (CEO) and chief financial officer (CFO), and only covered accounting restatements. While applying only to TARP recipients (Sarbanes-Oxley applied to all firms), the October 2008 EESA covered the top-five executives (and not just the CEO and CFO), and covered a much broader set of material inaccuracies in performance metrics. In addition, EESA lowered the cap on deductibility for the top-five executives from $1 million to $500,000, and applied this limit to all forms of compensation (and not just non-performance-based pay). EESA also prohibited new severance agreements for the top five executives, and limited payments under existing plans to 300% of the executives' average taxable compensation over the prior five years. When Treasury "invited" the first eight banks to participate in TARP (in some cases inducing reluctant participants), a critical hurdle involved getting the CEOs and other top executives to waive their rights under their existing compensation plans.

Merrill Lynch bonuses fuel a growing controversy

Congressional concern over executive compensation did not end with the October 2008 EESA enactment. Just three days after EESA was signed, congressional hearings on the failure of Lehman Brothers focused not on the firm's bankruptcy but rather on the compensation of Lehman's CEO.[3] By late October, Congress was demanding new and more-stringent limits on executive compensation at the bailed-out firms.[4]

[3] Sorkin, "If This Won't Kill The Bonus, What Will?," *New York Times* (October 7, 2008), p. 1.

[4] Crittenden, "U.S. News: Lawmakers Want Strings Attached," *Wall Street Journal* (October 31, 2008), p. A4.

A major flash point came in early 2009 when it was revealed the Merrill Lynch had paid $3.6 billion in bonuses to its 36,000 employees just ahead of its acquisition by Bank of America.[5] The top 14 bonus recipients received a combined $250 million, while the top 149 received $858 million (Cuomo (2009)). The CEOs of Bank of America and the former Merrill Lynch (neither of whom received a bonus for 2008) were quickly hauled before Congressional panels outraged by the payments, and the Attorney General of New York launched an investigation to determine if shareholders voting on the merger were misled about both the bonuses and Merrill's true financial condition.

By the time the Merrill Lynch bonuses were revealed, the U.S. had a new President, a new administration, and new political resolve to punish the executives in the companies perceived to be responsible for the global meltdown. Indicative of the mood in Washington, Senator McCaskill (D-Missouri) introduced a bill in January 2009 that would limit total compensation for executives at bailed-out firms to $400,000, calling Wall Street executives "a bunch of idiots" who were "kicking sand in the face of the American taxpayer."[6]

The Obama Proposal to amend EESA

On February 4, 2009, President Obama's administration responded with its own proposal for executive-pay restrictions that distinguished between failing firms requiring "exceptional assistance" and relatively healthy firms participating in TARP's Capital Purchase Program. Most importantly, the Obama Proposal for exceptional assistance firms (which specifically identified AIG, Bank of America, and Citigroup) capped annual compensation for senior executives to $500,000, except for restricted stock awards (which were not limited, but could not be sold until the government was repaid in full, with interest). In addition, for exceptional-assistance firms the number of executives subject to "clawback" provisions would be increased from 5 under EESA to 20, and the number of executives with prohibited golden parachutes would be increased from 5 to 10; in addition, the next 25 would be prohibited from parachute payments that exceed one year's compensation).

5 Bray, "Crisis on Wall Street: Merrill Gave $1 Million Each to 700 Of Its Staff," *Wall Street Journal* (February 12, 2009), p. C3.

6 Andrews and Bajaj, "Amid Fury, U.S. Is Set to Curb Executives' Pay After Bailouts," *New York Times* (February 4, 2009), p. 1.

Moreover – in response to reports of office renovations at Merrill Lynch, corporate jet orders by Citigroup, and corporate retreats by AIG – the Obama Proposal stipulated that all TARP recipients adopt formal policies on "luxury expenditures." Finally, the Obama Proposal required all TARP recipients to fully disclose their compensation policies and allow nonbinding "Say on Pay" shareholder resolutions.[7]

Congress ignores Obama and expands restrictions on pay

In mid-February 2009, separate bills proposing amendments to EESA had been passed by both the House and Senate, and it was up to a small "conference" committee to propose a compromise set of amendments that could be passed in both chambers. On February 13th – as a last-minute addition to the amendments – the conference chairman (Senator Chris Dodd) inserted a new section imposing restrictions on executive compensation that were opposed by the Obama administration and severe relative to both the limitations in the October 2008 version and the February 2009 Obama Proposal. Nonetheless, the compromise was quickly passed in both chambers with little debate and signed into law as the American Recovery and Reinvestment Act of 2009 by President Obama on February 17, 2009.

Table 1 compares the pay restrictions under the original 2008 EESA bill, the 2009 Obama Proposal, and the 2009 ARRA (which amended Section 111 of the 2008 EESA). While the "clawback" provisions under the original EESA covered only the top five executives (up from only two in SOX), the "Dodd amendments" extended these provisions to 25 executives and applied them retroactively.[8] In addition, while the original EESA disallowed severance payments in excess of 300% of base pay for the top five executives, the Dodd amendments covered the top 10 executives and disallowed *all* payments (not just amounts exceeding 300% of base). Most importantly, the Dodd Amendments allowed only two types of compensation: base salaries (which were not restricted in magnitude), and

[7] TARP recipients not considered "exceptional assistance" firms could waive the disclosure and "Say on Pay" requirements, but would then be subject to the $500,000 limit on compensation (excluding restricted stock).

[8] The number of executives covered by the Dodd Amendments varied by the size of the TARP bailout, with the maximum number effective for TARP investments exceeding $500 million. As a point of reference, the average TARP firm among the original eight recipient received an average of $20 *billion* in funding, and virtually all the outrage over banking bonuses have involved banks taking well over $500 million in government funds. Therefore, I report results assuming that firms are in the top group of recipients.

Table 1

Comparison of Pay Restrictions in EESA (Oct 2008), Obama Proposal (2009), and ARRA (2009)

	A. Limits on Pay Levels and Deductibility
Pre-EESA (IRS §162(m) (1994))	Limits deductibility of top-5 executive pay to $1,000,000, with exceptions for performance-based pay
EESA (2008) All TARP Recipients	Limits deductibility of top-5 executive pay to $500,000, with no exceptions for performance-based pay
Obama (2009) Exceptional Assistance Firms	In addition to deductibility limits, cash pay is capped at $500,000; additional amounts can be paid in restricted shares vesting after government paid back
Obama (2009) Other TARP Recipients	Same as exceptional assistance firms, but pay caps can be "waived" if firm offers full disclosure of pay policies and a non-binding "say on pay" vote
ARRA (2009) All TARP Recipients	In addition to deductibility limits, disallows all incentive payments, except for restricted stock capped at no more than one-half base salary. No caps on salary.
	B. Golden Parachutes
Pre-EESA (IRS §280G (1986)	Tax penalties for change-in-control-related payments exceeding 3 times base pay
EESA (2008) Auction Program	No new severance agreements for Top 5
EESA (2008) Capital Purchase Program	No new severance agreements for Top 5, and no payments for top 5 executives under existing plans exceeding 3 times base pay
Obama (2009) Exceptional Assistance Firms	No payments for Top 10; next 25 limited to 1 times base pay
Obama (2009) Other TARP Recipients	No payments for top 5 executives under existing plans exceeding 1 times base pay
ARRA (2009) All TARP Recipients	No payments for Top 10 Disallows all payments (not just "excess" payments)
	C. Clawbacks
Pre-EESA (Sarbanes-Oxley (2002))	Covers CEO and CFO of publicly traded firms following restatements
EESA (2008) Auction Program	No new provisions
EESA (2008) Capital Purchase Program	Top 5 executives, applies to public and private firms, not exclusively triggered by restatement, no limits on recovery period, covers broad material inaccuracies (not just accounting restatements)
Obama (2009) All TARP Recipients	Same as above, but covers 20 executives
ARRA (2009) All TARP Recipients	Covers 25 executives for all TARP participants, retroactively

restricted stock (limited to grant-date values no more than half of base salaries). The forms of compensation explicitly prohibited under the Dodd amendments for TARP recipients include performance-based bonuses, retention bonuses, signing bonuses, severance pay, and all forms of stock options. Finally, the Dodd amendments imposed mandatory "Say on Pay" resolutions for all TARP recipients.

Treasury "blends" EESA with the Obama Proposal

The Dodd amendments were signed into law as part of the amended EESA with the understanding that Treasury "shall promulgate regulations" to implement the amended compensation restrictions. In June 2009, Treasury issued its Interim Final Rule (IFR), along with the simultaneous creation of the Office of the Special Master of Executive Compensation. Ultimately, Treasury's regulations attempted to blend the restrictions in the Dodd amendments with those in the Obama Proposal in two important dimensions: the composition of compensation and the distinction between failing firms requiring exceptional assistance and relatively healthy firms participating in TARP's generally available capital access programs.

In order to blend the EESA restrictions (allowing only base salaries without limitation and restricted stock limited to one-half of salaries) and the Obama proposal (in which cash compensation was limited to $500,000 with no limitation on restricted stock that must be held until taxpayers were repaid), Treasury introduced a new compensation component: salary paid in the form of stock ("salarized stock") which was vested immediately but subject to transferability restrictions.

In addition to introducing salarized stock, Treasury's IFR also resurrected the distinction in the Obama Proposal between firms requiring exceptional assistance from the USA government and relatively healthy firms participating in generally available capital access programs. While the newly established Special Master had interpretive authority potentially affecting all TARP recipients, the IFR gave him specific authority to set the level and structure of compensation for executives in the seven exceptional-assistance firms: Bank of America, Citigroup, AIG, General Motors, Chrysler, and the financing arms of GM and Chrysler. Specifically, the Special Master was charged with approving every dollar paid to

Table 3

Changes in Pay Imposed by Treasury's Special Master for Firms Requiring "Exceptional Assistance"

	Percentage Change in Pay from 2008 Levels		Percentage Change in Pay from 2007 Levels		Number of Executives in Top 25
Corporation	Cash	Total	Cash	Total	
AIG	-90.8%	-57.8%	-89.2%	-55.7%	13
Bank of America	-94.5%	-65.5%	-92.2%	-63.3%	13
Citigroup	-96.4%	-69.7%	-78.4%	-89.6%	21
General Motors	-31.0%	-24.7%	-46.0%	-16.9%	20
Chrysler	-17.9%	+24.2%	+14.0%	+72.3%	25
GMAC	-50.2%	-85.6%	-42.5%	-78.2%	22
Chrysler Financial	-29.9%	-56.0%	na	na	22

Source: October 22 letters from Special Master to each company, available at the US Treasury website (www.treas.gov).

the top 25 highest-paid employees at each of these seven firms, and was charged with approving the structure of pay (but not necessarily the dollar amount) for the next 75 highest-paid employees.

Table 3 summarizes the compensation determinations for the top 25 executives made by the Special Master and announced in October 2009. Cash compensation at the three banks regulated by the Special Master were cut by an average of 94%, while total compensation was cut by an average of 64%.

III. Responses to Specific Questions

1. What was the intent of the legislation?

When ARRA with the Dodd amendments was enacted in February 2009, Congress (and the general public) were angry at Wall Street and its bonus culture, and suspicious that this culture was a root cause of the financial crisis. By limiting compensation to uncapped base salaries coupled with modest amounts of restricted stock, the Dodd amendments completely upended the traditional Wall Street model of low base salaries coupled with high bonuses paid in a combination of cash, restricted stock, and stock options. One interpretation of the Congress's intentions was to punish the executives and firms alleged to be responsible for the crisis. More charitably, Congress may have decided that banking compensation was sufficiently out of control that the only way to save Wall Street was to destroy its bonus culture. Whatever the intent, it is my opinion that the restrictions were misguided and not in the interest of taxpayers.

Once taxpayers became a major stakeholder in the TARP recipients (and especially in the seven recipients requiring "exceptional assistance"), the government arguably had a legitimate role in aligning the interests of executives with those of taxpayers. For example, compensation policies should clearly avoid providing incentives to take excessive risks with taxpayer money. More generally, one could imagine embracing an objective of "maximizing shareholder value while protecting taxpayers," or perhaps "maximizing taxpayer return on investment."

In return for the TARP investments, the government typically received a combination of preferred stock and warrants to purchase common equity at a pre-determined market price. Taxpayers therefore want executive compensation tied to the contractual dividend payments on (or repurchases of) the preferred stock and on the appreciation of the common stock. Most compensation consultants and practitioners working on behalf of taxpayers would have recommended low base salaries coupled with bonuses tied to company operating performance (likely based on cash flows available for preferred dividends) and stock options, restricted stock, and other plans tied to shareholder-value creation. Taxpayers would also want the ability to pay reasonable signing bonuses to attract executive talent into the company, and to pay reasonable severance to ease the transition of executives leaving the company. In contrast, the EESA (as amended) prohibited signing bonuses, incentive bonuses, severance bonuses, stock options, performance shares, and other components often found in well-designed compensation plans.

