Written Testimony Submitted by
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Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee, thank you very much for inviting me to testify today.[1]

Below I provide a brief account of some of the key issues facing us in examining compensation in the financial industry. My views on some of these issues are provided in more detail in the following three research papers from which this written testimony draws:

• The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008 (with Alma Cohen and Holger Spamann)
Harvard Law and Economics Discussion Paper No. 657, (December 2009).
Forthcoming, Yale Journal on Regulation (2010).
Available at SSRN: http://ssrn.com/abstract=1513522

• Paying for Long-Term Performance (with Jesse Fried)
Harvard Law and Economics Discussion Paper No. 658 (December 2009).
Available at SSRN: http://ssrn.com/abstract=1535355

• Regulating Bankers' Pay (with Holger Spamann)
Harvard Law and Economics Discussion Paper No. 641 (October 2009).
Forthcoming, Georgetown Law Journal (2010).
Available at SSRN: http://ssrn.com/abstract=1410072

Incentives for Risk-Taking

Standard compensation arrangements in publicly traded firms have rewarded executives for short-term results even when these results were subsequently reversed. Such arrangements have provided executives with excessive incentives to focus on short-term results. This problem, first

[1]The views expressed herein are solely my own and should not be attributed to Harvard Law School or any other institution with which I am affiliated. My affiliation is noted for identification purposes only.

highlighted in a book and accompanying articles that Jesse Fried and I published five years ago,[2] has become widely recognized in the aftermath of the financial crisis. In financial firms, where risk-taking decisions are especially important, rewards for short-term results provide executives with incentives to improve such results even at the risk of an implosion later on.

Standard pay arrangements have thus produced a divergence between the payoffs of long-term shareholders and the payoffs of executives. The *Wages of Failure* paper noted above provides a case study of this divergence in the case of Bear Stearns and Lehman Brothers, the two investment banks that melted down in 2008. Assuming that the executives of these firms saw their own wealth wiped out together with the firms, commentators have inferred from this assumed fact that the firms' risk-taking could not have been motivated by perverse incentives created by pay arrangements.[3] Our analysis of pay arrangements at Bear Stearns and Lehman Brothers during 2000-2008 concludes that this assumed fact is incorrect.

We find that the top-five executive teams of these firms cashed out large amounts of performance-based compensation during the 2000-2008 period. During this period, they were able to cash out large amounts of bonus compensation that was not clawed back when the firms collapsed, as well as pocketing large amounts from selling shares. Overall, we estimate that the top executive teams of Bear Stearns and Lehman Brothers derived cash flows of about $1.4 billion and $1 billion respectively from cash bonuses and equity sales during 2000-2008. These cash flows substantially exceeded the value of the executives' initial holdings in the beginning of the period, and the executives' net payoffs for the period were thus decidedly positive.

Designing Equity Compensation to Reward Long-term Performance

To better link equity compensation to performance, it is desirable to separate the time that equity-based compensation can be cashed out from the time in which it vests, as Jesse Fried and I proposed in *Pay without Performance*. As soon as an executive has completed an additional year at the firm, the equity incentives promised as compensation for that year's work should vest, and should belong to the executive even if he or she immediately leaves the firm. But the cashing out of these vested equity incentives should be "blocked" for a specified period after vesting – say, five years after the vesting.

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[2] Pay without Performance: The Unfulfilled Promise of Executive Compensation (Harvard University Press, 2004), Chapter 14.

[3] See, e.g., Floyd Norris, "It May be Outrageous, but Wall Street Pay Didn't Cause this Crisis," New York Times, July 31, 2009; Jeffrey Friedman, "Bank Pay and the Financial Crisis," Wall Street Journal, September 28, 2009.

In addition, executives should be permitted to cash out in any given year no more than a specified fraction of the portfolio of equity incentives that they hold. For example, an executive may be limited to unloading no more than 20% of his or her portfolio of equity incentives in any given year. Such a limitation would substantially limit the weight that the executive places on short-term stock prices.

