Wall Street Toughens Rules on Clawbacks

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By Robin Sidel
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Banks and securities firms are toughening rules that give them power to seize pay from employees whose bets or other actions blow up later. But they still mightn't be tough enough.

Known as clawback provisions, such internal rules used to cover just top executives or fraud. Last week, though, J.P. Morgan Chase & Co.'s board expanded the provisions to include any employee at the New York bank who gets company stock as compensation. In addition, J.P. Morgan can now grab stock awards from employees found to have taken excessive risks or who didn't blow the whistle on bad risk-taking.

Bank of America Corp. and Morgan Stanley also have recently sharpened their clawbacks as Wall Street responds to relentless outside pressure to overhaul its pay culture. Traders, investment bankers, and even some bank tellers will be told details about the new rules as they get their bonuses for 2009.

Compensation experts who got nowhere before the financial crisis when they pushed to make employees more financially responsible for their mistakes say the toughened clawbacks are a step in the right direction. But the rules could wind up being far less effective than they look on paper, some outside experts say.

"Firms have not been providing outsiders with the information that is necessary to assess whether the clawbacks are meaningful and effective or merely cosmetic," says Lucian Bebchuk, a Harvard University law professor who runs the college's corporate-governance program.

Morgan Stanley said Friday that its revised clawbacks allow the firm to "reclaim compensation for up to three years after it is awarded" if the company "realizes losses on certain trading positions, investments or holdings." Top executives, including new Chief Executive James Gorman, could lose deferred cash compensation.

The New York company didn't disclose how steep those losses would have to be to trigger the clawback rules or which trades and assets are subject to the tighter provisions.

David Danovitch, a lawyer at Gersten Savage LLP in New York who represents financial-services companies, says clawbacks could be difficult to enforce because the circumstances often are murky. For example, if a trading bet goes bad, should just the trader lose his compensation or also superiors who approved the bet?

The track record on clawbacks is mixed. Many bets by traders and bankers that backfired during the financial crisis likely didn't violate company policies, partly because the bets didn't seem risky when housing prices were rising and investors clamored for a piece of the action.

"When we pay a bonus based on certain performance metrics, we want to have the ability to, if that metric turns out to be salacious or inaccurate, to recover money from the employee later. But there isn't a lot of case history on seeing them being implemented," says Kevin Murphy, a finance professor at the University of Southern California.

Firms could have a hard time seizing compensation once an employee pays taxes on it, he adds. "It's hard to believe that those kinds of employees will ever be writing checks back to institutions," he says.

At J.P. Morgan, the narrower clawback rules usually were invoked when an employee was fired.

Under the new policy, J.P. Morgan can revoke stock awards from employees without firing them. The company already had rules that allow it to go after compensation previously paid to top executives for almost any reason.

"This year in particular, we tried to find the right balance between paying for performance and being competitive and showing the right balance and degree of restraint given the economy and political realities facing Wall Street," said Jes Staley, who runs J.P. Morgan's investment bank. "Increasing the bank's ability to claw back equity awards was one of the measures we took."

Most of the sharper clawbacks are aimed at stock that is awarded as compensation and vests over several years. The rules are likely to affect a growing percentage of overall compensation, since firms are distributing more deferred shares in response to public ire over their pay practices. Some companies also are considering provisions that would allow them to retrieve cash or vested stock in certain situations.

"Boards are struggling with it," said one executive at a Wall Street firm. "The issue is how to strike the balance between providing incentives to attract the best people and retain them with not giving people an opportunity to game the system."

Clawback policies drew attention in Washington earlier this month when the Financial Crisis Inquiry Commission grilled Wall Street titans about their role in the crisis. Phil Angelides, the former California state treasurer who is chairman of the panel, asked the executives to provide details about whether they have followed through on using clawbacks, how much money was seized and the percentage of compensation that was reclaimed. The responses haven't been made public.

The Federal Reserve has cited clawbacks as a way to align pay with risk-taking. The agency is nearing completion of new regulatory guidance on incentive compensation for U.S. financial companies.

At Bank of America, compensation packages to be delivered in early February will include new clawback provisions for the firm's banking and markets employees, or about 4% of the company's 283,000 workers. For the first time, deferred compensation will be subject to a performance-based clawback which will assess whether expected profits actually materialized, among other things.

The Charlotte, N.C., bank also beefed up its definition of "detrimental conduct," allowing Bank of America to claw back compensation if an employee is found to have disregarded company policies and rules. "This is part of a program to more tightly connect our associates to long-term shareholder interests," said spokesman Robert Stickler.

At Citigroup Inc., about 200 of the firm's highest-paid employees are subject to clawback provisions for violating company policies on risk or use of capital, according to a spokesman.