2. Did Treasury's regulations provide the Special Master with the appropriate guidance to achieve that purpose?

As discussed above, Treasury's regulations attempted to blend the restrictions in the Dodd amendments with those in the Obama Proposal. Under the EESA (as amended), compensation for TARP recipients could consist only of base salary and restricted stock, where salaries were unlimited and restricted stock was limited to be no more than one-half of salary. Under the Obama Proposal, non-equity compensation (including salaries and bonuses) was limited to $500,000, and companies could issue an unlimited amount of restricted stock provided that the executive was precluded from selling the stock until after the TARP funds were repaid in full. Importantly, the limits under the Obama Proposal were only binding for firms deemed to require exceptional assistance (assuming that the other TARP recipients complied with the disclosure and say-on-pay provisions).

In order to blend these seemingly disparate provisions, Treasury's IFR introduced a new type of compensation not anticipated (and therefore not explicitly prohibited) by the EESA: salary paid in the form of stock (henceforth called "salarized stock"). Salarized stock differs from restricted stock in exactly one dimension: restricted stock is subject to forfeiture if the executive leaves the firm prior to vesting, while salarized stock vests immediately and is not subject to forfeiture. However, both salarized and restricted stock can be subject to transferability restrictions, such as prohibiting executives from selling stock received as salary until a certain date in the future or a pre-specified event (e.g., repayment of TARP funds). Treasury's regulations therefore made it possible for companies to follow the Obama prescription of $500,000 in base salary and the remainder in stock that the executive could not sell until TARP repayment (or other performance- or time-based contingencies).

In practice, the vesting of restricted stock is often accelerated upon retirement or termination without cause, and executives therefore forfeit their restricted shares only in relatively rare situations when they are fired for cause or resign voluntarily. Thus, the distinction between restricted and salarized stock is largely semantic or at least of second-order importance. Treasury's introduction of salarized stock therefore represents a significant circumvention of the Dodd amendments. In my opinion, it was also a brilliant circumvention, since it mitigated the single most-destructive restriction on pay for TARP recipients (i.e., the elimination of all incentive compensation beyond a limited amount of restricted stock).

In addition, also as discussed above, Treasury's regulations resurrected the Obama-proposal distinction between failing firms requiring exceptional assistance and relatively healthy firms participating in generally available capital access programs. In particular, while the pay restrictions in the Dodd amendments applied equally to all TARP recipients, the IFR followed the Obama Proposal in placing harsher restrictions on the exceptional assistance firms.

The Treasury regulations virtually assured (perhaps inadvertently) that the Special Master's attention would be focused on the seven exceptional assistance firms and not on the broader population of TARP recipients. The IFR essentially required the Special Master to approve every dollar paid to a top 25 executive at each of the seven firms, as well as approving the structure of pay for the next 75 highest-paid employees at each of these firms. This task alone would require the full-time resources of a medium-size consulting firm. Working only with a small group of pro-bono attorneys and advisors and staff assigned from Treasury, it was not reasonable to expect the Special Master to devote commensurate time to the healthier TARP recipients. Indeed, the Special Master's preliminary audit of compensation for other TARP recipients was not even started until most of the TARP funds had been repaid in full.

3. Were the Special Master's compensation determinations generally consistent with the intent of the statutory and regulatory authorities and the goals of the TARP?

To my knowledge, the Special Master's compensation determinations were always consistent with Treasury's IFR. However, as noted above in my response to Question 2, the Treasury's regulations were significantly (but productively) inconsistent with EESA (as amended) in at least two dimensions: pay composition and exceptional assistance. In addition, as noted above in my response to Question 1, the pay restrictions in EESA (and, to a lesser-extent, in the IFR) were not generally consistent with the objective of protecting taxpayer investment in TARP.

4. Was the Special Master's "Public Interest Standard" the appropriate analytical framework for his compensation determinations?

An appropriate analytical framework for compensation design must begin with a well-specified objective function, such as "maximizing shareholder return while protecting taxpayer's interest" or "maximizing the return to taxpayers." Such objective functions often need to be considered in light of relevant constraints, such as the pay restrictions embedded in EESA. Explicitly specifying both the objective function and constraints allows the plan designer to weigh tradeoffs of design elements such as the mix of salaries, restricted stock, and salarized stock, and the vesting or transferability restrictions on that stock.

In my opinion, the "public interest standard" is not an objective function, but a ill-defined concept that allows too much discretion and destroys accountability for those exercising the discretion. For example, applying the "public interest standard" allows Congress to limit compensation they perceive as excessive, without evidence or accountability for the consequences. Similarly, invoking the "public interest standard" forced the Special Master to navigate between the conflicting demands of politicians (insisting on punishments) and taxpayer/shareholders (concerned with attracting, retaining, and motivating executives and employees).

As an example of how the "public interest standard" can lead to punitive pay cuts, consider the case of Bank of America's Ken Lewis, who as recently as December 2008 was named American Banker's "Banker of the Year" for his firm's rescue of Merrill Lynch.[9] In October 2009, Mr. Lewis announced he would step down at the end of the year, and indicated that he would forego his 2009 bonus and the remainder of his 2009 salary. The Special Master decided that wasn't enough, and demanded that Mr. Lewis return *all* the salary already earned for services rendered the year, or risk a determination that Mr. Lewis' contractual pension benefits were contrary to the public interest (and therefore subject to renegoiation).[10] It is difficult to view this decision as anything other than punitive and a misuse of the "public interest standard," since Mr. Lewis clearly rendered services on behalf of Bank of America during 2009, and should clearly be compensated for that service.

5. Did the Special Master strike the appropriate balance between prohibiting excessive compensation and permitting the appropriate competitive compensation necessary to attract talented executives capable of maximizing shareholder value?

When executive compensation is described as "excessive" (or "inappropriate" or "unwarranted") the individual offering the description usually means one of three things. First, the term might refer to cases where compensation is determined not by competitive

9 Fitzpatrick and Scannell, "BofA Hit by Fine Over Merrill --- Bank Pays SEC $33 Million in Bonus Dispute; Sallie Krawcheck Hired in Shake-Up," *Wall Street Journal* (August 4, 2009), p. A1.

10 Story, "Pay Czar Doubts Cuts Will Make Bankers Leave," *New York Times* (October 23, 2009), p. 8.

market forces but rather by captive board members catering to rent-seeking entrenched executives.[11] Second, the term might refer to concerns about the misallocation of resources, such as a belief that top executives shouldn't earn that much more than teachers because teachers are more important to society. Finally, although generally not acknowledged by the participants in these often frenzied debates, the term might reflect one of the least attractive aspects of human beings: jealousy and envy.

Without question, the highest-paid employees in financial services firms are paid more than their counterparts in other industries, driven largely by what has become known as the "Wall Street Bonus Culture." The heavy reliance on bonuses has been a defining feature of Wall Street compensation for decades, going back to the days when investment banks were privately held partnerships. Such firms kept fixed costs under control by keeping base salaries low and paying most of the compensation in the form of cash bonuses that varied with individual or company profitability. This basic structure of low salaries and high year-end distributions remained intact when the investment banks went public, but the cash bonuses were replaced with a combination of cash, restricted stock, and stock options. The rewards available to top performers have attracted the best and brightest college, MBA, and PhD graduates into financial services. While some might argue that it would be better to have the best and brightest graduates become doctors or public servants, a general advantage of a capitalist free-market economy is its propensity to move resources to higher-valued uses.

The fact that pay is *high* does not, however, imply that pay is *excessive* in the sense of not being determined by competitive market forces. Even the most vocal advocates of the view that powerful CEOs effectively set their own salaries rarely apply the view to executives and employees below the very top. The highest-paid employees in financial services firms typically have scarce and highly specialized skills that are specific to their industry but not necessarily to their employer. As a result, employees in financial services are remarkably mobile both domestically and internationally when compared to employees in virtually any other sector in the economy. When the Dodd amendments were enacted in February 2009, the entire global financial system was in crisis and there was a belief that pay

[11] See, for example, Bebchuk and Fried (2004a); Bebchuk and Fried (2004b); Bebchuk, et al. (2010); Bebchuk and Fried (2003); Bebchuk, et al. (2002); Fried (2008a); Fried (2008b); Fried (1998).

could be cut "across the board" since, after all, there was no where else for the employees to go. However, by the time the Special Master made his pay determinations in October 2009, the world had changed: most formerly constrained recipients had repaid their TARP obligations, were actively hiring and were competing with unconstrained hedge funds and private equity funds for top financial talent.

As evidence of the mobility of financial service executives, consider the following result from Table 3: of the 75 highest-paid executives in AIG, Bank of America, and Citigroup in 2008, only 47 (62%) had remained in their firms through October 2009 (and were thus subject to pay approval by the Special Master). While the 28 departures were not all "regretted resignations" (including several former Merrill Lynch traders and some resignations encouraged by the Special Master), the departures included several high-performing executives and traders. For example, Andrew J. Hall – the head of Citigroup's Phibro profitable energy-trading division – was set to receive $100 million in bonuses for 2009. Although Citigroup maintained that the bonus should be exempt from the Special Masters' scrutiny because it was based on a contract that pre-dated TARP, the Special Master contended that the contract could be voided because it promoted excessive risk taking and ran counter to the public interest.[12] To avoid the conflict, Citigroup sold the Phibro unit to Occidental Petroleum at approximately its book value, which in turn promptly (and happily) paid Mr. Hall his contractual bonus. The Phibro divestiture deprived taxpayers of approximately $400 million in annual net cash flow that would have been available to pay dividends or retire preferred stock.

6. Did the determinations effectively discourage excessive risk-taking by executives?

The EESA prohibits executive officers of TARP recipients from having incentives "to take unnecessary and excessive risks that threaten the value of the financial institution." While the IFR require compensation committees to "identify and limit the features" in pay plans that could lead executives to take excessive risks, the law stops short of defining "excessive risk" or providing guidance on how one might distinguish excessive risk from the normal risks inherent in all successful business ventures.

[12] Dash and Healy, "Citi Averts Clash Over Huge Bonus," *New York Times* (October 10, 2009), p. 1.

There are exactly two ways that bonuses – or incentive compensation more broadly – can create incentives for risk taking. The first way is through asymmetries in rewards for good performance and penalties for failure, as suggested by the title of the Cuomo (2009) Report ("The 'Heads I Win, Tails You Lose' Bank Bonus Culture"). When executives receive rewards for upside risk, but are not penalized for downside risk, they will naturally take greater risks than if they faced symmetric consequences in both directions. The classic example of asymmetries (or what economists call "convexities") in the pay-performance relation implicit in stock options, providing rewards for stock-price appreciation above the exercise price, but no penalties (below zero) for stock-price depreciation below the exercise price. Executives with options close to expiration that are out of the money have strong incentives to gamble with shareholder money; executives with options that are well in the money have fewer such incentives. Similarly, in cases of financial distress when stock prices are close to zero, executives paid a base salary and restricted stock also face asymmetric payouts and have incentives to gamble with taxpayer money, since stock prices are bounded by zero on the downside but are not limited on the upside.

The second way that incentive compensation can create incentives for risk taking is through performance measurement. For example, in the years leading up to its dramatic collapse and acquisition by JPMorgan Chase at fire-sale prices, Washington Mutual excelled at providing loans and home mortgages to individuals with risky credit profiles.[13] WaMu mortgage brokers were rewarded for writing loans with little or no verification of the borrowers assets or income, and received especially high commissions when selling more-profitable adjustable-rate (as opposed to fixed-rate) mortgages. The basic incentive problem at WaMu was a culture and reward system that paid people to write loans rather than to write "good loans" – that is, loans with a decent chance of actually being paid back. In the end, WaMu got what it paid for. Similar scenarios were being played out at Countrywide Finance, Wachovia, and scores of smaller lenders who collectively were not overly concerned about default risk as long as home prices kept increasing and as long as they could keep packaging and selling their loans to Wall Street. But, home prices could not continue to increase when prices were being artificially bid up by borrowers who could not realistically qualify for or

[13] The information in this paragraph is based on Goodman and Morgenson, "By Saying Yes, WaMu Built Empire on Shaky Loans," *New York Times* (December 27, 2008).

repay their loans. The record number of foreclosures in 2008, and the associated crash in home values, helped send the U.S. economy (and ultimately the global economy) into a tailspin.

In the current anti-banker environment, it has become fashionable to characterize plans such as those at Washington Mutual as promoting excessive risk taking. But, the problems with paying loan officers on the quantity rather than the quality of loans is conceptually identical to the well-known problem of paying a piece-rate worker based on the quantity rather than the quality of output, or the well-known problem of paying executives (or investment bankers) based on short-term rather than long-term results. Put simply, these are performance-measurement problems, not risk-taking problems, and characterizing them as the latter leads to impressions that the problems are somehow unique or more important in the banking sector, when in fact they are universal.

Under EESA (as amended), TARP recipients are allowed three forms of compensation: base salaries, salarized stock, and restricted stock. The relevant performance measures are shareholder return and any other measure that affect the transferability or vesting of the salarized or restricted stock. For TARP recipients with unusually depressed stock prices, the reliance on stock conceptually introduces asymmetries that can promote risk taking. However, these incentives are mitigated by the restrictions on transferability: since the executives cannot realize a gain on their stock until the government is partially or fully repaid, there are no opportunities to pursue a short-run gain at the expense of long-run performance.