Furthermore, to tighten the link between the value of equity compensation and long-term shareholder value and to prevent "gaming" of such compensation, it is desirable to adopt several additional design features that are described in detail in *Paying for Long-Term Performance*, a paper I co-authored with Jesse Fried. In particular, the principles below are worth following:

(i) The timing of equity awards to executives (option grants, restricted stock awards, etc.) should not be discretionary. Rather, such grants should be made only on pre-specified dates.

(ii) The terms and amount of post-hiring equity awards should not be based on the grant-date stock price.

(iii) The payoffs from the unloading of executives' restricted stock or options should be tied to the average price over a reasonably long period of time: If executives are permitted to choose the timing of unwinding, such decisions should be announced in advance; alternatively, the unloading of executives' equity could be effected according to a pre-specified schedule put in place when the equity is originally granted.

(iv) Executives should be contractually prohibited from engaging in any hedging, derivative, or other transactions with respect to equity-based awards granted as incentive compensation (such as buying puts, selling calls, or employing other risk-minimizing techniques) and be subject to penalties (including, but not limited to, forfeiture of any profits made from such transactions) if they engage in such prohibited transactions.

Designing Bonus Compensation

Two important principles for a desirable design of bonus schemes are worth noting. First, firms should avoid rewarding executives with bonus compensation that they may keep even when those results are subsequently reversed. To address the short-term distortion arising from such arrangements, bonuses should not be cashed right away, but instead placed in a company account for several years, and they should be adjusted downward if the company subsequently learns that the reasons for the bonus no longer hold up.

Second, firms should avoid using guaranteed bonuses. An analysis of the effects of such guarantees shows that they create perverse incentives to take excessive risks.[4] Indeed, guaranteed bonuses are worse for incentives than straight salary. Guaranteed bonus schemes insulate executives from the downside of risks they take but leave them with the upside, and they consequently encourage risk-taking.

Steps Taken by Financial Firms

Some firms have announced changes to their compensation structures aimed at tightening the link between compensation and long-term results. In particular, firms have announced increases in the fraction of compensation paid in stock that will have to be held for a specified period. However, for executives who are responsible for units whose performance does not have a substantial effect on the firm's overall performance, having to hold stock cannot produce the desirable link between the executive's compensation and the unit's long-term performance. To do so, it is necessary to have the executive's compensation for a given year adjusted downward if the unit's results are subsequently reversed, and paying the executive with stock that must be held for a certain period would not have such an effect.

Firms have also announced that bonus compensation will be subject to clawbacks. But the devil is in the details, and firms have not provided sufficient information for outsiders to be able to assess whether the adopted clawbacks are meaningful or merely cosmetic.

Because the changes adopted by firms appear to be largely driven by a desire to appear responsive to outside criticism, there is a basis for concern that arrangements whose details are not disclosed might not be sufficiently effective. Past experience with the arrangements adopted by firms suggests that strengthening of shareholder rights and regulatory monitoring are necessary to ensure that excessive incentives for risk-taking are fully eliminated.

Strengthening Shareholder Rights

Shareholders have a strong interest in preventing pay structures that are detrimental to long-term shareholder value. But shareholders should have tools and rights that would enable them to secure such a state of affairs.

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[4] See Bebchuk, Bonus Guarantees Can Fuel Risky Moves, *Wall Street Journal Online*, August 27, 2009.

H.R. 3269 would establish say-on-pay votes. I testified in favor of introducing such votes in the past, and I continue to view their introduction as warranted.

