Kenneth Feinberg's Comments to the ERC Fellows: January 21, 2010

Thank you very much. I'm really honored to be here today. I see some familiar faces.

I must say that Congressman Oxley attempted to do the impossible in getting Congress to codify a process to try to improve internal corporate governance. That legislation with all of its pros and cons and all of the supporters and critics has certainly, I think, articulated what corporations have to go through or consider in deciding how corporations are going to run day-to-day. And I think the American people owe him a tremendous debt of gratitude.

I also must acknowledge Jim Hamilton, who's here. There is nobody in this town who's more involved in the legality of what constitutes appropriate ethics restrictions on public service. He's carved out an area of expertise where woe be unto the official who doesn't talk to Jim first before entering public service as to whether or not there are conflicts, what the guidelines are and again. I think Jim's a national resource when it comes to talking about the ethical requirements of public officials and the revolving door involving private sector into government back to the private sector, etcetera. I'm a client of his. Wisely.

What you guys are doing is incredibly important and I must say, very much under the radar screen. In my day-to-day work as the compensation special master I really have only a marginal [effort?] to play when it comes to "ethics compliance." I think the role I'm playing is to prescribe prescriptions on compensation from Treasury, and leaving to the internal corporate offices how those restrictions will be implemented, what considerations will enter into compliance with those restrictions, and I'm very eager to be here today to learn – I mean, you guys deal with this every day. I have another assignment – I'm moving in and eventually moving out. You guys, every day, are dealing with executive compensation, how it [fits?], what ethical restrictions should be placed on compensation. So what I want to do in the next 20 minutes, really, is just remind everybody what I'm doing and what I can't do, and then participate in a panel where I'm hoping to be educated, frankly.

First, what am I doing? Let's be sure you understand my rather limited role under legislation enacted into law by Congress. I determine compensation for the top 25 officials in what were seven of the largest TARP recipients. Bank of America, Citigroup, AIG, GM, Chrysler, GMAC, Chrysler Financial. That's it! That's all! And it's to those seven companies I actually determine compensation packages for just the top 25 people in each of those seven companies. 175

people. What I'm doing The New York Times accurately calls somewhat of a sideshow, because my mandatory jurisdiction is limited by statute to those 175 people. That's it.

Now, my second function, I also under the law have mandatory jurisdiction to design compensation structures for officials 26 to 100 at those seven companies. Not the individual packages but the overall structure of compensation that should govern employees 26 to 100. That's it! And only for those seven companies.

Third, I have discretionary authority to seek to claw back money that's already been paid officials at any company that received TARP assistance. That's over 400 companies. I have that discretionary authority. It has not yet been exercised. By law I have to make a determination whether to exercise that discretion in about the next 45 days. I've said publicly that I am reluctant to exercise that authority except in the most egregious cases. Whatever that means.

So, that is it.

Now, I started out with seven companies under my jurisdiction. Fortunately, from my perspective and the perspective of the taxpayer, Bank of America and Citigroup repaid their TARP obligations, $85 billion, automatically exiting from my program. In 2010, they're out, they're on their own, they're not subject to my mandatory jurisdiction, so now I'm down to five companies. And my determinations will be made in the first quarter of this year, 2010. So you can see that my jurisdiction is so restricted it's a blip on the screen.

Why, then, is there such interest in what I'm doing? Well, I think there's two reasons. One, the uncertainty of the American economy today is such that everybody is very interested, angry, frustrated. Ten percent unemployment. So everybody's rather interested in what Wall Street's making. Second, although there are a great many prescriptions that have been articulated governing compensation – the Federal Reserve's done it, the FDIC, the SEC, the G20. Although there are a fair number of vanilla prescriptions, I think I'm the only one that's actually taking the prescriptions and calculating how much that guy's going to make. And there's a lot of interest in that these days. So I think that also fuels the interest and the anger and the frustration.

So that's sort of an overview. Now there are a couple of other overview points worth mentioning. How come there was very little criticism from The Wall Street Journal or anywhere else about my role in fixing compensation in the private sector? Even for one person. How come there isn't more of a pushback? How come there aren't more critics saying it's none of the government's business what the private market place pays people? That's not the appropriate role for government. Why isn't there more of a philosophic argument being raised about that, because somewhat surprisingly there is very little of that. And there's a very practical reason, it seems to me. My jurisdiction is limited to seven companies where the taxpayers are the owners of the companies. They are creditors who lent money to keep these companies in business. So most of the philosophic aversion to what I'm doing is trumped by the argument that since we

own these companies, the government has every right as a creditor to try and influence corporate decision making. Like any private creditor would. And as long as my jurisdiction is not expanded to encompass other corporations – and it's not and it won't be – and no [?] even suggested it should be, Republican or Democrat – that sort of blunts any argument that this is a philosophically bad idea inconsistent with the Constitution and Thomas Jefferson would like it, because we're creditors and that changes everything. Especially among those who didn't like the TARP aid in the first place. The argument was we didn't think they should be bailed out, and now that they're bailed out the government has every right to try to get its money back. That sort of thing is what I hear all the time.