Overall, the Special Master pay determinations neither encouraged nor discouraged excessive risk taking. In any case, the asymmetries in the rewards and punishments inherent in the determinations of current pay are trivial compared to those associated with large out-of-the-money option holdings, FDIC insurance, and "too big to fail" guarantees.

7. Did the determinations provide any incentives for executives to make decisions that were not in the best interest of taxpayers, for example, prolonging a company's dependence on the government rather than taking it into bankruptcy?

As discussed above, the pay restrictions in EESA (as amended) were not in the best interest of taxpayers and were not constructed with the objective of rewarding taxpayers' return on investment or rewarding shareholder return while protecting taxpayers. Given the pay restrictions in EESA (as interpreted by the IFR), the determinations by the Special Master in regards to the mix of salary and stock seem appropriate, while the determinations relating the overall level of pay made it difficult for the recipients of exceptional assistance to attract and retain qualified employees. However, I am not aware of any specific decisions made that were driven by the pay determinations and ran counter to the best interest of taxpayers.

One arguably positive aspect of the pay restrictions is that many TARP recipients found the EESA reforms sufficiently onerous that they hurried to pay back the government in time for year-end bonuses. I have heard expressed (but largely dismiss) a concern that such early repayment was not in the taxpayers' interest.

8. What is your general view of the role of government in regulating executive compensation at financial institutions?

Compensation practices in financial services can certainly be improved. For example, cash bonus plans in financial services can be improved by introducing and enforcing bonus banks or "clawback" provisions for recovery of rewards if and when there is future revision of critical indicators on which the rewards were based or received. Several banks, including Morgan Stanley, UBS, and Credit Suisse have introduced plans with clawback features over the past several months, and I applaud these plans as moves in the right direction.

Bonus plans in financial services can also be improved by ensuring that bonuses are based on value creation rather than on the volume of transactions without regard to the quality of transactions. Measuring value creation is inherently subjective, and such plans will necessarily involve discretionary payments based on subjective assessments of performance.

Compensation practices in financial services can undoubtedly be improved through government oversight focused on rewarding value creation and punishing value destruction. However, it is highly unlikely that compensation practices can be improved through increased government rules and regulations. Indeed, the reality is that executive pay *is* already heavily regulated, in both the financial sector and in other sectors. There are disclosure rules, tax policies, and accounting standards designed explicitly to address perceived abuses in executive compensation. There is also direct intervention, such as the prohibitions on option grants and incentive bonuses in bailed-out banks. Common to all existing and past attempts to regulate pay are important (and usually undesirable) unintended consequences. For example, the 1984 laws introduced to reduce golden parachute payments led to a proliferation of change-in-control arrangements, employment contracts, and tax gross-ups. Similarly, the 1993 deductibility cap on non-performance-related pay is generally credited with fueling the escalation in pay levels and option grants in the 1990s, and the enhanced disclosure of perquisites in the 1970s is generally credited with fueling an explosion in the breadth of benefits offered to executives.

The unintended consequences from regulation are not always negative. For example, reporting requirements in the 2002 Sarbanes-Oxley bill (in which executives receiving options had to report those options within 48 hours) are generally credited for stopping the unsavory practice of "option backdating," even though the authors of the bill had no idea the practice existed. As another example discussed above, the pay regulations imposed on banks accepting government bailouts had the arguably positive effect of getting investors paid back much more-quickly than anyone expected, in order to escape the regulations. Even the 1993 deductibility cap – which backfired in its attempt to slow the growth in CEO pay – had the positive effect of greatly increasing the alignment between CEOs and their shareholders. But, these positive effects are accidents and cannot be relied upon.

Thus, my strong recommendation is to resist calls for further government regulation, and indeed governments should re-examine the efficacy of policies already in place. Part of the problem is that regulation – even when well intended – inherently focuses on relatively narrow aspects of compensation (or narrow definitions of firms or industries) allowing plenty of scope for costly circumvention. An apt analogy is the Dutch boy using his fingers to plug holes in a dike, only to see new leaks emerge. The only certainty with pay regulation is that new leaks will emerge in unsuspected places, and that the consequences will be both unintended and costly.

A larger part of the problem is that the regulation is often mis-intended. The regulations are inherently political and driven by political agendas, and politicians seldom embrace "creating shareholder value" (or, "taxpayer value") as their governing objective. While the pay controversies fueling calls for regulation have touched on legitimate issues concerning executive compensation, the most vocal critics of CEO pay (such as members of labor unions, disgruntled workers and politicians) have been uninvited guests to the table who have had no real stake in the companies being managed and no real interest in creating wealth for company shareholders. Indeed, a substantial force motivating such uninvited critics is one of the least attractive aspects of human beings: jealousy and envy. Although these aspects are never part of the explicit discussion and debate surrounding pay, they are important and impact how and why governments intervene into pay decisions.

9. What lessons from the TARP experience with regulating executive compensation that might be applicable to all financial institutions?

As of December 2009, there were approximately 700 unique financial institutions that had received TARP funds. Most of the recipients were small, private, or closely held, and were not significantly constrained by the EESA restrictions. Of the larger banks that were constrained, most had repaid the government in time to pay 2009 bonuses and stock options. Even among the seven "exceptional assistance" firms subject to enhanced scrutiny by the Special Master, the only two traditional banks (Bank of America and Citigroup) repaid the government in December 2009 and were no longer subject to the pay constraints.[14] Therefore, apart from the cost of early repayment, the pay restrictions were ultimately of little consequence to the vast majority of financial institutions receiving TARP funds, and thus there is little to learn from their experience.

[14] Citigroup became unconstrained when the government's investment was exchanged for transferable Citigroup common stock.

Nonetheless, the TARP experience has provided useful evidence on the challenges of regulating executive compensation in a wide variety of organizations (even within a relatively homogenous industry). Central to the regulation are prohibitions on excessive compensation and incentives to take excessive risk, both imposed without guidance (either from Congress or Treasury) on how to define or measure what is "excessive." The TARP experience also illustrates the danger of prohibiting certain forms of compensation (e.g., bonuses, severance pay, stock options) because of perceived abuses in isolated cases. Finally, the experience of the Office of the Special Master in closely regulating just seven companies hints at how costly (in terms of both time and resources) it would be to regulate an entire industry.

10. Are the Special Master's determinations a useful model for corporate executive compensation structures in the future?

In introducing salarized stock and distinguishing it from restricted stock, Treasury and the Special Master have broken the seemingly inextricable link between vesting and transferability. Traditionally, vesting has always referred to the date when the executive could not only keep the shares if he left the firm, but was also free to sell the shares on the open market. However, and aside from satisfying tax obligations, there is no obvious reason why we should allow executives to sell company shares at the same time they are no longer subject to forfeiture. Separating vesting and transferability is a brilliant idea, and one that I hope will gain traction in corporate boardrooms.

11. Is there any evidence that the Special Master's determinations have been adopted by companies that were not subject to his oversight?

"Connecting the dots" between the Special Master's determinations and practices in other firms is difficult, because in economic downturns we often see reductions in cash bonuses and stock options. Indeed, the most dramatic trends in executive compensation over the past decade has been a flattening of total compensation levels, and a reduction in the importance of stock options coupled with an increase in restricted stock – trends pre-dating but generally consistent with the Special Master's determinations. Overall, I am not aware that the Special Master's determinations have been adopted by any companies that were not subject to his oversight.

IV. Author's Statement

I am currently the Kenneth L. Trefftzs Chair in Finance at the University of Southern California Marshall School of Business. I have been a full professor of the Department of Finance and Business Economics at the USC Marshall School since 1995. In addition, I hold joint appointments in the USC School of Law (as Professor of Business and Law) and in the USC College of Letters, Arts, and Sciences (as Professor of Economics). I served as chair for the Marshall School's Department of Finance and Business Economics from 2003-2004, and as the Marshall School's Vice Dean of Faculty and Academic Affairs from 2004-2007. From 1991 to 1995, I was an Associate Professor of Business Administration at the Harvard Business School, and from 1983 to 1991, I was an Assistant and Associate Professor at the University of Rochester's William E. Simon Graduate School of Business Administration.

I received a Ph.D. in Economics from the University of Chicago in 1984, where my honors included a National Science Foundation Fellowship, Milton Friedman Fund Fellowship, and a Social Science Foundation Dissertation Fellowship. I also have an M.A. in Economics from the University of Chicago, and a B.A. degree (summa cum laude) from the University of California, Los Angeles. I am a member of Phi Beta Kappa, the American Economic Association, and the American Finance Association. I am an associate editor of the *Journal of Financial Economics* and the *Journal of Corporate Finance,* a former associate editor of the *Journal of Accounting and Economics*, and serve as referee to over thirty professional and academic journals. I am the former chairman of the Academic Research Committee of the American Compensation Association.

I am a recognized expert on executive compensation, and have written and published extensively on issues related to executive compensation. During 1992 and 1993, I conducted annual surveys of executive compensation practices in the 1,000 largest U.S. corporations. The surveys, sponsored by the United Shareholders Association, were used extensively by institutional investors and large shareholders in evaluating and comparing the effectiveness of compensation policies. I also advised the SEC in formulating their 1992 disclosure rules for top management pay, and was a prominent member of the 1992 and 2003 National Association of Corporate Directors' Blue Ribbon Commissions on Executive Compensation, which issued reports calling for the overhaul of CEO pay practices.

I have written nearly fifty articles, cases, or book chapters relating to compensation and incentives in organizations. Results from my research on executive compensation have been widely cited in the press (including the *Wall Street Journal, New York Times*, *Washington Post*, *Los Angeles Times*, *Chicago Tribune*, *USA Today*, *Economist*, *Fortune*, *Forbes*, *Business Week*, and *Time*) and on national television (including CNN and CBS news). I have offered testimony relating to executive compensation to the U.S. House of Representatives, and given speeches and presentations on compensation and incentives to a variety of academic and practitioner audiences, including the Conference Board, the American Compensation Association, and the Board of Governors of the Federal Reserve.

My university teaching at USC, Harvard, and Rochester encompasses a wide variety of courses at the undergraduate, MBA, Ph.D., and executive levels. I have developed and taught undergraduate, MBA, and Ph.D. courses in compensation, incentives, human resource management, corporate finance (including mergers, acquisitions, and leveraged buyouts), and corporate governance.

I have testified as an expert witness in multiple proceedings in federal and state courts; my testimony has focused on virtually all aspects of compensation. I have consulted with organizations and conducted research on compensation and incentives in professional partnerships and corporations. I have consulted with, or given speeches to, top managers and compensation committees at several large corporations, including IBM, AT&T, Merck, Bristol-Myers-Squibb, Genzyme, Procter & Gamble, Philip Morris, General Motors, Prudential, and Chubb. I spent the 1994-1995 academic year on leave from Harvard as the Visiting Scholar and Consultant at Towers Perrin, a major benefits and compensation consulting firm, where my activities included making formal presentations and leading informal roundtable discussions on executive compensation to clients nationwide, as well as being involved in a variety of consulting engagements.

From July 2009 to January 2010, I served as an external advisor to the U.S. Treasury's Special Master of Executive Compensation. During this time, I participated in several conference calls or on-site meetings, and prepared several reports in response to specific questions related to the structure of compensation. I did not have access to confidential data provided by the companies, and never (to my knowledge) participated in calls that revealed such data. While I gave advice when asked (and often when not asked), I am not aware whether that advice was reflected in any ultimate determinations made by the Special Master. I neither requested nor received any compensation in return for my services.

I have not received any Federal grants or contracts (including subgrants or subcontracts) related to my testimony, and I am not representing any organization that has received such grants related to my testimony.

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The CHAIRMAN. Professor Tung.

STATEMENT OF FRED TUNG, HOWARD ZHANG FACULTY RESEARCH SCHOLAR AND PROFESSOR OF LAW, BOSTON UNIVERSITY SCHOOL OF LAW

Mr. TUNG. Good day, Senator Kaufman, Panel members. Thank you for the opportunity to allow me to testify.

My name's Fred Tung. I'm a law professor at Boston University. I teach and research in the areas of corporate and bankruptcy law. Among my research interests, I have been doing work on corporate executive compensation and am currently investigating the incentive structure of banks, executive compensation preceding the financial crisis, and its potential role in the crisis.

For today's hearing, I've been asked, among other things, to draw on my recent academic work to suggest executive pay structure reforms that might help curb executives' incentives toward excessive risktaking. I have a few suggestions, all of which come under the general themes of: number one, one size won't fit all; and, number two, a light regulatory touch may be best. So, I'm taking something—more of a prospective approach to these issues than maybe some of the other panelists.