Say-on-pay votes, however, are only part of the reform of shareholder rights that is necessary. In the United Kingdom, shareholders have say on pay votes, but they also have other rights that make directors more attentive to their interests and more likely to be influenced by the preferences expressed by shareholders. Shareholders in the United States continue to have much weaker shareholder rights than shareholders in the UK and other English-speaking countries. In particular, the following aspects of the existing state of affairs excessively weaken shareholder rights and limit the extent to which public firms can be expected to be run in their interests:

(i) A substantial fraction of publicly traded firms still do not have majority voting, with a small number of "for" votes being sufficient to elect directors;
(ii) A substantial fraction of publicly traded companies still have staggered boards, which make board replacement more difficult;
(iii) A substantial fraction of public firms have supermajority requirements making it difficult for shareholders to amend the company's bylaws and giving boards excessive control over the company's governance arrangements;
(iv) Shareholders still lack the power to place director candidates on the corporate ballot; and
(v) Shareholders lack the power to bring to a shareholder vote proposals to amend the corporate charter or reincorporate in another state.

Reducing the extent to which shareholders rights are weakened in these ways would make boards more attentive to shareholder interests – both in general and with respect to the setting of pay arrangements.

Regulation of Compensation Structures

In addition to strengthening shareholder rights and improving corporate governance, there is another rule that the government should play. As the provisions in H.R. 3269 would require regulators to do, regulators should monitor and place limits on compensation structures in financial firms. Such a regulatory role is called for by the very same reasons that provide the basis for the long-standing prudential regulation of financial firms.

Curtailing corporate governance problems in financial firms could eliminate risk-taking that is excessive even from shareholders' perspective. But it cannot be expected to eliminate incentives for risk-taking that are excessive from a social perspective but not from the perspective of shareholders.

Shareholders' interest in more risk-taking than is socially desirable implies that they could benefit from providing financial executives with incentives to take excessive risks. Executives with such incentives could use their informational advantages and whatever discretion traditional regulations leave them to further increase risks. Given the complexities of modern finance and the limited information and resources of regulators, the traditional regulation of financial firms' actions and activities is necessarily imperfect. Thus, when executives have incentives to do so, they may be able to take risks beyond what is intended or assumed by the regulators, who may often be one step behind financial executives. Because shareholders' interests favor incentives for risk-taking that are excessive from a social perspective, substantive regulation of the terms of pay arrangements – limiting the use of structures that reward excessive risk-taking – can advance the goals of financial regulation. By doing so, regulators would induce financial executives to work for, not against, the goals of financial regulation.

The regulation of pay in financial firms could nicely supplement and reinforce the traditional, direct regulation of such firms' activities. Indeed, if pay arrangements are designed to discourage excessive risk-taking, direct regulation of activities could be less tight than it should otherwise be. Conversely, as long as the pay arrangements of financial firms are unconstrained, regulators should be stricter in their monitoring and direct regulation of these firms' activities.

At a minimum, when assessing the risks posed by any given financial firm, regulators should take into account the incentives generated by the firm's pay arrangements. When pay arrangements encourage risk-taking, regulators should monitor the financial firm more closely and should consider raising its capital requirements.

<u>Objections to Regulatory Intervention</u>

Opponents of the above regulation may argue that it will drive talent away, and that financial firms will lose valuable employees. However, the regulation prescribed by H.R. 3269 would explicitly focus on compensation structures and would not limit compensation levels. Thus, to the extent that the use of pay structures that eliminate perverse incentives would be less attractive to some executives, financial firms would be able to compensate those executives with higher levels of expected pay. Even when such an increased pay level proved necessary, providing more efficient incentives would be worthwhile

Opponents may also oppose regulation on grounds that the government does not have a legitimate interest in telling shareholders how to spend their money. Choices of compensation structures, it might be argued, inherently belong to the province of private business decisions where regulators should not trespass. This objection is not persuasive, however, because the government does have a legitimate interest in the compensation structures of private financial firms. Given the government's interest in the safety and soundness of financial firms, its intervention here will be as legitimate as the traditional forms of intervention that limit firms' investment and lending decisions.

Finally, opponents may also argue that regulators will be at an informational disadvantage when setting pay arrangements. But placing limits on compensation structures that incentivize risk-taking would be no more demanding in terms of information than regulators' direct intervention in investment, lending, and capital decisions. Furthermore, the setting of pay arrangements should not be left to the unconstrained choices of informed players inside financial firms because such players do not have incentives to set risks at levels that are socially desirable.