The second area of interest. In calculating compensation for 175 people and in designing these compensation structures, what are the guiding principles that guide me in my work? Well, the statute's pretty clear as to what the principles are. Unfortunately, the statute is, um, very inconsistent in some of these clear principles. Make sure that in fixing compensation the companies continue to thrive, compete financially so that the taxpayers get their money back. That's a good principle. It worked with Bank of America and Citigroup. They were so glad to get rid of my jurisdiction, they paid everything back! That's wonderful! That was the goal of the legislation. But then the legislation says make sure in setting compensation that the compensation does not promote excessive risk. Well, ask Congress, ask Oxley, does anybody here know? We could send around a pencil and a pad of paper for everybody in this room. You tell me what is excessive risk. Not risk! Excessive risk. And I'll come up with a very good, for my purposes, a very good formula, definition for determining excessive risk. And it simply is, I know it when I see it. Then there is a principle in the law that the compensation should promote long-term performance. Avoid guaranteed compensation. Okay, we can try and do that.

So what does that translate into with one to 100 – 1 to 25 and 26 to 100? Here are the creative principles, prescriptions that guide compensation. One: low cash-based salaries. Salaries that are cash are guaranteed and we don't want guarantees. Low cash-based salaries except under exceptional circumstances, under $500,000 cash per year. Two: salarize stock. Stock that vests immediately upon payment of your salary. Salarized stock that vests immediately, by law I have no control over that. But that stock cannot be transferred, sold or redeemed up to four years. One-third after two years, one-third after three years, one-third after four years or longer. In other words, tie the compensation of the individual official to the long-term growth of the company. Link the individual's performance with that of the company. Duh! I don't think that's so creative or ingenious but it's something that has been I think rather widely praised. Third, as to 26 to 100, I'm no longer under the [?], if you want to give cash bonuses, fine. But those cash bonuses must be based on objective performance criteria and redeemable or paid in two tranches over two years. Again, stick around, perform, the performance should be objectively determined, and then you'll get your money.

Next, no perks over $25,000 per person. Country club dues, golf club dues, private jets. $25,000 max per person absent exceptional reasons for good cause shown to vary and the special master

must approve it. No golden parachutes. No special retirement or severance programs. Officials should be treated like everybody else when it comes to retirement and severance. No gross-ups, tax gross-ups. Those are the determinations that lead to actual – Joe will make $1 million, Mary will make $800,000, Barbara will make a million six, Steve will make four million one, and there you are. All public – not the names of the people, that's private. You can go -- my reports are available online, October 22 and I think December 14 and there they are for 2009 and it's all laid out.

Now that's how it works. Now what don't I do, that's of great interest to you guys and one reason I'm here. My mandate does not include corporate governance reform. That's not what I'm about. People ask me all the time, what do you think about shareholder rights, say on pay, what about independent compensation committees? Not on my watch. That separate legislation with Barney Frank and the others – I'm not involved in that. Well, what do you think of independent compensation consultants? I haven't found one. I looked to hire a couple of independent compensation consultants to help me evaluate the petitions that I got. I couldn't find an independent compensation. . . I finally found great independent compensation consultants from academia. Lucian Bedcheck [?] at Harvard Law. Kevin Murphy at Southern Cal business school. Fabulous! Fabulous guys. But in terms of trying to retain at Treasury, even Jim Hamilton couldn't get these guys into Treasury. There are too many conflicts, they're involved in too many other activities. We gave up after a while. So corporate governance is not on my watch. Regulatory reform is not on my watch. That's again legislation that's moving through Congress. That simply is beyond my jurisdiction. But I am interested, and I've noted with some interest, and you've been reading about this in the papers the last few days, some of these other mega-companies on Wall Street like Goldman, like Morgan Stanley, have voluntarily adopted my prescriptions, saying, for obvious political reasons, we basically are adopting, voluntarily, what the special master's doing, we think it's the right thing to do, blah blah blah. Now I think that is very, very helpful. I think it's constructive. I think it's useful. I must say, though, and I've said this publicly, I don't think adopting my voluntary prescriptions is going to satisfy populist outrage when those prescriptions still translate into double-digit bonuses. I mean it's nice that you're giving $10 million in comp in stock but it's still $10 million in stock. So it is, I think, of course the glass is half-full when you see corporate Wall Street doing this. But I don't think it obviates the justification or the argument for a bonus fee imposed on large financial institutions. That's a way to deal with just the magnitude of the dollars in a time when I am amazed at the gap, the perception – the difference in perception between Wall Street and Main Street when it comes to pay. It's astounding to me. "Mr. Feinberg, you're only giving me $5 million. What do you have against me? I mean, last year I made $12 million, the year before $15 million." I mean the dollars are staggering and you try to bridge differences but it's very, very hard to do. What we're trying to do, our contribution, I think, to the financial system, modest as it may be, is to come up with these performance and these prescriptions for compensation. And I am pleased to see and I think the Administration's glad to see there is more compliance with some of these prescriptions voluntarily. But it's a small step. Neil Wolen, the deputy secretary of the Treasury, put it best. Two of his comments are excellent, I think. He said it's a small step when we see the