So, number one, I think it would be useful to focus more on portfolio incentives and less on annual pay. The current discussion of financial executives' compensation structures has missed what I believe to be a very critical issue, the issue of portfolio incentives. There's been an almost singular focus on annual compensation structures, to the virtual exclusion of any consideration of executives' existing portfolio incentives. Most executives at large financial institutions hold large portfolios of their own firms' securities, primarily stock and options and other claims on the firm. Because these portfolios typically dwarf the value of executives' annual pay packages, their existing portfolios exert much stronger influence on their risktaking tendencies than does annual pay.

So, for example, at the end of 2006, just before the financial crisis, the average large-bank CEO held an equity-based portfolio worth over $92 million. By contrast, the average annual compensation then was a mere 5 million. So, the composition of the portfolio—the stock, the options, and potentially other claims against the firm—has a far greater influence on CEO decisionmaking than the composition of the pay portfolio—the annual pay. We should be thinking about using the structure of annual pay to tailor portfolio incentives, as opposed to looking just at annual pay, thinking that's the only incentive that matters.

The other important idea I want to raise is, we should think about paying financial firm executives with something other than just their equity interest in the firm. One suggestion is the use of inside debt. Recent theoretical and empirical work outside the banking context suggests that when executives hold debt claims against their own firms, what academics call, "inside debt," their appetite for risk declines.

I see I'm running out of time. Let me just say that I also believe that, when we think about reform of executive pay, we need to think of it as part of an integrated piece of a multifaceted financial regulatory system. It's not a substitute, but a complement to existing financial regulation.

And thank you for the opportunity to testify.

The CHAIRMAN. Thank you, Professor.

Mr. White.

STATEMENT OF TED WHITE, STRATEGIC ADVISOR, KNIGHT VINKE ASSET MANAGEMENT; COCHAIR, EXECUTIVE REMUNERATION COMMITTEE, INTERNATIONAL CORPORATE GOVERNANCE NETWORK

Mr. WHITE. Good afternoon, Chairman Kaufman, panel members. I would also like to express my gratitude for the opportunity to be here with you today.

My background is that as of an active manager. I have a tremendous amount of experience with the institutional community; in particular, in engaging companies on matters of corporate governance and executive compensation.

What I would like to do is get right to the point it—with some of the very significant aspects of executive comp, particularly with the financial sector, which we have identified through some of our work with companies—and some of those in the TARP, in fact—where I think that the most significant differences of opinion on alignment of interests come from.

In many ways, the matter of executive comp is actually quite simple. The implementation of it, I find to be extremely complex. And I have a fair amount of sympathy for the special master in the task that he had before him; in general, give him good marks for taking on—you know, for climbing that mountain, but I think there's very significant aspects of comp that were, frankly, unaddressed in this.

Let me get right to some very significant aspects of comp where I think you should pay particular attention.

First is in disclosure. Disclosure is obviously important to investors, in that we—that's how we understand plans. But, I think that it also has a very significant role in making companies go through an extremely rigorous process in justifying the—not only the design of comp plans, but also their implementation. All right.

There is a certain amount of rigor that goes into a plan when you know that you have to justify it.

Term structure, which I think would be consistent with the issue that the previous panelist just got to, is another area where I think there's very significant disconnect. By "term structure," I mean a number of elements of a plan that lead to an alignment of interests along a horizon, so not only annual pay versus long-term pay, but also the mechanics of long-term pay, the types of metrics that are encompassed in that. There's an all-encompassing equation that you look at to try to determine whether or not a plan is well aligned with your interests as a long-term investor. And I think, in the cases of financial institutions, in particular, there's a big disconnect between the cycle of that industry and where the alignment of interest is driven, from the comp plans. They are way too short-term.

The metrics and mechanics. There are several metrics that I would point to. One, in particular, the use of ROE, which is prevalent in the industry. That metric is not risk-adjusted and, I think, probably had a role in emphasizing a certain risky behavior, and it missed an opportunity for comp plans to mitigate risk taking behavior.

Realizing that I'm out of time, I'm going to—I'm just going to list the other areas where—I'll talk about later, under questions—is: the mechanics of the plan; the role of the committees—in particular, whether or not they use the subjective or a formulaic-type process; risk, as a category; and, in employment contracts, severance change of control.

[The prepared statement of Mr. White follows:]

Testimony of Ted White

Vice Chair, Knight Vinke Asset Management

Hearing on Executive Compensation Restrictions under the Troubled Asset Relief Program (TARP) and the work of the Special Master for TARP Executive Compensation

October 21, 2010

Good afternoon Chairman Kaufman, and members of the Oversight Panel. My name is Ted White, I am Vice Chairman of Knight Vinke Asset Management, and a consultant to U.S. institutional investors in areas related to corporate governance. I have worked in varying capacities for institutional investors and a key focus of my career has been in the area of active management and corporate governance. My clients include major long-term oriented institutions, such as the California State Teachers' Retirement System (CalSTRS), and the Council of Institutional Investors (CII), which is a member organization consisting of many of this nation's most significant institutional investors. I have extensive experience engaging directly with corporations on behalf of major institutional investors on topics related to strategy, performance, corporate governance, and perhaps of particular interest to the panel, executive compensation. This includes engagement with senior management as well as board members.

I have developed a particular interest in the area of executive compensation during my career as I have found it to be one of the most direct and most powerful links between core governance issues and long-term performance. I address this issue with the perspective of a long-term investor, and as such I am delighted to be with you today and offer any observations and input possible to assist the Oversight Panel. I would like to offer my input as a professional investor, and be clear that my views are my own, and do not necessarily reflect the views of my employer or clients. I am pleased to see interest in this topic from the regulatory arena, and can only stress that input from investors on this topic may help focus oversight efforts significantly.

Matters related to executive compensation are among the most difficult topics to discuss with companies during engagements, which clearly stems from the importance of this issue to the individuals and corporation, but also the significance to investors. It goes without saying that executive compensation has attracted an enormous amount of scrutiny in recent years. While there are some major areas of disagreement between investors and companies in this area, there are also some areas of agreement and progress.

In an attempt to provide input for the Panel of some value and interest, I would like to provide a basic framework for the analysis and evaluation of executive compensation programs. This is similar in structure to how I might work with a major investor in considering an engagement. Through this framework I hope to provide some perspective on the work of the Special Master from the view of long-term investors, and to your broader question regarding compensation policy, design, and implementation in situations of distress.

A typical process involves many steps, usually over an extended period of time. We examine plans first and foremost from a "total compensation" standpoint, but of course we focus on each component as well. For the purpose of this testimony I would like to focus on several key areas that are most important to your questions, and where we have identified significant concerns over appropriate alignment or incentives. I will be general in my comments so as not to identify specific institutions.

Disclosure:

An analysis of executive compensation always begins with disclosure. Not only is public disclosure the primary means by which investors have to gain knowledge of a particular program, there is also a qualitative assessment of the disclosures, which is where in most engagements we find areas of recommended improvement. The importance of this step should not be under estimated. We attempt to achieve better disclosure for the obvious reason of providing comprehensive and clear information for our own use, but also to facilitate an introspective process at the companies.

To expand upon this point, let me explain the perspectives by which we might gage disclosures. This process begins with a basic evaluation of the compensation philosophy. While these statements are usually somewhat general, they do provide insight in to the committee's view on major policy points such as performance and alignment. More importantly they provide the foundation of an analysis as to whether the program design and implementation are consistent with the philosophy.

Secondly, we also begin a comparison of the compensation program with the company's business plan. We look for consistency between the articulated business strategy, the challenges and opportunities the company faces, its near-term and long-term business objectives, and the compensation plans.

I believe robust disclosures can force a more deliberative initial design process, and a healthy periodic review that directs compensation programs more efficiently from the start, thereby potentially mitigating some common sources of poor alignment (from a long-term equity holder perspective).

The communication process that is encompassed in the disclosure regime also serves a critical role in setting and maintaining expectations. I believe this concept is often missed in current disclosures and leads to some discontent among owners as well as other key constituencies. This leads to my first suggestion pertaining to a unique situation, such as your question on distressed circumstances. In my observation, disclosures from companies during TARP oversight could be dramatically improved by expanding the outlook on each company's current situation, potential transition plans, and particularly the impacts on specific aspects of the compensation plan. While disclosures certainly emphasize the restrictive elements of the oversight, they have done little to discuss the implications for compensation strategy going forward, and this is key.

Equity markets discount uncertainty. Compensation plan design can and should be used to communicate certain themes to equity markets, such as respect for capital and appropriate alignment, and in this way minimize uncertainty. Within this context however, I believe investors are generally flexible, and provided that companies provide an appropriate rationale, they will have significant leeway to design and implement a compensation plan appropriate to a distressed situation.

Term Structure:

By term structure I am referring to several aspects of the plan that determine alignment specific to the horizon. Key aspects to this question relate to the mix of short-term and long-term elements, the measurement period for performance-based elements, the methodology for measurement of performance, and other items.

In the case of financial institutions I have observed a significant emphasis on short-term performance, and I believe there are some inconsistencies that flow from this point in terms of: the stated compensation philosophy of many companies; appropriate alignment with long-term owners (and perhaps other constituencies); and an appropriate risk profile specific to this industry.

My observations flow from several points, again without being specific to any one institution. These include:

- Use of an annual bonus pool from which the bulk, or the whole, compensation program is derived (short-term and long-term payouts are derived from this pool)
- Lack of significant long-term oriented performance-based pay
- Lack of rigor in some instances where long-term performance-based pay is utilized, which may include methodologies or pay scales for example
- Duplication of short-term performance measures in the long-term plan

To be fair, but without getting too deep on this topic, many companies use equity with associated vesting periods as a form of long-term alignment, and articulate that it satisfies investors' desire for performance. While I believe investors generally support the use of equity, and recognize certainly the retention aspects of this tool, there is less agreement on pure incentive characteristics. The key policy discussion centers upon whether equity, or the more narrow point with stock options, is inherently performance-based due to the fact it fluctuates with the value of the company.

In the case of TARP companies, I observed the use of longer-term vesting periods, and I believe investors support this concept. However, in terms of performance measurement it appeared to be more oriented toward the perspective of a creditor in terms of differing incentives on any program (not insinuating this is necessarily inappropriate).

The application of these observations in a potentially distressed situation brings me to the following points. First, the financial services industry is volatile, and I believe it is more appropriate to emphasize longer-term performance in this circumstance. The ultimate goal should be to provide some incentive and alignment to manage through cycles rather than defined periods within cycles. In a sense, I believe the short-term emphasis may have an unintended consequence of making the industry (or specific managements as the case may be) too myopic. In a distressed situation this perspective is perhaps even more amplified, as by definition the potential outcomes may be even more contrasting.

Second, specific attention should be applied to determining the rational for the transfer of value. I use this term broadly because it is impacted by numerous factors, any one of which has the potential to seriously undermine the merits of the plan. The rationale for the transfer of value will help determine key aspects of the plan including appropriate time periods, metrics, measurement methodology, and scales for example.

Metrics and Mechanics:

More detailed analysis of executive compensation plans necessarily involves taking a view on the specific metrics employed (which may of course be financial or non-financial), and importantly the methods by which the plan measures and pays in relation to performance.

The devil is often in the details, and these aspects of compensation plans are one area they come out. In the case of the financials, there are two particular discussion topics I would like to raise today as examples:

- Return on Equity (ROE): ROE is a prevalent performance measure in the financial services industry, but has a significant weakness in that it is not adjusted for the risk taken to achieve a specified level of performance. In the case of financials this may have exacerbated a potential problem because of the lack of, otherwise prevalent, disciplines upon the capital structure of a company.
- Subjective measurement processes: While this issue is not isolated to the financial services industry, a number of prominent firms use a highly subjective process to evaluate performance. Again generalizing, this involves a committee evaluation process at the end of a defined performance period to determine how the company performed, usually against a basket of metrics that are not weighted or prioritized. The key policy debate around this issue is between the merits of a more formulaic approach and one that effectively cedes this process to the committee. Without getting too deep in the pros and cons of each perspective, suffice to say that a number of very significant pitfalls related to a highly subjective approach are concerning to institutional investors.

In terms of considering metrics and methodology there are perhaps some lessons that institutional investors have encountered that have particular application. First, as a matter of course, when companies use individual financial metrics within compensation plans, we prefer to see a thoughtful consideration of the pros and cons of the associated performance drivers. In practice we tend to see discussion of perceived ties to long term performance, but little in the way of: 1) potential unintended drivers; and 2) ways in which these can be off-set by use of other metrics or other elements of the plan.

Second, I believe there is significant merit in communicating the specific actions and potential outcomes for which the committee will reward a management team. The merit comes both in terms of discipline it forces on the committee (and management) in defining success and planning/implementing the path to achieve this; but also in the fairness to investors the committee represents, and secondarily other constituencies.

Risk

I give high marks to companies and to the oversight of TARP for progress related to examination of risk as it relates to compensation. This is clearly an important topic, and companies have made significant efforts in this area. Even a casual review of current proxy statements will reveal detailed processes that have been applied to the question of risk. I think in some cases however, the question may be taken too literally and too narrowly – with reference to "unnecessary or excessive risks that threaten the value of the TARP recipient..." It appears that companies are seriously evaluating the more micro risks within the business as it relates to compensation, but may be missing more macro issues related to compensation program design and longer-term structural issues in the industry.

