Can Financial Firms Get Executives to Give Back Pay?

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By Stephen Gandel
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Wall Street is sharpening its claws.

In the past few months, a number of financial firms have instituted or beefed up rules that would allow them to force employees to return year-end bonuses. So-called clawbacks would be triggered by subsequently discovered misconduct and some firms say they may even apply in cases where employees made trades that looked profitable at first, but go sour.

But employment lawyers and pay experts say more needs to be done to rein in Wall Street compensation. In practice, it is often hard to get employees to return pay. Moves to limit clawbacks only to deferred compensation (money that is earned but not paid out until a specified future date), which is the easiest to recover, may actually increase risky behavior. What's more, clawbacks vary widely from firm to firm. Some provisions only cover top executives; other firms exclude top executives from the plans.

"Rather than relying on clawbacks, companies should make sure they get their compensation decisions right in the first place," says Hye-Won Choi, who is the head of corporate governance at TIAA-CREF, which manages retirement accounts. "It is much easier not to give awards up front than it is to take them back once paid out."

On Friday, Wall Street pay was again in the spotlight in Washington. The House Committee on Financial Services held a hearing on executive compensation. Harvard professor Lucian Bebchuk, who recently consulted pay czar Kenneth Feinberg in setting compensation limits at bailed-out firms, said Congress should regulate and "place limits" on Wall Street pay. Nobel Prize–winning economist Joseph Stiglitz told the panel that bank pay incentivized traders and other employees to take the excessive risks that contributed to the financial crisis. And corporate-governance expert Nell Minow asserted that Wall Street firms had done little to change the pay practices that she believes were a "symptom and cause" of the financial crisis. "In the postmeltdown world, the pay packages and especially the bonuses continue to widen the gulf between pay and performance — and between integrity and outrageousness," said Minow.

Fearing regulation, financial firms are eager to prove they can police their own pay policies. At a recent Washington hearing into the causes of the financial crisis, executives from four top banks all cited recently instituted clawback provisions as evidence the firms had reformed the pay practices that many believe were at the root of the financial crisis. Clawback provisions are at the heart of that effort. While companies have always had the right to sue employees for ill-gotten gains, more firms are adding provisions to reclaim pay not just for illegal behavior, but poor decisions. And they are expanding those provisions to more employees. A few months ago, Morgan Stanley extended its clawbacks to trades that end up being losers. Bank of America is planning to extend its clawback provision to its top executives. And Goldman Sachs recently said bonuses for its top executives will be paid in restricted stock, making it easier to recoup pay down the road.

Clawbacks are catching on in other industries. A recent study by executive compensation research firm Equilar found that nearly 73% of *Fortune* 100 companies now had clawback provisions in their executive pay packages, up from just under 18% in 2006.

While compensation consultants say clawbacks are a nice idea, they are very hard to execute. Getting employees to return paychecks that they have already cashed, spent and paid taxes on can be tricky. And most policies are not specific enough as to when pay can be recovered. That, employment lawyers say, can lead to abuse of the policies by the companies. "No question this is going to lead to a lot of litigation," says Michael Deutsch of law firm Singer Deutsch. "Clawbacks are unwieldy and can subject employees to abuse."

In order to get around the repayment problem, a number of firms say their clawbacks will only apply to deferred compensation and not immediate cash payments. At Morgan Stanley, for instance, the firm's clawback provision only applies to the portion of their employees' compensation that is paid in deferred cash, which for most employees is only about a third of their pay. The other two-thirds of the firm's employees' compensation, paid out in cash and restricted stock, are not subject to the clawback provision. But in limiting the repayment provisions, Morgan Stanley might actually be promoting risky behavior, not limiting it. That's because traders may do whatever they can to boost the now smaller portion of their pay that, barring misconduct, is theirs to keep.

Adding to the uncertainty is the fact that firms have adopted different structures for the clawback provisions. The differences in the plans — including such details as what employees are covered and which specific portions of compensation are subject to clawback — make it tough to know which features are most effective in getting employees to be more careful.

Citigroup's clawback only applies to its top executives, or about 200 of the company's 250,000 employees. And it only requires employees to return pay in instances when they have broken either the law or firm policies. Bad trades are exempt. But unlike other firms, Citigroup's clawback covers all types of pay, including cash or vested stock.

At Bank of America, the clawback covers all the employees of the bank that are involved in investment banking and trading, or roughly 9,000 employees. Top executives, for now, are excluded. Only the employees' deferred compensation is subject to the clawback, which is about three-quarters of pay for most executives. And once employees have received the pay, which vests over three years, it is theirs to keep for good.

"The devil [of clawbacks] is in the details," Harvard’s Bebchuck told the House panel on compensation on Friday. "Firms have not provided sufficient information for outsiders to be able to assess whether the adopted clawbacks are meaningful or merely cosmetic."