Task Force on Regulatory Reform
Banking Law Committee
American Bar Association [1]

Recommendation Regarding Executive Compensation

The Task Force recommends the adoption of interagency regulatory best practices for compensation, based on those found in the Financial Stability Forum's Principles for Sound Compensation Practices and the Aspen Institute's Corporate Values Strategy Group report, among others. The best practices should include and/or identify: (1) a formal recognition of the responsibility of the board of directors for compensation decisions based on risk management principles; (2) a statement that numerical caps on compensation are unworkable and potentially detrimental to the financial industry; (3) the legal mechanism (*e.g.* safety and soundness) under which the functional regulator has authority to address compensation practices that incentivize risky behavior; and (4) a requirement that the compensation committee consist entirely of independent members. Rules and/or guidance on compensation should, at least, take into account a long-term time horizon of risks, including incentives for long-term portfolio performance. In addition, the compensation of those within the firm charged with risk management should be reviewed to ensure that such staff has the independence and authority to carry out its mission.

Misaligned incentives associated with some compensation practices appear to have contributed, in part, to the financial crisis by rewarding short-term performance while allowing long-term risks to accumulate. Interagency regulatory best practices should be adopted to emphasize long term systemic stability, as opposed to taking excessive short term risks which pose overall systemic risks. We believe that, while the best practices should apply to all financial institutions and bank holding companies, larger firms posing systemic risk regardless of charter also should be subject to sound compensation practices regulation. We also recognize that smaller firms do not necessarily require the formal committees and structures envisioned in some of the proposed principles.

Any government regulation of executive compensation should encourage compensation practices that will contribute to the sustainable long-term value of America's business as we emerge from this crisis, rather than simply "fixing" specific compensation practices which are seen as having contributed to the crisis. What is needed is a set of principles to guide the design and operation of any responsible executive compensation program. The guidelines recently announced by the Treasury Department relating to public companies do this, focusing in part on pay for performance and, in particular, long-term performance (see TG-163, June 10, 2009; http://www.treas.gov/press/releases/tg163.htm; Fact Sheet

[1] This recommendation was approved by members of the Banking Law Committee's Task Force on Regulatory Reform in their individual capacities and is to be used for information purposes only. The recommendation has not been approved by the American Bar Association, its Presidential Task Force on Financial Markets Regulatory Reform, or any section or committee of the American Bar Association, including the Business Law Section and the Banking Law Committee.

on Providing Compensation Committees with New Independence at http://www.treas.gov/press/releases/reports/fact_sheet_indepcompcmte.pdf). However guidelines of this nature, to have real practical application, must provide guidance to, and reinforce accountability by, the body that makes the decisions about executive compensation—the board of directors. A measured and principled approach overseen by corporate boards is the only way to ensure that the eroding trust between companies and their shareholders is restored, based on a shared commitment to the sustainable long-term value of the enterprise. Further, the principles we have set forth should apply to both public and privately held financial institutions for safety and soundness purposes.

The principles-based approach to regulating executive compensation has two significant benefits. First, it places responsibility for executive compensation squarely where it belongs – with directors who are elected by and responsible to shareholders. Companies and their shareholders will be much better served by engaged and accountable directors, appropriately guided, who can tailor compensation plans and awards to the immediate and long-term needs of the organization, respond nimbly to unforeseen corporate, industry, and economic events, as well as evolving trends and developments, and fine tune a program to address investor priorities and concerns. Second, it gives company boards and compensation committees sufficient flexibility to design executive compensation programs appropriate and in the best interests of their shareholders. This not only avoids the rigidity that detailed prescriptions would bring but also reduces the need for complex implementing regulations and clarifying interpretive guidance, and the risk of unintended consequences and evasions.

In addition to executive compensation, the best practices should also consider compensation and authority of back-office, risk-control, and compliance employees. The compensation of staff responsible for risk management and reporting should not be influenced by personnel in front-line business areas. Back-office and risk control employees play a key role in ensuring the integrity of long-term accuracy of measures of profit-and-loss. If their own compensation is importantly affected by short-term measures, their independence will be compromised. If their compensation is too low, the quality of such employees may be insufficient to their tasks and their authority may be undermined.

We further note that the federal bank regulatory agencies already are empowered as part of their prudential supervisory responsibilities to regulate compensation in financial institutions under their respective jurisdictions. While these agencies may separately or jointly issue compensation guidance, such non-binding guidance may be of limited effect. The Task Force, thus, would prefer interagency regulations applicable to all types of regulated financial firms.

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