For example, if the term structure of the compensation programs is indeed inconsistent with the underlying cycle of the industry, it may well alter the risk appetite of management, perhaps even causing the potential to overshoot at both ends of the spectrum (reduce risk too dramatically in the downside of a cycle, and increase risk too dramatically in the upside). I believe this type of analysis merits discussion, and in doing so companies will demonstrate an increased respect for owner's capital which gets back to a point I made earlier in regards to communication.

Employment contracts, severance, and change in control:

The TARP obviously restricted the use of certain contractual arrangements, therefore we have been focused on companies potential use of contracts once they exit, particularly for severance and change in control. The key concern for investors in this category are arrangements that can materially alter alignment of interests. There are a number of perquisites companies provide senior executives which may have poor optics, or may be "expensive", but they are not likely drive behavior in a meaningful manner (this is not to downplay the potential damage of the optics, see earlier points on demonstrating respect for owners' capital). However, I believe major issues related to alignment and incentive may arise from some provisions found in contractual arrangements. While the contracts may be somewhat unique, there are several areas to examine closely:

- Definition of terms. This includes determination for an event, such as change in control, and can include low thresholds for ownership change, or even a change in board members that was not authorized in some way by the incumbent board.
- Altered vesting. This includes material acceleration of vesting, and in some cases the cancelation of performance-based requirements.
- Value enhancement. This includes significant multipliers (to payouts) and gross-ups to cover applicable taxes.

To summarize I would like to touch on a specific thesis we have proposed to one particular company. While this situation is not distressed in the true sense of the word, it nonetheless offers an example that may be applicable. This is a TARP company, and operates under the specific restrictions accordingly. We have approached this company, similar to other engagements, in a forward looking perspective with minimal emphasis on its program during TARP, and major emphasis on the scenario for coming out. Our position is simple: First, the company has a distinct opportunity to start fresh, at least to some degree, and we view this as an event worthy of attention; and 2) to accomplish a successful exit it is possible the company will need to raise capital (but our points are still valid otherwise). We are suggesting the company consider the compensation program (in conjunction with other aspects of its governance and strategy) as a key selling point in going to investors, and it should be able to raise capital at a lower cost if it addresses issues of concern to the market. This has led to a discussion around detailed aspects of their plan, such as: performance measurements in the long-term portion of the plan (for example, items related to the success of M&A); incorporating measures of risk; increasing the use of performance-based methods; hedging as it may affect the compensation program; the use of adjusted performance measures; change in control and employment agreements; as well as other aspects of their governance.

The most important point is the process by which we are discussing the merits of their compensation program as it relates to their current circumstance, and the key role it plays in the success of their transition from TARP.

Thank you for the opportunity to discuss these issues with you today, and I would be happy to take any questions at the appropriate time.

The CHAIRMAN. Thank you very much.
Ms. Orens.

STATEMENT OF ROSE MARIE ORENS, SENIOR PARTNER, COMPENSATION ADVISORY PARTNERS, LLC

Ms. ORENS. Good afternoon, and thank you, Mr. Chairman and Panel, for inviting me.

My background is a bit different. I'm actually executive compensation consultant to boards of directors, primarily compensation committees, of course, and have been for over 25 years. In the last 15, I have spent most of my time with financial institution companies. So, I'm pretty well—pretty knowledgeable about TARP and their—those issues, as well as those who have not been involved in TARP.

So, I thought that would—might be a helpful perspective.

I have spent the last several years being heavily involved in the issue and the question that has come up among many committees: To what degree has incentive compensation brought on the financial crisis? My view is that is has not helped, but it was certainly not the primary cause. And I think we've started to talk about that today. It was a plethora of things. Incentive compensation will not be the solution to the problem, but it is something that we need to fix.

The debate and the—what I'll call "the intervention," by the government in the United States and Europe, that is going on is probably positive, in terms of getting us thinking about this. But, we really have to now move on to where we—it is that we want to go. And that's, I think, the objective.

When we look back in 2008 and '09 at TARP, aside from the special master, there were a number of aspects of TARP that have actually been very positive. We don't spend that much time talking about them. It was TARP that brought up risk assessment for the first time. And if I say one thing that's come out of TARP, in terms of compensation and for companies overall, the word "risk" is heard on everyone's—in everyone's mouth, in every program, in every committee that I go to—every comp committee. This is a real and very sincere effort that is taking place today, that did not exist prior to 19-—to 2008. Didn't exist. Nowhere near where we are today.

Also, the other issues that TARP brought out and required as part of the other TARP participants was a mandatory "say on pay," which is—as you know, is now being required by the SEC for everyone; an end to "golden parachutes," as we knew them, and "gross-ups." These were all practices that we had tried to get away with for a long time, to get companies used to giving them up; and TARP put us in a position to be able to do that. And they've been broadly accepted now by all other companies, and they're now part of the Dodd-Frank bill in the SEC. And so, besides pay, there were a lot of practices and mentality that has changed tremendously in compensation over the last few years that probably doesn't get as much press.

As we go forward, I think the one thing we really should take away from today, and continue to, is that risk is not a fact in companies. All right? It was not front and center, as it ought to have been. It certainly was not front and center in compensation, mostly because companies didn't know how to manage it or what it—how to determine it. They are all wrestling with that. They've done that because of regulation. They will continue to get better at it. There is an integrated process that exists today, between risk management, HR, and finance, in the development of compensation programs, that was never there before. It's very positive. It will continue. Compensation committees are committed to it and required to by the Treasury and the other regulations.

I think, in terms of where we've been, I do not really call the special master's program a pay-for-performance structure. I think it was pay-for-stock. And I think "pay in stock only" is a really frightening concept. As you know, people had millions of dollars of stock; it didn't change anything. I think it's an easy way to think you're paying for performance, but you're not. It's much more complex.

The CHAIRMAN. Could you begin to wrap this up?

Ms. ORENS. Yup. Only one thing.

The CHAIRMAN. Thank you.

Ms. ORENS. I would leave you with one last thought, which is, there is no size-fits-all. An investment bank and a regional bank have very little in common, in their pay programs, risk, or their culture. All right? So, we focus so much on Wall Street, and, as a result, all these other banks—regionals and communities—have to live with the outcomes. And I would ask you to think about—there was a huge difference there in how we do things and how compensation is administered.

[The prepared statement of Ms. Orens follows:]

The Congressional Oversight Panel (COP) Hearing

October 21, 2010

Testimony of: Rose Marie Orens
Senior Partner
Compensation Advisory Partners LLC

Professional Background

I am a senior partner and founder of Compensation Advisory Partners LLC ("CAP"), a boutique consulting firm that specializes in providing independent executive compensation advice to compensation committees of boards of directors of public and private companies. Our clients range from Fortune 50 companies to mid-sized firms operating in a variety of different industries. I have been an executive compensation consultant for more than 25 years. For more than 15 years, I have specialized in working with boards and company management teams in the financial services industry. Recently I have worked closely with several TARP participants and their compensation committees to interpret and apply TARP regulations to "covered employees'" and to manage the companies' overall compensation programs.

Design of compensation structures that attract and retain executives, align with long term success, and discourage excessive risk-taking

The design of effective compensation programs is a multi-faceted process that begins with the company's business strategy and specific goals, identifies the talent necessary to reach these goals and then determines how pay, formalized into an articulated compensation philosophy or set of guiding principles (i.e. pay-for-performance), can be structured to support the desired outcomes.

As part of this process, the competitive universe is defined and reviewed, including an examination of the mix of compensation components -- fixed vs. variable, short-term vs. long-term, and cash vs. equity. Setting and calibrating the level of pay for a commensurate level of performance and selecting the right measures to evaluate short-term and long-term results are critically important steps in the pay design process.

A relatively new, but essential, component of the pay design process involves evaluating the potential for excessive risk-taking. Compensation committees are actively involved in risk assessments. Companies have responded to TARP, SEC, Treasury guidance and current Federal Reserve/regulatory reviews by developing processes that integrate risk management with human resources and finance in incentive compensation design and retrospective reviews. Where the potential for undesirable risktaking or an inappropriate focus on short term results (at the expense of the firm's long term welfare) is identified, corrective measures including mandatory deferrals of compensation, claw backs, adjustment to metrics, etc. - are being introduced.

Most financial services firms emphasize long term performance in their compensation programs for senior executives. The majority of pay for a CEO and other proxy reported executives is based on performance that extends beyond one year. Firms use a variety of vehicles – stock options, restricted stock and long term performance plans-- that contain vesting requirements or performance periods of at least 3-5 years. Properly designed to align sustained long term financial goals with value creation for shareholders, these plans can be effective in rewarding as well as in attracting and retaining talented executives. In addition, most banks have significant stock ownership guidelines and/or share retention requirements that require executives to hold a high proportion of the shares they receive from company plans over their careers.

Special Master's compensation determinations

EESA and Treasury's Interim Rules (TARP Standards for Compensation and Corporate Governance) imposed numerous limitations on TARP recipients and more stringent rules on the seven firms that received "exceptional assistance". The Special Master's role was to evaluate and set pay levels within the limitations and consistent with the principles provided by the Interim Rules. Working within these constraints, the Special Master crafted an approach that could be applied across all seven firms. In summary, the program includes: (a) significantly reduced cash compensation, with salaries generally kept below $500,000 and no cash bonuses permitted; (b) proportionately large grants of "salary stock" – i.e., shares that are vested but restricted from sale for at least two years; and (c) awards of restricted stock, predicated on performance, with a minimum 3-year vesting period. As a practitioner, here are several observations:

- As a result of the limitations in the Interim Rules, only a modest amount (at most 1/3) of each employee's compensation was actually based on performance – the portion that was provided in restricted stock. Existing pay programs would have had a far larger amount conditioned on performance.
- Compensation paid was fixed. Salary and salary stock were paid bi-weekly. The dollar value of the salary stock was set in advance. The number of shares varied based on the stock price at the end of each pay period.
- Having executives who are substantially invested in company stock is an appropriate program objective. Having the right balance between cash and stock, and the appropriate performance objectives for each is critical. Executives at TARP firms were significant shareholders who lost the value of their investments along with those of other shareholders. While delivering compensation in stock reinforces a long term focus, it does not guarantee the existence of a pay-for-performance program or a culture that properly evaluates individual risk-taking.
- Company performance for many financial service firms was abysmal in 2009 and is just beginning to recover now. Compensation committees are well aware of shareholder sentiments

and regulatory scrutiny. In this environment, it is doubtful that the pay-for-performance programs that were in place would have been as generous as what TARP allowed. By their own terms, cash bonuses would have been reduced or non-existent (as many were in 2008) and equity awards would have been apportioned more appropriately

- The Special Master's actions may have supported the public interest and attempted to lower the tension between Wall Street and Main Street, but most companies would not view them as a model for effective incentive compensation.

Impact of TARP restrictions on the ability of firms to recruit and retain

TARP participants and the seven firms receiving "exceptional assistance" were tainted. At the beginning of the financial crisis, their stability was questionable. Would the firms survive? How long would the government's involvement last? What would the organization look like after? This instability affected existing employees, as well as potential new hires. Very quickly, being associated with a TARP firm was a "negative" on an executive's resume.

I have had more direct experience with recruiting issues among TARP participants outside of the Special Master's direct oversight. For these firms, the possibility of recruiting new talent at the highest levels in the firm was viewed as virtually impossible. If they could locate appropriate talent, pursuing candidates and getting approvals was too time consuming. Between the negative impression of TARP banks and the relatively inflexible pay programs, they chose to promote from within or "manage" until they repay their obligations. For companies under the Special Master's oversight, and the other TARP banks the opportunity to discuss special needs was available.

From a retention perspective, initially, alternative positions for TARP executives were not readily available. Now as the market improves and companies emerge from TARP, we will see more turnover and companies will need to rethink how to keep their talent.

Special Master's determinations as a useful model for corporate executive compensation structures in the future

Some aspects of the Special Master's approach and the regulations will serve as a model. The importance of identifying and minimizing 'unnecessary or excessive risk' in the design and evaluation of incentive arrangements will remain a critical design principle for financial firms. This was further confirmed in June when the Federal Reserve, joined by the Office of the Comptroller of the Currency, the Federal Deposit Insurance and the Office of Thrift Supervision, issued its final guidance and the disclosure of risk assessments in proxy statements was extended to all companies with the SEC's endorsement in late 2009.

Other practices that are consistent with the TARP regulations have become synonymous with "good governance" practices for companies outside of TARP and are likely to endure. These practices include the introduction of clawbacks, limitations on perquisites, prohibition of accrual of benefits under supplemental retirement or non-qualified deferred compensation programs, and prohibitions on 'gross-up's on perquisites or severance arrangements. TARP companies were the first companies required to conduct say-on-pay votes that are now mandatory under the Dodd Frank Wall Street Reform and Consumer Protection Act.