corporations looking at stock, long-term performance, and he says, you know what we're trying to do is thread the needle between populist outrage, which is perfectly understandable, and Wall Street's sense of what it needs to compete.

You know it's very interesting – last point – when these individuals on Wall Street submit their data and they say, "This guy needs to be paid $4 million or he'll leave and he's irreplaceable." Graveyards are filled with irreplaceable people. DeGaulle, not me, that's DeGaulle. Secondly, they never say to me – where are they going to go? They're going to go to China. They're going to go to UBS, Credit Suisse, foreign banks. They're not going to go across the street to another domestic entity. I mean the arguments – and some of the arguments may be valid. You're looking at a crystal ball. This irreplace-ability argument, which is buttressed by the fact that the law talks expressly about these companies thriving and being competitive to repay the taxpayer. You know, it's not an argument that can be lightly ignored. It is a factor in our deliberations.

So that's kind of an overview that leads me to throw it open for a few questions before the 1:15 panel. I'm frankly very interested in the panel and what I'll learn today. You guys are the experts.

Questions.

Q: First, I want to say thank you for the work that you're doing. It's really important and I think everyone in this room just feels that you're doing great work, so thank you. Quick question. Your opinion on how widespread you think the compensation issues are in U.S. corporations and is this a systemic problem or is this kind of a few bad apples that we're overreacting to.

Feinberg: From my perspective, narrow as it is, it's systemic. I'm dealing with seven companies as vastly different as Bank of America and Chrysler Financial, and it's systemic. Not one of the seven companies presented me with compensation proposals that were in the public interest. I think it's systemic. Whether or not those problems can be addressed by government, I'm dubious in the long run, certainly. But I do think it's systemic. I must say, in my work, narrow as it is, there is very, very little interest in GM or Chrysler or Chrysler Financial. The real interest is directed at Bank of America, Citigroup, AIG – the financial services industry. [Garbled.] So I do think it's systemic but I think populist outrage, and historically in American history, directed at Wall Street and the banking and the financial institutions because of the magnitude of the problem. I mean, when you look at the top 25 individuals getting paid by me, General Motors – when you get down very quickly to 11, 13, 20, I mean the dollars are, you know, 200, 300,000 – 225 – 410 – versus demands -- $12 million, $16 million, $9 million. So that's why I think it's systemic but I think the real direction here seems to be at the financial institutions.

Q: I think that your compensation plan is great but you still have the problem of no control over the actual objectives set. What can you do to make sure that the objectives are not set low and then they crawl under them?

KF: I don't understand the question.

Q: For instance, if you've got a task and a measure, like I'm going to show up every day –

KF: Oh, your performance criteria. You have to approve them. So the objective performance criteria may be fixed by the corporation because I don't know what the objective performance criteria – GM versus Chrysler Financial which is in runoff. The performance criteria have to be approved by the special master's office as appropriate benchmarks to trigger executive compensation.

Q: First of all, I'm one of the outraged people so I don't want you to get the wrong impression from my question. I'm very outraged by what's going on on Wall Street. We talk about the fact that compensation has to allow the company to thrive. But you're only managing compensation for a very small number. Do we really believe that they can be competitive – these few companies that you're looking at? Can they really be competitive if everybody else is off and running?

KF: Well, I have a couple of answers for that. First of all, don't assume that the compensation structure for 26 to 100 ends with 26 to 100. One interesting feature, Congress decided it's 26 to 100. Many of the companies tell me, we don't have any arbitrary cutoff at 100. What if your compensation structure for 26 to 100 is 26 to 3,063? So don't think that the 26 to 100 built into the law simply ends with number 100. We've got a compensation system where – it governs way beyond that. That's first. Second, the companies seem to argue, if you can meet our compensation demands for 1 to 25 and 26 to whatever, we will be competitive. We think we can be competitive. Now you're going to cut our demands, saying that they're against the public interest. That raises the specter of whether we can be competitive. But we think we can thrive. Bank of America and Citigroup proved they could do it when they paid us back. I don't if they can thrive. They certainly thrive enough to get out of the domain of the special master. Third, there are a lot of reasons companies thrive or don't thrive quite beyond executive compensation. One thing I've learned and have tried to explain is that this link between executive comp and financial success is only one of a number of causal connectives. I mean, to talk about General Motors, which just came out of bankruptcy, and to say that executive comp for 25 people is the difference between financial success and failure is I think very, very myopic. There are a lot of reasons that General Motors suffers competitively and there are a lot of reasons why it believes that it can turn it around. So you can't look to what I'm doing and say this is the litmus test between success and failure in terms of competitiveness. It's one factor, I think.

