August 30, 2017

Secretariat to the Financial Stability Board
Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Via email: fsb@fsb.org

Re: Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices, Consultative Document, June 20, 2017

Dear Sir or Madam:

Better Markets[1] appreciates the opportunity to comment on the Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices, Consultative Document ("Guidance"), which was published by the Financial Stability Board ("FSB" or "Board") on June 20, 2017.[2]

The Guidance would enhance the Financial Stability Forum ("FSF") Principles for Sound Compensation Practices[3] and the corresponding FSB Implementation Standards[4] ("Principles and Standards" or "P&S"). The Principles and Standards already consider reputational and operational risk with respect to compensation practices, and they appropriately cover a broad range of actions and behaviors short of misconduct that can cause harm. The Guidance would strengthen the framework by recommending that significant financial institutions develop better practices to consider **misconduct risk** when implementing the existing Principles and Standards. We believe the Board is taking a much-

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability in the financial markets.

[2] Financial Stability Board, Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices, Consultative Document (June 20, 2017) ("Guidance"), *available at* http://www.fsb.org/wp-content/uploads/R200617.pdf.

[3] Financial Stability Board, FSF Principles for Sound Compensation Practices (April 2, 2009), *available at* http://www.fsb.org/wp-content/uploads/r_0904b.pdf.

[4] Financial Stability Board, FSB Principles for Sound Compensation Practices, Implementation Standards (September 25, 2009), *available at* http://www.fsb.org/wp-content/uploads/r_090925c.pdf.

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needed step to bolster its policy on risk management through sound compensation practices by applying the letter and spirit of the Principles and Standards to misconduct risk, although some additional steps would further enhance the Guidance.

INTRODUCTION

Major contributors to the financial crisis were misaligned incentives generally and executive compensation policies in particular at many financial institutions that motivated corporate leaders to engage in high-risk activities for short term profit and lucrative bonuses. Citigroup CEO Chuck Prince's infamous quote captures much of what went so wrong in the suites of the too-big-to-fail banks on Wall Street:

> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."[5]

These short-sighted policies, fueled by misguided competitiveness and greed rather than principles of sound corporate governance, came at the expense of real threats to the long-term viability of those institutions, the entire financial system, and, ultimately, the U.S. economy. As a result, the financial crisis of 2008 will cost over $20 trillion in lost GDP in the United States alone, in addition to the long-lasting suffering still being experienced by millions of Americans who lost their jobs, savings, and homes.[6]

A specific problem in the realm of corporate governance was the tendency of some corporate executives to engage in accounting fraud or manipulation to justify inflated compensation awards. As one Congressional study of the crisis concluded:

> "Even before the current crises, many criticized such incentive plans for encouraging excessive focus on the short term at the expense of consideration of the risks involved. This short-term focus led to unsustainable stock buyback programs, accounting manipulations, risky trading and investment strategies, or other unsustainable business practices that merely yield short-term positive financial reports."[7]

Appropriately, executive compensation was a significant focus of reforms following the crisis. In the Dodd-Frank Act, the U.S. Congress passed a broad series of measures aimed at correcting the structural flaws in our traditional approach to executive compensation.

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[5] Michiyo Nakamoto and David Wighton, Citigroup chief stays bullish on buy-outs, Financial Times (July 9, 2007), *available at* https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac

[6] See generally Better Markets, The Cost of the Crisis (July 2015), *available at* http://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

[7] Congressional Oversight Panel Special Report on Regulatory Reform, "Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability," (2009), *available at* https://www.gpo.gov/fdsys/pkg/CPRT-111JPRT47018/html/CPRT-111JPRT47018.htm.

Those measures include shareholder votes on executive compensation, new listing standards to ensure that compensation committees and their consultants at public companies are independent from management, mandatory disclosure of executive compensation in relation to corporate performance, and recovery of erroneously awarded compensation.[8]

While regulators in Europe and the United States have both undertaken reforms to address the impact of perverse incentives rooted in compensation, the subsequent events of the ever- expanding Wells Fargo scandal lay bare the need for further regulations, specifically to address the misconduct risk that clearly and dangerously exists long after the 2008 crisis exposed the full breadth of the industry wide problem.