Compensation Structures to meet the "Public Interest Standard"

The principles behind the "Public Interest Standard" – mitigation of risk, ensuring pay-for-performance both in make-up and timing, retaining program competitiveness, recognition of individual value to the enterprise, and appropriate balance between elements offered -- are valid objectives. Compensation committees and management are capable of weighing these objectives and they will as part of the regulations. Companies are not "one-size-fits-all'; compensation plans are not "one-size-fits-all." It is critical that programs be structured to reinforce each company's strategic objectives and that Committees be empowered and held responsible for making these decisions.

The "exceptional assistance recipients", given the public's high level of investment and appropriate concern over potential repayment, required additional oversight. If overall compensation and current cash was the area of greatest concern and political consternation, negotiated reductions in the aggregate levels of cash and total compensation, related to performance, would have been more effective. Selecting the '20 highest' paid executives (plus the NEOs) and imposing a program that fundamentally guarantees a minimum level of compensation is not pay-for-performance.

Compensation Structures for distressed companies or a 'turnaround' situation

Attracting a management team to a turnaround or distressed company utilizes the same elements of compensation as healthy companies with some tailoring of its features depending upon the severity of the company's condition. A company in crisis with little time to generate results, would structure its programs differently from one that may have severe problems but a reasonable period of time to demonstrate progress. The elements of pay and emphasis placed on them, operating as a business tool, would reflect these realities. For example, the compensation structure for a company with little time would rely heavily on annual incentives (payable in cash/stock) to support the often very short-term objectives necessary to survive. Although long term incentives, performance based and payable in stock, would be part of the program, when survival is that questionable, it is unlikely to be the primary focus of the program. If recovery is less questionable, but a matter of strategy, economic conditions and the right leadership, a more balanced program with greater focus on long term incentives would be appropriate. The vesting schedule for the equity, the magnitude of the award, etc. would be tailored to the appropriate time frames and competitive market. The board would also have to determine if any

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employment contracts were necessary and the related provisions. Attracting executives to a turnaround situation requires a careful calibration of the risk/reward aspects of the compensation program. Initially pay may be low(er) with considerably more opportunity placed on the long term and the 'upside'. It is important to ensure that the program cannot enrich executives if their efforts end in failure. If the team is successful, the pay-off should be significant but aligned with the value created for shareholders.

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The CHAIRMAN. Great. Thank you.

Mr. White, would you comment? In your experience now, recently, has risk become more and more important, in terms of executive compensation? Have you noticed a difference?

Mr. WHITE. I completely agree with that. I think one of the—probably the most significant lasting impact from TARP and the special master's work is in the area of risk and the recognition of the interaction of risk and executive comp. I would say, though, that I think the work is somewhat in its infancy, and there's greater emphasis right now on what I would call "micro risks" within the company, and less emphasis on "macro risks."

The CHAIRMAN. Thank you.

Can I—I'd like each of the panel—we'll start at the other end, Ms. Orens, with you, and—how do you think the special master did? Did he do a good job, an appropriate approach of balancing fairness and competitiveness?

Ms. ORENS. I think that the special master had a thankless job. [Laughter.]

It's extremely difficult. I can only imagine what it—how difficult it was, when you looked at the variety of companies and the situation. I think that he did implement the program, as it was put in place——

The CHAIRMAN. Okay.

Ms. ORENS [continuing]. With little choice. But, I don't think it's a model for the future.

The CHAIRMAN. Mr. White.

Mr. WHITE. I have a tremendous amount of sympathy for the role; I think, incredibly difficult, under the circumstances. There's a number of areas where I would give the work of the special master positive marks. I do think there's some nuances to particularly what I'd reference as "term structure" within the industry, which, frankly, was, to my knowledge, not addressed, as well as some of the underlying drivers in performance metrics, where I think there was probably an opportunity to bring those things out, debate those with the companies, and maybe set some structures that were more appropriate for long-term performance.

The CHAIRMAN. Professor Tung.

Mr. TUNG. I have a tremendous amount of respect for Ken Feinberg and the work that he's done with TARP and some of his other activities. I think that the salary-stock approach was a useful way to generate a longer-term perspective than what came before. I think there are other approaches that could do that as well. I think it's a hard task.

We don't know, really, very well how to limit risk through executive comp. As Kevin Murphy's memo points out, for 20 years we've been trying to get executives to take more risk, because we thought that—remember, back in the '90s, companies were big, they were run like bureaucracies; we wanted to incentivize them to be leaner and meaner, and came up with this, you know, performance-based pay. And now we're essentially trying to do the opposite, trying to figure out how to sort of cabin the beast. And I think it's a tricky task.

The CHAIRMAN. Professor Murphy.

Mr. MURPHY. Yeah. Now, as Mr. Feinberg himself recognized, he had a very limited set of tools available to him. And so, what he was doing, at most, was constrained by—he had base salaries to work with, he had restricted—some amounts of restricted stock to work with, and then this new construct of salarized stock to work with. What—within those concepts, I was disappointed that he didn't take more of a taxpayer perspective. In other words, how do we maximize taxpayer return, how do we protect taxpayers, or maximize shareholder return while protecting taxpayers? I don't think that protecting taxpayers meant punishing executives by lowering the competitive compensation. I would have liked—I'd like to see large potentials for upside gain, large potentials for downside losses, and relatively small base compensation. And I don't really quarrel with Mr. Feinberg in the structure of pay that he established.

The CHAIRMAN. Good.

Mr. McWatters.

Mr. MCWATTERS. Thank you.

I'd like for each of you to respond to a question that I asked in my opening statement. And I'll go ahead and read the question again: How does a TARP recipient—a too-big-to-fail TARP recipient, let's specify that—such as Citi, Bank of America, Goldman, or AIG—structure a compensation program so as to identify and minimize unnecessary and excessive risktaking while encouraging managers to assume sufficient risk so as to ensure the long-term profitability of the enterprise?

We'll start with Professor Murphy.

Mr. MURPHY. Unnecessary and excessive risks are always something that's easy to detect in hindsight, but something that is very hard to identify ex ante. And I share your concern that the implicit too-big-to-fail guarantee is certainly the cause of a lot of concern, much more concern than direct investment—government investments into companies where we actually can measure what the return are—is on those investments. The—then I believe that the best way—the best way to encourage executives to not take unnecessary and excessive risks is to make sure that their longrun wealth is tied to the longrun prospects at the firm, which is not only the shareholder wealth, but also penalizes them highly if they rely on the government for assistance.

Mr. MCWATTERS. But, wasn't that true with respect to Merrill, Lehman, and Bear a few years ago? Didn't they have long-term compensation packages?

Mr. MURPHY. I——

Mr. MCWATTERS. And they were wiped out. So, I mean, there was a—there was an implicit clawback there. They gave the money back.

Mr. MURPHY. They—we can look, in retrospect, and—when we uncover all the causes of the financial crisis, I suspect that we'll find that compensation played some role, but a fairly minor role compared to housing policy, monetary policy. And clearly, these executives were punished by—for their actions.

Mr. MCWATTERS. Okay. And so, it sounds like it's just difficult to do this, difficult to look into a crystal ball and figure out what the—what is excessive and unnecessary risktaking today.

Mr. MURPHY. Absolutely. It's easy after the fact, when something happens and we can say, "Hey, that looks like an unnecessary risk." I think, if you go back 3 years ago, no one thought Mr. Mozilo, at Countrywide, was taking unnecessary risks; we were celebrating the fact that he was getting—helping to get so many people into housing that could have not afforded it before.

Mr. MCWATTERS. Absolutely.

Professor Tung.

Mr. TUNG. I—sir, let me go back to my earlier suggestions. I think, number one, we have to look at portfolio incentives. Number two, to the extent that we can pay executives, at least in part, with, for example, debt securities issued by their own firms—debt securities are more sensitive to risk than equity—that may be a way to make executives at too-big-to-fail firms a little more concerned about risk—gives them a little bit more skin in the game, because the bond—the market pricing of the bonds would, to some extent, reflect risktaking by the company.

Now, having thrown out those two ideas, I do think the devil's in the details. We don't know how much debt is the right amount. We don't know what the right proportion is. The research on inside-debt incentives is relatively new. Conceptually it seems to make sense. But, I think, whatever we do, it's going to involve a lot of tinkering, and we should be cognizant of the fact that we're really going down a road of experimentation, to some extent.

Mr. MCWATTERS. Okay, well, taking some debt as compensation, does that make the executive overly conservative? And is that in the best interest of the equityholders, who may want the executive to take more entrepreneurial risk?

Mr. TUNG. That's exactly the problem. Sir, the question, "Will the executive be too risk-averse?" really depends on the proportion of debt-to-equity compensation. Certainly, shareholders would be less excited about executives taking debt, because their interest is in the stock price. To the extent that we have government subsidy of the risks that financial institutions are taking, it seems to me that it's not just the stockholders' return we're concerned about. We're concerned about preserving the deposit insurance fund. We're concerned about the costs of too-big-to-fail and other sorts of implicit government subsidies.

Mr. MCWATTERS. Okay, thank you.

My time's up. We'll continue next time.

The CHAIRMAN. Mr. Silvers.

Mr. SILVERS. Professor Tung, I—in a way, Mr. McWatters took my question, and your answer, away from me, but I want to push you a little further on it. Do you think that, in relationship to your ideas, that there is a difference between, say, the stress-test institutions, which we should use as perhaps a proxy for too-big-to-fail, and, say, the typical bank that's subject to FDIC insurance?

Mr. TUNG. Do I think there's a difference in what——

Mr. SILVERS. In terms of the suitability or the need for your type of compensation.

Mr. TUNG. Okay. So, right—by the way, I have to say to Mr. Silvers, I was gratified that you knew what was in my paper. And we don't get many—we don't get high subscription volume for the academic papers we write, so I'm grateful.

Mr. SILVERS. Thank the staff. [Laughter.]

Mr. TUNG. Thank you.

So, I do think one important facet of sub-debt compensation, you have to worry about the depth of the market in the securities that you're using as compensation, because if the market is in a deep one, where you don't have a lot of analysts following a lot of institutions involved with it, you can't be as confident that the market price is going to reflect risktaking, because there's not enough folks paying attention to that particular institution. The smaller the banks get, the less volume you have in their debt trading, the more that's going to be a problem.

Mr. SILVERS. Now, you heard, I assume, my exchange with Mr. Feinberg about the sort unique circumstances of a implicit—or, in certain respects, explicit—guarantees, and the position of the government as both holder of preferred stock and guarantor of the balance sheet. What are your reflections on that circumstance, which is really, in a sense, what we're about here?

Mr. TUNG. You mean, how do we fix that?

Mr. SILVERS. No. I'm not going to task you with that. I'm interested in the—so, the government is in that position, as we continue to be at AIG, at Citigroup, perhaps at all of them—perhaps at all of the stress-test institutions, we continue to be in that position. What's the appropriate public policy, in relation to pay, at institutions that—where the government has that combination of interests?

Mr. TUNG. Well, I guess, one of the things—I mean, it seems to me that, because of the large taxpayer investment in those institutions, we want to worry about getting the taxpayers' money out. At the same time, we're worried about the safety and the soundness of those——

Mr. SILVERS. Yes, we do—there's been a lot of talk about how much we want that money back. Do we want the money back at the expense of destabilizing those institutions?

Mr. TUNG. Absolutely not. No.

Mr. SILVERS. All right.

Mr. TUNG. We don't want them to lever up to buy off the taxpayer. I mean, it's——

Mr. SILVERS. Right.

Mr. TUNG. And I think the point's been made that, to the extent we make the compensation constraints too onerous, that provides incentive for those companies to try to get out from under—they don't want the government being an investor if the government is——

Mr. SILVERS. Although, that's only true if we let them——

Mr. TUNG. Right.

Mr. SILVERS [continuing]. Right? Isn't—that's only true if Treasury or the regulators allow them to lever up recklessly. Professor Tung, if you don't mind, my—I want to stop you there.

Mr. White, you talked about, essentially, I think, an issue you had about the construction of time horizons in the work of Mr. Feinberg. Can you expound on that?

Mr. WHITE. Yeah, sure. The point that I would make is that one of the things that we examine very closely when looking at executive comp across any industry, and certainly applies here, is whether or not the incentives that are inherent in the compensation plan are consistent with the cycle that the industry finds itself in, with its opportunities, its challenges. It is very circumstantial, and I agree with all the comments from the panelists, including earlier, that it is a case by case scenario.

In the situation with the financials, I think the disconnect is probably larger than most other industries, in that I believe that the cycle that they operate in is multiyear—right?—and it—and they're, effectively, leverage plays on the economy. But, their comp programs are heavily weighted towards annual performance. I think there is a very significant macro risk, encompassed in that disconnect, that simply wasn't addressed. Right? The—some of the micro risk with whether or not, you know, they understand a VAR model or—there are some things that are very programmatic, I think are—they're coming up the scale very fast. But, at the same time, I think we're missing what is an elephant in the room.

