24-3141

IN THE

United States Court of Appeals for the Second Circuit

MATTHEW T. SHAFER, individually and on behalf of all others similarly situated, MACE TAMSE, STEVE SHERESKY, GEORGE LIVANOS, JEFFREY SHOVER, MARK LOFTUS, SANDY JUKEL, STEVE NADLER, SHERI HAUGABOOK, JEFFREY SHERESKY, PETER HEIDT, JEFFREY SAMSEN,

Plaintiffs-Appellees-Cross-Appellants,

v.

MORGAN STANLEY, MORGAN STANLEY SMITH BARNEY LLC, MORGAN STANLEY COMPENSATION MANAGEMENT DEVELOPMENT AND SUCCESSION COMMITTEE,

Defendants-Appellants-Cross-Appellees,

JOHN/JANE DOES, 1-20,

Defendant.

On Appeal from the United States District Court
for the Southern District of New York
No. 20-cv-11047
Hon. Paul G. Gardephe

BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF DEFENDANTS-APPELLANTS-CROSS-APPELLEES

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, the Securities Industry and Financial Markets Association states that it is a non-profit corporation. It has no parent corporation, and no publicly held corporation owns 10% or more of its stock.

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INTEREST OF *AMICUS CURIAE*[1]

The Securities Industry and Financial Markets Association (SIFMA) is the leading trade association for broker-dealers, investment banks, and asset managers operating in the United States and global capital markets. On behalf of industry members and their one million employees, SIFMA advocates on legislation, regulation, and business policy affecting retail and institutional investors, equity and fixed income markets, and related products and services. As relevant here, SIFMA and its members have a strong interest in ensuring that the regulatory structure of equity markets serves the interests of investors and that regulations affecting SIFMA's members are sound, fair, and administrable. SIFMA regularly files amicus briefs in important cases arising under and relating to the federal securities laws.

INTRODUCTION

Deferred incentive-based compensation programs have become ubiquitous in the financial sector because they incentivize long-term

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[1] Pursuant to Federal Rule of Appellate Procedure 29(a)(4)(E), *amicus* certifies that no counsel for a party authored the brief in whole or in part, and no person or entity other than *amicus* and its counsel made a monetary contribution intended to fund the preparation or submission of the brief. All parties have consented to the filing of this brief.

performance over short-term gains. U.S. regulators have long encouraged deferred compensation programs for this very reason. And a rule proposed in May 2024 would make deferring incentive-based compensation *mandatory* at large financial institutions.

The reason deferred compensation plans are effective at aligning risk is because they allow financial institutions to adjust their employees' variable incentive-based compensation to account for performance over a longer time horizon. That very feature, however, is what would make this valuable tool incompatible with the anti-forfeiture provision applicable to ERISA employee pension benefit plans—if deferred incentive-based compensation programs were ERISA employee pension benefit plans. Fortunately, such programs, as exemplified by those at Morgan Stanley, are plainly *not* ERISA employee pension benefit plans—as the vast majority of courts to consider the question have found. The district court was wrong to conclude otherwise. The impact of the district court's error here is not limited to this one case. Because the nerve center of the U.S. financial sector is located in the Southern District of New York, the district court's decision has had an outsized and destabilizing effect on the

entire industry, creating a cloud of uncertainty over the status of deferred compensation programs for structuring incentive-based compensation. If the district court's order stands, financial institutions in the Southern District of New York will find themselves in an impossible position, forced to choose between financial regulators' crystal-clear guidance to maintain deferred compensation programs on the one hand, and the district court's interpretation here of their obligations under ERISA on the other.

ARGUMENT

I. Deferred Incentive-Based Compensation Plans Encourage Finance Executives And Employees To Prioritize Long-Term Performance Over Short-Term Gains.

After the 2008 global financial crisis, "[d]isgruntled shareholders and the general public began to express concern that executive pay and corporate performance [were] misaligned," citing the fact that "the top executives at many of the [affected] financial institutions made money despite the fact that their companies suffered huge losses." Lisa H. Nicholson, *Corporate Governance in the Financial Services Industry: Dodd-Frank Reforms to Banker Compensation Arrangements*, 47 Ind. L. Rev. 201, 204 (2014). One particular concern was that "compensation

policies at many of the large financial institutions often rewarded short-term gains in an environment of intense competition for talented professionals and eager investors instead of consideration of the long-term consequences of the entities trading activities." *Id*. at 201. Studying this problem in the immediate aftermath of the financial crisis, federal regulators likewise concluded that "[f]lawed incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007." Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. 36,395, 36,396 (June 25, 2010).

