

## In Merrill's Failed Plan, Lessons for Pay Czar

*The New York Times*

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October 8, 2009

It sounds like something Washington's pay czar might propose to rein in runaway bonuses on Wall Street.

Tie executives' compensation to their company's stock price. Withhold big paydays for years. Claw back bonuses if things go wrong. And force risk-loving traders to gamble with their own money, not just their company's.

In fact, those strictures were part of a compensation plan that Merrill Lynch adopted voluntarily in 2006 — two years before the company collapsed into the arms of Bank of America.

But the Merrill program, which was supposed to align its top employees' pay with the company's long-term performance, did not keep workers from taking risks that nearly sank the brokerage giant. And some of its senior executives still stand to collect millions of dollars in stock under the plan.

As the Obama administration's pay czar, Kenneth R. Feinberg, contemplates curbing compensation for the top 100 executives at each of the seven companies that received big bailouts — including Bank of America — the Merrill experience raises some sobering questions.

Can Washington really control outside pay on Wall Street, which many critics say fueled this crisis? And can Mr. Feinberg and federal regulators ensure that their plans will work?

Most of the financial industry, after all, is out of Mr. Feinberg's reach. And after the bailouts, many banks are moving toward paying employees more in the form of stock, rather than in cash, and spreading out workers' payouts, much as Merrill did a few years ago.

At Merrill Lynch — whose 2008 bonuses have come under sharp scrutiny in Congress — some employees stand to profit from the 2006 incentive plan, which was turbo-charged by the company's own money. The payments, due in January, are outside Mr. Feinberg's purview, because they were guaranteed before pay restrictions were imposed on bailed-out banks. But the office of the New York attorney general, Andrew M. Cuomo, who is investigating the 2008 payouts, has questioned at least one Merrill executive about the 2006 plan.

Robert Stickler, a spokesman for Bank of America, said the coming Merrill payouts would be awarded as scheduled. Since the payments were tied to Merrill's performance over four years, including a dismal 2007, some of the money has already been clawed back. Such punitive features, Mr. Stickler said, resemble some of the potential solutions the bank is considering. "In some aspects, that's where we have been going in compensation in working with Feinberg's office, so it is a sort of template," Mr. Stickler said.

The Merrill plan, copies of which were reviewed by The New York Times, was authorized by the firm's board and recommended by Towers Perrin, a compensation consulting firm.

Under the 2006 plan, top Merrill executives contributed a part of their bonuses from the prior year to an incentive plan that was then converted into stock. If Merrill did well, the firm doled out more shares to the employees at the end of each year. The plan was repeated over three years, and employees could not sell their stock until 2010.

Compensation experts who reviewed the plan commended much of it. They noted that the 34 Merrill executives included lost all of the money they put in for 2007, because Merrill performed poorly that year. But the main failure, they said, was that Merrill used leverage to juice its employees' returns in good years.

As of this week, some managers have made a 9 percent return on their investments in the plan, although top executives have lost 17 percent. But both groups have fared better than an ordinary shareholder would have with similar investments in Merrill stock. Those investors would have lost 45 percent.

"What we have here is something that was by and large good, and now the spotlight is on plans like this," said Lucian A. Bebchuk, a professor at Harvard Law School who has studied compensation. "But there are elements that could be improved on."

The Merrill bonus plan was controversial from the start. It was created by Ahmass L. Fakahany, Merrill's former co-president and chief operating officer, as part of a broader pay overhaul that also placed greater limits on workers' ability to sell company stock and increased the amount of their pay that would come in stock.

For the top six executives, Merrill contributed \$1.5 million for every \$2 million each executive invested in the plan, leveraging the possible returns. For the next 28 workers in the plan, Merrill paid in an amount two and a half times their investments. That meant that the workers started out ahead, no matter how the shares performed.

"That's an awful lot of leverage," said Brian Foley, a compensation consultant in White Plains. "Would you risk a buck in order to make six bucks? Yeah, you would. Maybe that's why people there were focused on the upside and not the risks."

A year into the Merrill plan, a \$2 million investment by a senior executive was worth \$11.5 million. Merrill's subsequent losses in 2007, though, meant that the money invested that year would be forfeited, essentially clawing back part of old bonuses.

Compensation experts who reviewed the Merrill plan wondered if it should have applied to more employees. Rank-and-file workers also take risks that can jeopardize a bank.

Merrill might also have used a longer-term measure than a single year's results to decide how many shares to grant executives, Professor Bebchuk said.

And the plan also contained a provision that would automatically award top workers more stock in the event that Merrill was sold — which it was.

“Hindsight in these plans is 20/20,” said Charles M. Elson, a professor of corporate governance at the University of Delaware. “Feinberg is going to be coming up with a model for the bailed-out banks, and the question is, will he use a model like this? He can’t possibly know what the next few years will bring for these companies.”

In January, the Merrill plan will expire, and the stock held within it will be awarded to Merrill executives who are still at Bank of America, or those who have retired. Most Merrill executives in the plan have already broken even, and the top six will if Bank of America’s share price reaches \$30 by January, from \$17.35 now.

But for a regular investor who put in money with the same timing, a break-even by then would not be possible unless the stock quadrupled.