And the potential implications, in my mind, are this, that an industry that is so short-term-oriented may overcompensate for risk, wherever it happens to be on that slope. If my vision is only a year long and we're on a downward slope, I'm going to manage with that in mind; same on the upward slope. And I think that probably has the potential to make them overemphasize behaviors in each one of those aspects of the term.

Did I cover it—does that——

Mr. SILVERS. Yes. And, my time is expired. You've covered it admirably.

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you.

I thought the point that Professor Tung made is an important one to remember. I do recall being in graduate school and hearing and seeing papers by Professor Michael Jensen and George Baker, and then a very young Professor Murphy at the time, telling us about the fact that executive pay was not closely enough tied to the risk of the company. And I think it's had a major influence.

Professor Murphy, first I'd like say I agree with your claim in your report that one of the primary effects of the special pay master was to push firms to pay back their TARP funds very quickly. I guess I consider that a pretty big success of the program. I think he indicated he did, as well. Do you agree? Do you—couldn't we view the work of, sort of, the special pay master as a way to sort of push firms, to punish them, in some sense, for taking this money, and maybe that was a good outcome?

Mr. MURPHY. I believe it's a good outcome, although I share the potential concern, by Mr. Tung and Mr. Silvers, that, to the extent the companies borrowed money from the private sector in order to escape those regulations, they haven't really escaped the problem, but they've certainly gotten off the taxpayers' dime. I think that was very beneficial.

But, when we're talking more broadly about regulating pay, this was a case where regulating only a couple firms and—who could escape the regulations by taking particular actions. If we regulate more broadly, we won't have that opportunity.

Dr. TROSKE. So, let me ask you—I'm sort of—I'm going to put you on the spot a little. There's a proposal—I think it's—as my opening statement indicated, I think one of the problems that—inherent in all of this is just the fact that firms are insured against failure; they're too big to fail. There's been a proposal floated by the Narayana Kocherlakota, the president of the Minneapolis Federal—the Federal Reserve Bank of Minneapolis, to essentially float bonds against these companies. So, there's a Goldman Sachs bond that pays off if the government has to—had to step in and bail out the firm. And then, simply, the price of that bond will be what we charge Goldman Sachs for the insurance that we're providing them. Presumably, the price will reflect the riskiness that the executives and the firm are engaging in, both investment decisions and executive—and their compensation. And once firms are forced to pay for this insurance, then they make the appropriate decisions.

I know I'm putting you on the spot a little. I don't know whether you've seen Narayana's—or——

Mr. MURPHY. I think it's——

Dr. TROSKE [continuing]. His plan.

Mr. MURPHY. I think it's an intriguing idea. I think that then AIG will create some synthetic CDOs that are associated with these bonds, then we'll see what—we'll see how that works out. The—there—it has always—it's just going to be a fact of life that we can reward executives on the upside all day long, but we're never going to be able to penalize executives efficiently for huge downside occurrences, whether they're buying insurance or not. We're—we can't—we're never going to be able to punish them sufficiently for huge downside occurrences to eliminate this problem.

Dr. TROSKE. Professor Tung, I'd like your thoughts on that, because it seems like Dr. Kocherlakota's plan seems, certainly, related to yours; it's an alternative way of getting to the same outcome. You want to provide these executives—force them to hold debt. Dr. Kocherlakota wants them to just sort of pay for the insurance. Either way, they have to—that cost becomes part of something they have to take into account. What are your thoughts?

Mr. TUNG. I mean, it sounds plausible. You know, I'd want to read the paper. I guess you'd have to find some private institution or group of institutions to take the—essentially, the failure risk of Goldman Sachs or whatever entity you're trying to insure. And then, of course, you're essentially putting—shifting the credit risk to those institutions that are selling the insurance, which is—basically, we're back to CDS and CDOs. Right? So, it's just sort of more bets—more side bets on the solvency of a particular institution.

Dr. TROSKE. Okay, thank you.

My time's up.

The CHAIRMAN. Mr. Neiman.

Mr. NEIMAN. Thank you.

You know, we're talking about using bonuses and long-term awards to reward performance and discourage excessive risktaking. I'm intrigued by Professor Tung's use of sub-debt. Mr. White was—I think, also referenced that a return on equity is not a risk-adjusted measure and misses an opportunity. But, both of those are corporatewide and—or are at least bankwide measurements, and may not necessarily reflect the risk taken by an individual business unit or executive. So, two executives, both generating $1 million in revenue, or even earnings, may have very different risk profiles.

And, in a bonus award program, issuing the same bonus to both really misses the boat.

I'd be interested in some of your reaction as to what are the appropriate metrics to use to distinguish and change behavior under those regimes.

Ms. Oren's just nodding, so it seems like——

Ms. ORENS. Well, I do this for a living, so I can certainly opine on it. What is going on in a—on a broad scale in most financial institutions, both the large ones and the regionals, is an assessment of where their risk is, where is their greatest level of risk within their organization. And you can start with the credit risk, but they also look beyond that. There is credit, market, operational—there's, obviously, the whole area—there's a variety of risks that we wouldn't relate to the kind of problems we've had, but are still certainly within that risk umbrella and need to be considered. And if you start with the theory that you're—you can begin to allocate capital to businesses, which they are trying to do, and can now look at each of those—major business units and ultimately the lower—the smaller ones, and assess where the greatest risk is, then you can begin to really charge the costs of capital, you can calculate the risk-weighted assets——

Mr. NEIMAN. Right.

Ms. ORENS [continuing]. And you can assess that as part—that has become, in a sense, a metric.

So, two businesses that may each bring in $20 million, on the bottom line, one that takes a lot of capital and is risky beside—taking capital alone, is not a negative, it—you'll get charged for it, but if, on top of it, this is viewed to be a particularly risky but appropriate business for the company—that's already been decided—then you're charged even more—versus the other business.

And then, secondarily, to, I think, this gentleman's point is where you say, "What's the time horizon, then? If this is such a risky type of business to us, how do we pay this?" And we don't have to pay it the same as we do another business unit.

Mr. NEIMAN. And then, is this where, whether you're using clawbacks or longer-term vesting periods comes into effect to change——

Ms. ORENS. Absolutely. The clawback is actually being put in, across the board, because you don't know where that issue is going to arise. And you want to—you don't want people to feel, "Well, in this business unit, I'd have to have a clawback; in another one, I wouldn't." So, they're really being very broadly put into programs.

But, absolutely, the time horizon, the balance of cash and other forms of compensation, even though it might be cash, but it's longer-term in nature, is being determined, if you will, business by business.

Mr. NEIMAN. I'd like to——

Thank you.

I'd like to give any other witnesses a chance to comment on that, as well.

Mr. MURPHY. I agree that there's going to be two ways to charge executives for the risk, and one is up front, with how we measure their performance, whether we adjust that performance for risk. And I have—certainly endorse what Ms. Orens says. More generally, though, we need to hold—to the extent possible, we need to hold executives and employees accountable for the downside, as well as the upside.

Ms. ORENS. Uh-huh.

Mr. NEIMAN. Great. Thank you very much.

The CHAIRMAN. I'd like to go through each panel member, starting Ms. Orens, and—one of the objectives of the special master was to have some impact on executive compensation down the road. Do you think there's been a long-term effect of what the special master's done?

Ms. ORENS. I think there is an effect from what TARP and all the government intervention and the public outcry has been. I think that's been actually enormous. I think that's been a huge impact on compensation committees, on management understanding the level of scrutiny, and in the fact that the Treasury, clearly, and now the regulators, as they've gone around to the horizontal reviews, how serious and, you know, different the environment is than it used to be.

So, if you say that, "Yes, there was lots of press and people understand all that," and whatever, I think the aspect that has really gotten more important is the issue of, really, governance. You know, there's just a whole lot more attention to, and there's a whole different way of looking at compensation than I think there was prior to the crisis. And that's——

The CHAIRMAN. So, you——

Ms. ORENS. A positive.

The CHAIRMAN [continuing]. Do you think it's actually affected executive compensation?

Ms. ORENS. I'm sorry?

The CHAIRMAN. Do you think it's actually affected executive compensation?

Ms. ORENS. I think it has, today. I have the same concern that Mr. Feinberg offered, which is: Can we stay the course. I—let's not just start this process, let's keep at it. I'd like to believe we will, because of—back to the question of enforcement. We need the regulations. We need them interpreted and implemented appropriately. You know—there's a lot of education that needs to occur on that side, if you will. I can't take an examiner seriously who doesn't know anything about compensation and tells me the same three things they've told every bank. So, it's going to take a while, but I think there's an enormous willingness today to say, "Look, you know, we get it. We want to do the right thing. We understand what happened." You know, we've all been extremely hurt by it——

The CHAIRMAN. Right.

Ms. ORENS [continuing]. Both, you know, the public as well as the employees. And right now, it resonates; it resonates broadly.

The CHAIRMAN. Great, thank you.

Mr. White.

Mr. WHITE. I think the area with the most long-lasting impact is likely to be in the sensitivity to risk. And I think that's a very positive thing. I think the second most significant implications will be in areas around the periphery of contractual arrangements, severance change in control, some of those. I suspect those will be longer-lasting. I'm anticipating some companies will unwind some of the restrictions that have been placed there.

And then, I think the work will also be somewhat foundational for how the Fed, in particular, picks up its oversight role; hopefully, with nuances toward the things that we're bringing out today, which are actual drivers of performance, in terms of structures and things like that. I would agree with Dr. Murphy, that just outright restrictions on incentive are ultimately not going to be that—you know, from an equityholder's perspective that's a tool that we need.

The CHAIRMAN. Got it.

Professor Tung.

Mr. TUNG. I agree with the comments of the other two panelists. Certainly, the process of crafting TARP, the process of crafting ESA and then ARRA and then the Fed guidelines, have all focused public, congressional, executive regulatory attention toward the role of executive compensation in financial institutions. And that, I suspect, would be long-lasting. How it plays out, in terms of actual behavior of corporate boards and executives, I think there's going to be a—you know, an interaction between regulators and the regulated that will be interesting as it unfolds.

The CHAIRMAN. Great.

Professor Murphy.

Mr. MURPHY. I think we can connect the dots directly from TARP to the Dodd-Frank Wall Street Reform Act. And that Act included in it the most sweeping reforms of executive compensation applicable to all firms, not just financial institutions, in U.S. history. That is going to have implications for executive compensation for decades to come.

The CHAIRMAN. Thank you.

Mr. McWatters.

Mr. MCWATTERS. Thank you.

Ms. Orens, I read your opening statement. And I want to read a sentence to you and see what your response is.

You say, on page 2, that, "While delivering compensation in stock reinforces long-term focus"—okay?—"it does not guarantee the existence of pay-for-performance programs or a culture that properly evaluates individual risktaking."

Ms. ORENS. Uh-huh.

Mr. MCWATTERS. Well, this just sort of blows a lot of stuff out of the water. So, what do you mean?

Ms. ORENS. Be happy to answer that. I think this goes back to some of the comments that were made by Mr. Feinberg. Stock is an important vehicle in executive compensation. It's a very important vehicle. But, when we think about stock that's just given to you as restricted stock—all right?—which has been the TARP type of stock or the deferred stock—we call it all-you-have-to-do-is-breathe stock. All right? I stay employed, I get this. I thought we didn't want guarantees. It's a guarantee. The risk is, the stock might go up and stock might go down, but I still have a great chance of getting something.

On the other hand, we dislike options intensely, because, we say, "Oh, they create risk. They create people who want to just, you know, blow through and get all these huge numbers." Well, at least they don't pay unless there's some performance above a certain level. So, that's a contrast there, between performance and not performance, to me.

If you go back to the point of—to me, the company develops the culture of risk, or it doesn't. From everything I've seen, there are companies who, at their heart, were willing to take enormous risk. How much they were taking, they didn't even know. Go back from 2005. All right? It's——

Mr. MCWATTERS. Okay.

Ms. ORENS. They——

Mr. MCWATTERS. Okay. That's helpful.

Ms. ORENS. Yeah.

Mr. MCWATTERS. What if an employee, one employee, runs a division, and that division does very well, that employee makes a ton of money for the company, but the company, overall, does poorly. What happens to that employee?

Ms. ORENS. Mr. McWatters, that's actually a philosophic question that, as a designer of programs, you start with the committee—compensation committee—and you say, "What kind of program do you want to have?" In true pay-for-performance—I'll take away the risk of this individual and all that, for the moment—but, if I even had a salesperson who was extraordinary sales performance in this year, and the rest of us are not getting bonuses, do you want to pay, or don't you? That's part of your philosophy and design. People might very readily say, "No, you're a part of the team. We will not structure compensation that way. That's the way it is. Salesperson, join the company, don't join the company. You know the facts."

Mr. MCWATTERS. Okay. Okay. But, if that made the media, the employee that walked away with the big bonus even though the company is doing poorly might not be well received.

Ms. ORENS. But, I would say to them, "Are you willing"——

Mr. MCWATTERS. Sure. I——

Ms. ORENS [continuing]. "To have that published?"

Mr. MCWATTERS. Absolutely.

Ms. ORENS. That's how you have to answer it.