<u>SUMMARY OF COMMENTS</u>

Better Markets believes that overall the Guidance is an appropriate and much-needed supplement to the existing FSB Principles and Standards. We commend the FSB for identifying a clear coverage gap in existing policy and addressing it in an efficient and proactive manner across a variety of nations and regulators.

Acknowledging the restraints placed on the Guidance by national laws and regulations, there are a few critical policy points that should be addressed in order to achieve a comprehensive policy in regards to misconduct risk:

- Explicitly establishing that all compensation practices be the sole responsibility of independent board members would prevent significant conflicts of interest.
- All incentive-based compensation should be at risk, regardless of label, given that labels can be manipulated to exploit potential definitional loopholes.
- Misconduct risk has inherent long-term components which should be addressed by creating equally long-term periods for appropriate compensation adjustment.

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[8] Better Markets has previously commented on a number of these executive compensation reforms as proposed by U.S. regulators, including the Securities and Exchange Commission. This letter reflects some of the same points we made in those letters. *See* "Comment Letter on Incentive-Based Compensation Arrangements" *available at* https://bettermarkets.com/sites/default/files/FRS%20NCUA%20FDIC%20OCC%20SEC%20FHFA%20-%20CL%20-%20Incentive-Based%20Compensation%20Arrangements%20-7-22-2016.pdf ; "Comment Letter on Listing Standards for Recovery of Erroneously Awarded Compensation" *available at* https://bettermarkets.com/sites/default/files/SEC%20-%20CL%20-%20Listing%20Standards%20for%20Recovery%20of%20Erroneously%20Awarded%20Compensation%209-14-2015.pdf ; "Comment Letter on Listing Standards for Compensation Committees" *available at* s https://bettermarkets.com/sites/default/files/CFTC-%20CL-%20CCO%20Duties%20and%20Annual%20Report%20Requirements%20for%20FCMs%2C%20SDs%2C%20and%20MSPs%3B%20Amendments-%2020170707.pdf ; "Comment Letter on Incentive-based Compensation Arrangements" *available at* https://bettermarkets.com/sites/default/files/documents/SEC-%20Comment%20Letter-%20Incentive-based%20comp%205-31-11.pdf

- In-year adjustment, malus, and clawback are all important tools that must be available to address misconduct, but due to the discussed long-term nature of misconduct risk, clawback policies should be of particular importance.

- Any compensation adjustment should be a derivative of the total amount of compensation, as well as responsive to the nature of the misconduct, in order to provide adequate deterrents and remedial measures in an industry with exceptionally generous executive compensation.

- The imposition of compensation adjustments must be mandatory once the appropriate trigger for action is met in order to counteract the perverse incentives inherent in board decisions regarding misconduct risk.

COMMENTS

The Guidance appropriately emphasizes the paramount role of the board in ensuring that compensation adjustment policies are in place and applied.

Compensation adjustments can be an enormously important tool for influencing corporate conduct in a positive way. They become especially important where there are significant gaps in the ability of regulatory authorities to address the challenge. Often, they either do not have or do not exercise their enforcement powers sufficiently to punish and deter misconduct or excessive risk-taking at financial institutions. Like a strong Chief Compliance Officer, compensation adjustment policies can help deter harmful behavior before it begins. And because these measures focus on management behavior, it is imperative that they be implemented and overseen by boards of directors. Therefore, Better Markets supports the approach in the Guidance of clearly assigning the ultimate responsibility for implementing compensation controls to the board.

One significant improvement would be to include a requirement that all compensation practices at covered financial institutions be established, implemented, monitored, and revised solely by **independent** board members. Those independent board members should comprise the financial institution's compensation committee, but regardless of form, the key requirement is that only independent board members oversee compensation matters.

All incentive-based compensation should be at risk, regardless of label.

Ultimately determining the true character of any type of compensation can be exceedingly difficult if issuers are bent on manipulating such distinctions. The Guidance should provide for pro rata recovery of all forms of incentive-based compensation paid during the look-back period, regardless of how it may be characterized. Subjective, nonfinancially-calculated compensation should be recovered in the same proportion as the accounting-based incentive compensation is recovered. This approach in effect creates a reasonable and necessary presumption that all discretionary compensation is based at least

in whole or in part on financial performance measures. This is particularly true given that the variable and unpredictable scope of misconduct risk may require unique measures of harm and value.

