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AFR Bulletin: Key Rules on Executive Pay and Derivatives Regulation

Several comment dates are approaching for important rules under the Dodd-Frank Act (DFA). Specific rules are summarized below. If you would like to discuss any of these issues further, please contact Marcus Stanley, AFR's policy director at marcus@ourfinancialsecurity.org.

Section 956 – Changing Incentives In Wall Street Compensation

It's clear that Wall Street pay arrangements have focused financial executives on short-term performance. The top ten executives at Bear Stearns and Lehmann Brothers – the firms whose failure triggered the economic crisis – got $2.4 billion in total stock options and bonuses between 2000 and 2008, none of which was ever repaid. Executives at firms from AIG to Goldman Sachs also earned billions of dollars in bonuses. Compensation based purely on immediate profits, without any accountability for long-term outcomes, encourages excessive risk-taking.

The DFA contains several provisions addressing this problem. Regulators are authorized to "claw back" past compensation from managers who are responsible for the failure of a major bank. More generally, Section 956 of the DFA instructs regulators to prohibit pay practices that encourage excessive short-term risk taking at Wall Street banks. The regulators joint rule implementing this section would require the largest banks to defer at least half of top executives' pay over a three year period. It would also increase regulatory oversight over excessive short-term pay that encourages risk-taking. These are important steps forward and represent a real improvement over current practices.

However, there are some issues with the rule. These include:

1) The rule allows banks to pay out the deferred bonuses in equal shares each year over the deferral period. This means that less than a fifth of executive pay would be at risk for the full three-year period. A longer deferral period, or a greater percentage of pay subject to deferral requirements, would address this.

2) The rule continues to permit executives to hedge their compensation (make side deals to get most of their money today and get around deferral). Research shows that executives who do this are generally betting on future losses for their own company. Regulators should require banks to prohibit this practice among top executives.

3) The reporting requirements for bank compensation practices are excessively general and should be made more specific and detailed.

Comments on the rule are due Tuesday, May 31.

CFTC derivatives regulation

The Commodity Futures Trading Commission (CFTC) has reopened and extended the comment period for its comprehensive set of 31 derivatives market rulemakings under the DFA. This request allows broad comment on the entire structure of CFTC derivatives regulation.

Some broad issues in these rules include:

- The definition of "hedging commercial risk" – which allows companies certain exemptions from derivatives regulations – is overly broad and sweeps in certain types of purely financial hedges.

- Owners of key elements of derivatives infrastructure, like clearinghouses and swaps data repositories, could profit by restricting access to their facilities. The ownership and conflict of interest rules laid out in the derivatives regulations are not strong enough to address this issue and should be strengthened.

- Rules for Swaps Execution Facilities – the new exchanges for trading derivatives – should allow true transparency and competition in determining derivatives prices.

There are also other areas in the rules (such as the definition of "swap dealer") which are worthy of support. Please contact AFR if you wish to discuss any of these issues further.

The extended comment period closes on Friday, June 3rd.

Treasury exemption of foreign exchange swaps

Secretary Geithner has proposed to exempt the $25 trillion market in foreign exchange (FX) swaps and forwards from clearing and exchange trading requirements under the Dodd-Frank Act.

The justification for this exemption is that FX derivatives do not raise systemic stability issues. However, the foreign exchange market clearly failed during the 2007-2008 financial crisis and had to be bailed out by the Federal Reserve. Prominent financial experts like Darrell Duffie of Stanford University agree that the FX derivatives raise real systemic stability issues and the exemption is not justified. AFR also agrees with this assessment.

The blanket FX exemption opens up a potentially serious loophole in Dodd-Frank derivatives reforms. FX derivatives can approximately simulate many of the interest rate swaps that make up almost 80 percent of the world swaps market, so the FX exemption could open up avenues to evade other derivatives rules.

Comments on the proposed exemption are due Monday, June 6th.