Mr. MCWATTERS. Professor Murphy, also reading from your opening statement, on page 2, you say, "It is my opinion that the TARP pay restrictions were ultimately destructive and designed to meet political objectives rather than their legitimate purpose of protecting U.S. taxpayers." That's very interesting to me. What do you have to say?

Mr. MURPHY. Now, remember, when I'm talking about the TARP restrictions there, I'm talking about the TARP restrictions actually in the February 2009 bill——

Mr. MCWATTERS. Yes.

Mr. MURPHY [continuing]. Which, of course, were changed in the——

Mr. MCWATTERS. Yes.

Mr. MURPHY [continuing]. Treasury restrictions. The elimination, the exclusion, of any kind of bonuses, stock options, signing bonuses, severance bonuses, any kind of incentive pay, except for modest amounts of restricted stock, coupled with no restrictions on the level of base salaries, would run counter to virtually any concept of best practices in compensation design.

Mr. MCWATTERS. And it sounds like we've moved away from that.

Mr. MURPHY. Excuse me?

Mr. MCWATTERS. Sounds like we have moved away from that.

Mr. MURPHY. That if—well, we heard the special master talk about his own vision for pay. It was the opposite. It—his vision of pay was low base salaries coupled with high longrun pay for performance.

Mr. MCWATTERS. Okay. Thank you.

The CHAIRMAN. Mr. Silvers.

Mr. SILVERS. Okay. Professor Murphy, you say that—and you just said that—you said you thought that pay ought to be more aligned with common equity through—and should have been in the amendment to the TARP statute. Did I hear you right?

Mr. MURPHY. I believe the pay should be aligned with the longrun value of the firm, which is not equivalent to the common equity.

Mr. SILVERS. Well, you just talked about options as something that you thought should've—there should've been an ability there to award more stock options.

Mr. MURPHY. I included, in the arsenal of tools, the compensation practitioners use, includes stock options, restricted stocks, salarized stock——

Mr. SILVERS. Okay, stop.

Mr. MURPHY [continuing]. Performance bonus plans——

Mr. SILVERS. Stop. What instrument did the Federal Government hold in the firms at issue at the time that that statute was passed?

Mr. MURPHY. The Federal Government held preferred stock and warrants.

Mr. SILVERS. All right. And, the preferred stock was the dominant instrument, was it not?

Mr. MURPHY. The——

Mr. SILVERS. Economically dominant. I mean, I refer to our February 2009 report, where, in general, the warrants were a small fraction of the value of the preferred, were they not?

Mr. MURPHY. That's correct.

Mr. SILVERS. All right. And was the government not, effectively, the guarantor of these firms?

Mr. MURPHY. That is—well, that's correct.

Mr. SILVERS. All right. So, in what sense was the government's interest the same interest as the same common stockholder's?

Mr. MURPHY. I was not insinuating what they were.

Mr. SILVERS. Okay. Now——

Mr. MURPHY. If you read my report——

Mr. SILVERS. Now that——

Mr. MURPHY [continuing]. I——

Mr. SILVERS. No, but—stop.

Mr. MURPHY. Okay.

Mr. SILVERS. What was the public interest in this circumstance? Was it to maximize the financial payout, risk—on a risk-adjusted basis—to the public of its investment in these firms? Is that an adequate description of the public interest?

Mr. MURPHY. Yes.

Mr. SILVERS. Yes, it is.

Mr. MURPHY. In general terms, yes.

Mr. SILVERS. All right. So then, are you aware of this committee's February 2009 report finding that we underpaid, by 30 percent, roughly, for the securities we purchased, in the capital purchase program, from the nine major banks and AIG?

Mr. MURPHY. Not the details, but, yes, the finding.

Mr. SILVERS. All right. So, would you agree that we started off on the wrong foot by doing that, that we should have taken 100 percent?

Mr. MURPHY. It's beyond the scope of my testimony.

Mr. SILVERS. Well, doesn't it flow logically, from your proposition, that it's all about that narrow interest? How can it be that we should be structuring executive pay to achieve this narrow financial interest? And we start off, essentially, throwing that financial interest to the wind and acting in a manner precisely contrary to the way that any financial actor would act in this circumstance. Why does one not flow completely from the other?

Mr. MURPHY. Taxpayers had a legitimate interest in the compensation policies to protect their interest and to maximize the return on their interest.

Mr. SILVERS. So—but, not in the interest to get full value for their money when they made the investment?

Mr. MURPHY. They should have received full value for the money when they made the investment.

Mr. SILVERS Okay, good.

Now, here's my second question. You said, earlier in your testimony, that you thought folks had been punished—what was my quote? You said, you thought that the executives involved in these firms have been adequately punished or severe—I forget the quote exactly. I'm trying to find my notes. "Clearly, they were punished for their actions," that's a quote from your earlier testimony.

Mr. MURPHY. The——

Mr. SILVERS. Am I quoting you correctly?

Mr. MURPHY. Yes, that was in——

Mr. SILVERS. Okay.

Mr. MURPHY [continuing]. Regard to the people——

Mr. SILVERS. Do you know——

Mr. MURPHY [continuing]. At Bear——

Mr. SILVERS. Do you know—well, you—you made a broad statement. Let's take Bear Stearns. To your knowledge, is any executive of Bear Stearns homeless today as we sit here?

Mr. MURPHY. Not to my knowledge.

Mr. SILVERS. Is any executive of Bear Stearns drawing unemployment?

Mr. MURPHY. Not to my knowledge.

Mr. SILVERS. Is any executive of—has any executive of Bear Stearns had to take their children out of college——

Mr. MURPHY. Not to my——

Mr. SILVERS [continuing]. And put them to work——

Mr. MURPHY [continuing]. Knowledge.

Mr. SILVERS [continuing]. To support their family?

Mr. MURPHY. Not to my knowledge.

Mr. SILVERS. Has any executive of Bear Stearns lost their healthcare and had to go to an emergency room to get it?

Mr. MURPHY. Not to my knowledge.

Mr. SILVERS. All right. Has any executive of Bear Stearns had to—has any executive of Bear Stearns suffered in any respect, comparably, to that of the millions of Americans whose lives they destroyed?

[Pause.]

My time is expired.

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you.

Ms. Orens, I guess I'll ask you a similar question that I asked Mr. Feinberg. You've worked with these TARP companies. Do you think they, in essence, scrambled to get out from under his purview by—because they were concerned about the impact that he was going to have on their pay?

Ms. ORENS. I think it's more—a little bit more complex, Dr. Troske. From the moment that anyone became a TARP participant—and I think this was part of that unknown aspect of TARP and—you know, it was one thing in October, and it changed a bit later—you became a tainted company. Companies felt that they were just being looked at as if they were, you know, severely at a disadvantage and in terrible shape, when some of them thought that they'd actually taken the money and been patriotic. So, you had a number of companies who really felt like, you know, they were tainted. It wasn't even the—the compensation just exacerbated it, but they felt—TARP became just very negative. Their—you know, their share price, everything was affected. And so, I think they acted, those that went, about July—a number of them paid back, in the first big group. They did it for both reasons. But, I will tell you, they did it more for the taint than they did it for the comp, initially.

Dr. TROSKE. Thank you.

I want to ask a question. So, recent article in the New Yorker magazine claims that capital had become accustomed to saying yes to talent, even in cases where talent does not end up being all that talented. I guess the implication seems to be that executives are overpaid and they're not worth what they're—the value that they bring is less than the compensation that they've received. Is that your opinion? Do you think that there's any evidence——

Ms. ORENS. I think they're——

Dr. TROSKE [continuing]. That suggests that?

Ms. ORENS [continuing]. Just like athletes and actors and actresses, some points people are definitely not worth the money that they've been paid, but they've convinced someone or have been good enough for a long enough period of time. I think, unfortunately, companies don't do a good enough job of determining that people are really worth their contribution, not just on a market basis, but that if I'm going to pay somebody several million dollars, they're really—they really are very good. I don't think they do a good job.

Dr. TROSKE. Mr. White, I like to—your response to that.

Mr. WHITE. It's an excellent question. I agree there's—that it is a complicated issue in determining the value in—from an investor standpoint, I think the problem is, is that companies don't view that with a return-on-investment type of perspective. And it comes up in a number of facets of our discussion with them; for example, when they ask the market for equity. When they come for approval for equity, their question is always raised in, "What's your limit?" In other words, "How much can we get? What's—how much dilution will you allow?" instead of, "This is the amount of investment we need to make in the management team, and this is the return we expect on it, and this is how we're going to measure it over time, and adjust, if our approach to this is incorrect." So, I think that the philosophy of how they pay doesn't lend itself well to making that evaluation.

Dr. TROSKE. Okay. Let me ask you another question. We talked a little bit about "say on pay." Mr. White, from investors—is that something meaningful? I mean, a nonbinding vote—is that—do you think that that's—has any impact?

Mr. WHITE. I think it has tremendous potential to bring equityowners—long-term equityowners more into the discussion and more into a role of oversight. If there's anything that, you know, I would have to say is—been missing in the issue of executive compensation, is a greater scrutiny from long-term owners. Right? We care about the issue, but we simply haven't done enough. And I think that is one vehicle that will facilitate that.

Dr. TROSKE. Thank you.

The CHAIRMAN. Superintendent Neiman.

Mr. NEIMAN. Thank you.

Most of the focus and discussion so far has been on the compensation of sales and revenue generators within our large firms. But, what about the risk-and-control functions? And, while I've seen instances of senior risk and credit folks being attracted away with big comp packages, overall I think the surveys will show that they are compensated at significantly less levels. There's a recent IIF, Institute International Finance, study out on compensation in wholesale institutions. So, I'm interested in—on your views on both the level of compensation and the incentives—and really, it does relate to the independence, as well—with respect to risk and control and compliance folks.

Who'd like to start?

Ms. ORENS. I'll be happy to start.

Mr. NEIMAN. Go ahead. Ms. Orens.

Ms. ORENS. It's an excellent point, Mr. Neiman, another area we would look to what went wrong, historically. It's—particularly within the Wall-Street-type firms, I think, as you well know, risk management was not a particularly attractive function, and you tended to report within the business unit, which meant that you really weren't going to criticize, to a large degree, what was going on. And maybe you had a dotted-line relationship to the head of risk on a corporate basis. And now that's all changed.

Mr. NEIMAN. And are there incentive programs out there for risk?

Ms. ORENS. Yes. You—it's part of, obviously, the Treasury regulations, as well, to determine how best to do that. But, they are no longer compensated within their line of business, nor—typically would those leaders—have final say about how they've done their role. The determination will be done by the head of risk. It will normally be a more corporate-style payout—you know, less short-term, more long-terms; actually, an attractive salary, because it's a very professional-type position. It's being compensated, as it should be, to the type of perspective that person needs to have.

Mr. NEIMAN. I want to shift onto some international global competitiveness issues. You know, there are a number of areas where the U.S. has been a first mover on many issues in regulatory reform. But, I'm interested in the impact. And you hear the feedback. If we are the first mover in areas of compensation, what impact will that have on where individuals—will they shift to jurisdictions with less constrictive compensation schedules? You know, we heard Mr. Feinberg say that, despite the rules he put into place, 85 percent were still there after that—a year after. Any thoughts on these issues—the international issues? Should there be anything restraining the U.S. from proceeding with a stringent regime?

Mr. MURPHY. I'll start, if I may.

Mr. NEIMAN. Mr. Murphy.

Mr. MURPHY. This is—the United States is still the place you want to be if you're an executive, even given the current restrictions. If we look at what's going on in Europe in the financial institutions, they have adopted more of a rule-based system and not a principles-based approach. They're—I think, will be much more restrictive, in years to come, than anything I anticipate out of the United States.

Ms. ORENS. Yeah. I think we're having pressure, obviously, from Europe to adopt similar-type programs. And, the U.K. is currently, kind of, in between, also. They don't totally want to go the full route of the European Parliament.

Mr. NEIMAN. Then my—I think—my recollection, after London bank tax, is that what they feared was a big shift. There—it—I don't think there was a—any major impact on movement of employees outside of——

Ms. ORENS. It was a 1-year event. You have to watch it about 1-year events. If there's sustained view that the U.K. doesn't want to have people there, U.S. companies will—you know, their employees will say, "I don't want to go to the U.K. if I'm going to be subject to those types of restrictions." So, I think coordination is important. And I—but, I do think that the U.S. should keep to a more principled—even if there's some clear—you know, clearly some guidelines, but principles rather than fiats. And the Europeans now are just saying, "They'll pay X in cash, X in stock, some of it will be contingent, et cetera." And, again, it's a one-size-fits-all approach, assuming everybody in the world is exactly the same kind of company, and they're not.

Mr. NEIMAN. Thank you.

Ms. ORENS. And I think it makes us uncompetitive, which is a problem right now. I don't think we want to lose those jobs.

Mr. NEIMAN. Thank you.

The CHAIRMAN. I want to thank the panelists for doing a great job. I want to thank you for coming. I want to thank you for what you had to say.

And, with that, the hearing is adjourned.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]