Absent this approach, the Guidance should at least include some type of anti-evasion clause. It should provide that regardless of label, all incentive-based compensation is subject to recovery under the rule if it is in fact based in whole or in part, and directly or indirectly, upon financial information metrics. While this falls short of a presumption, it would still require the recovery of any incentive-based compensation that could be shown to be accounting-based in light of all the facts and circumstances.

Due to the longer-term nature of misconduct risk, there must be a commensurate period in which compensation can be adjusted.

The Guidance correctly recognizes the longer-term nature of misconduct risk and, in a footnote, recommends:

> "Given that often the full impact or details of events take some time to come to light, it is reasonable that firms should have the ability to make subsequent additional adjustments, where appropriate, to variable compensation for the applicable period. It is therefore important to ensure alignment between the length of the time period over which the impact of misconduct is likely to materialise and the length of the period over which variable compensation remains at risk in accordance with applicable provisions on periods of limitation."[9]

This, though, is part of a recommendation on "subsequent additional adjustments" and does not appear to account for new adjustments that may be necessary. As has just been exposed most recently by the Wells Fargo fake accounts scandal, misconduct may be perpetrated over many years and can take a decade or more to uncover. While Better Markets understands implementation of the Guidance is constrained by national laws and regulations, as the Guidance acknowledges, misconduct fraud is differentiated specifically by its long-term nature. Therefore, it is vital that any mechanism used to adjust compensation, as well as the variable compensation at risk, be available through a significant look-back period for both **initial** and **subsequent** adjustments. Clearly, any limited timeframe that is tied to the specific dates of occurrence of the misconduct would fail to capture misconduct that takes more time to discover and would allow significant incentive-based compensation to escape the clawback remedy.

The Guidance appropriately incorporates in-year adjustment, malus, and clawback as tools to address misconduct.

Better Markets fully supports the Guidance's usage of in-year adjustment, malus, and clawback as remedies to address misconduct within a firm. All three tools are appropriate

[9] Guidance at 11-12.

and necessary. There is no basis for withholding application of any one of the three tools where excessive risk-taking or misconduct has occurred to the detriment of the entity, its shareholders, or its clients and customers. Unless all mechanisms for redress are included, compensation policies could be manipulated to specifically target any loopholes available. And as argued above, given the often-long periods of time over which the nature and scope of misconduct risk emerges, clawback mechanisms should be particularly strong and applicable over commensurate periods.

Any compensation adjustment should be a derivative of the amount of total compensation as well as responsive to the nature of the misconduct.

The amount of compensation at risk will largely determine the effectiveness of the compensation adjustments. Too little and the deterrent effect is minimal or non-existent. A relevant factor is the context: Where salaries and bonuses typically extend into the millions annually, the corrective effect will be minimal unless the adjustments are also on that scale.

While the Guidance suitably recommends that adjustments to amounts of compensation take into account "all relevant indicators of the severity of impact,"[10] it fails to integrate the influence of astoundingly high base compensation for most executives. Better Markets recommends that the Guidance add an additional mechanism to ensure that potential adjustments are commensurate with and consider the massive annual and cumulative wealth of many financial executives.

The Guidance should recommend that national regulations and/or guidance establish mandatory adjustments.

Finally, while we understand the difficulty that comes with a diverse range of regulators attempting to implement the Guidance, ultimately the board should have a mandatory obligation to take remedial actions once the trigger for action is met. While discretion may be relevant in determining the precise scope and amount of adjustments within clear boundaries, the decision to do so should be mandatory and not limited to circumstances where a financial restatement is required. Boards and executives face huge incentives to attempt to brush past misconduct in an effort to quietly resolve an issue likely to damage their and the company's reputation. Mandatory action is the only way to ensure boards overcome these incentives and take the appropriate and responsible steps following discovery of misconduct.

[10] Guidance at 11

CONCLUSION

We hope these comments are helpful in your consideration of the Guidance.

Sincerely,

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