Q: Going back to the point you were making about the government owns these companies which is where you get the authority for setting the compensation and nobody's really pushing back. What I find curious is that, okay, so it's the government that's now the shareholder, if you will, the majority shareholder. But somehow because the government is the majority shareholder their

rights are different than, say, a majority private shareholder, and as the shareholder you're kind of usurping, the government is, the power that had been vested through all of our corporate laws in the company and in the board to set that compensation. And so I find it interesting and curious and would like you to comment on how it is the decision's been made that that has been turned on its head, essentially, and that in this situation because of the government that as a shareholder they are usurping the power that should be and has been historically reserved to the board, with no prior precedent that I can see. And just wondering what does that mean that these companies and the boards of these companies, you sort of doing their job for them.

KF: Two answers. That is a great question. That would be a great seminar. You can talk about that the whole semester. I have two quick answers for you. One, it is unprecedented. The government has insisted it wants more. It wants a preference as to its authority governing these companies because, in an unprecedented manner, it saved them. And private capital couldn't have saved them. The government rescued those seven companies. So the government says, consistent with Adam Smith, "You know? We saved those companies. We want more than just a private shareholder's interest and stake in these companies because we're a surrogate for millions of taxpayers, many of whom thought it was a mistake in the first place. So we want a preference." That's one. And it is unprecedented, our preference. So is the consideration we provided to these companies that led to that preference in being unprecedented. That's one answer. The second answer is, we are perfectly willing to work with these independent compensation committees and these boards. We're in a way in a partnership created by Congress. Feinberg is called a pay czar. Very unfortunate term. First of all, my grandmother in Lithuania wouldn't [loud laughter]. You have no idea. But beyond that, I'm not a pay czar issuing imperial edicts without input from anybody, without asking the companies what's the right way to go, without meeting with independent compensation boards and chairmen of independent compensation committees, asking them what do you think, what about these arguments that are being made by other companies. It's more a mediation than it is an imperial imposition. So I would temper somewhat your argument by saying, even though the government does have a preference, it's really not "you'll do what I say." It's more, "What do you think we ought to do to make the company thrive?" Ultimately I do have the authority, you're right, but we're trying to minimize that perception that you accurately raise. The perception that somehow we're going to cram this down. That's really not what we're trying to do. Last question. Yes, sir.

Q: Just to make a couple of observations you might make a comment on. I spent 35 years in the financial services industry largely in lower Manhattan so everything you speak about I'm quite familiar with in my career. A couple of observations: when the firm that considers itself doing God's work, Goldman Sachs, was privately held they were trading on their own capital. Today they're trading on public capital and to me that leaves a very bad taste in my mouth when they go out on the risk curve. If they want to do it with their own money, God bless 'em. But if they want to do it with everybody else's money I think there should be different risk parameters. Second observation: in my experience the best plans for compensation were symmetrical, that is,

the upside and the downside had some relationship to one another. I think of Mr. [Andrew J.] Hall at Citigroup who earned $100 million and the only way Citigroup could cure that vis-a-vis their relationship to you was to sell the entire company, Phibro. Let's put it in perspective. If Hall earned a billion dollars for Citigroup and thus earned $100 million in his contractual relationship, that's fine. But what if he lost a billion dollars? He doesn't have $100 million to give back to Citigroup, nor does that compensate the shareholders, so I just welcome your comments.

KF: Let me comment on both of those because I'm thoroughly familiar with both of those arguments, and they are well stated. First, if you want to look at an example of a financial institution over the last couple of years that sailed through this crisis with flying colors and is the model of avoiding excessive risk, it is the private bank of Brown Brothers Harriman. A private bank betting its own money. It's exactly your point. And Brown Brothers is now getting all of this praise, rightfully deserved. How come you guys are so far removed from this problem? Look, your balance sheet's fine. You've taken a hit but it's nothing. You're moving on. Answer, over and over again, it's exactly your point. We're a private bank investing our own private bank officials' money and we know excessive risk when we see it. We wanted nothing to do with the housing bubble or anything like that. That's not what we do. Fabulous example corroborating that first point. Second point: Hall and Phibro. Excessive risk? I know it when I see it. Citigroup knew, we've gotta spin it off. We see the statute – excessive risk. We sort of have a feeling what will happen. And so they spun the whole thing off. I'm criticized: they spun it off for a song. It was a lousy deal. Citigroup could say lousy deal, the handwriting was on the wall anyway. I mean, we couldn't deal with that. So, excellent points.

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