This observation was not limited to the United States. The question of how to optimize incentive-based compensation policies at financial institutions to align employee incentives with long-term financial health received significant attention at the 2009 G20 summit, with world leaders agreeing "to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking." The Leaders' Statement: The Pittsburgh Summit September 24-25, 2009, https://tinyurl.com/4ae673j8 (last visited Jan. 27, 2025). "The G-20 proposals were supported," among

other things, "by a 2009 study of 20 global financial institutions by a group of senior financial supervisors from seven countries including the United States … which found that 'historical compensation arrangements evidenced both an insensitivity to risk and the skewed incentives to maximize revenues.'" Nicholson, *supra*, 47 Ind. L. Rev. at 228 (quoting Senior Supervisors Grp., Risk Management Lessons from the Global Banking Crisis of 2008 at 4 (2009), https://tinyurl.com/mcmjdxdd).

When identifying *solutions* to the widely recognized misaligned-incentives problem, one near-universal proposal came up repeatedly: deferring incentive-based compensation. The U.S. Department of the Treasury issued non-binding compensation guidelines advising that "incentive compensation arrangements for senior executives at [large banking organizations] are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period." 75 Fed. Reg. at 36,410. The G20 similarly endorsed "requiring a significant portion of variable compensation to be deferred." The Leaders' Statement at 9, *supra*; *see also* Financial Stability Board, FSB Principles for Sound Compensation

Practices: Implementation Standards ¶ 6 (Sept. 25, 2009), https://tinyurl.com/yevxrymy (body created by the 2009 G20 summit recommending that "a substantial portion of variable compensation" be deferred "[f]or senior executives" and "other employees whose actions have a material impact on the risk exposure of the firm"). Indeed, the European Union "*mandates* the deferral of variable remuneration." Emilios Avgouleas & Jay Cullen, *Excessive Leverage and Bankers' Pay: Governance and Financial Stability Costs of a Symbiotic Relationship*, 21 Colum. J. Eur. L. 1, 11 n.62 (2014) (emphasis added).[2]

Deferring variable incentive-based compensation has proven such an attractive tool for aligning risk incentives precisely because such compensation can be reduced or rescinded over time. As the Federal Reserve has explained, "[i]f payout of a portion of incentive compensation awards is deferred for a period of time … late-arriving

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[2] U.S. regulators have several times proposed rules like those in the European Union that would require deferral of incentive-based compensation for certain large financial institutions. *See, e.g.*, Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670 (June 10, 2016); Notice of Proposed Rulemaking, "Incentive-Based Compensation Arrangements," Office of the Comptroller of the Currency (May 6, 2024), https://bit.ly/40CKEqA. So far, no such final rule has been promulgated.

information about risk taking and outcomes of such risk taking can be used to alter the payouts in ways that will improve the balance of risk-taking incentives." Bd. of Governors of the Fed. Reserve Sys., *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations* 6 (2011), https://tinyurl.com/2p9vbdsk; *see also id*. at 15 (deferred compensation allows "adjusting the payout for actual losses or other aspects of the employee's performance that are realized or become better known only during the deferral period"); Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670, 37,681 (June 10, 2016) (proposed rule on deferred incentive-based compensation explaining it works by "reduc[ing] … the amount of deferred incentive-based compensation … that has not vested" based on certain "adverse outcomes," like "[i]nappropriate risk-taking").[3] In short, the ability to adjust the amount of variable incentive-based compensation over a longer time horizon is what "provides long-term

[3] Note that deferred incentive-based compensation is distinct from a clawback. While deferred compensation programs place conditions on an incentive-based compensation award that may prevent it from vesting at all, "the term 'clawback' refers to a mechanism by which [an] institution can recover *vested* incentive-based compensation … if certain events occur." 81 Fed. Reg. at 37,681 (emphasis added).

incentives" in the financial sector to prioritize long-term performance over short-term gains. Avgouleas & Cullen, *supra*, 21 Colum. J. Eur. L. at 11; *see also* William C. Dudley, President, Fed. Reserve Bank of New York, Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry: Enhancing Financial Stability by Improving Culture in the Financial Services Industry (Oct. 20, 2014), https://tinyurl.com/2y3ybtce (deferred compensation requires employees "to more fully internalize the consequences of their actions"). And indeed, extensive academic "research suggests that deferred debt-like compensation reduces incentives for risk taking and risk shifting." Hamid Mehran & Joseph Tracy, *Deferred Cash Compensation: Enhancing Stability in the Financial Services Industry*, 22 Econ. Pol'y Rev. 61, 67 (Aug. 2016), https://tinyurl.com/3j2rzrha (collecting studies).

For all of these reasons, deferred incentive-based compensation programs are ubiquitous in the finance sector. Even before the 2008 global financial crisis, deferred compensation was "fairly common." Fed. Reserve, *Incentive Compensation Practices, supra* at 2. Now, however, "[a]lmost all" large financial institutions use some form of deferred compensation allowing them to "adjust downward the amount

of deferred incentive compensation" in certain circumstances. *See id.*; *see also id.* at 1 n.1 (listing large financial institutions evaluated). Such compensation may include cash, stock, or both. *E.g.*, *id.* at 15. Because deferred incentive-based compensation awards do not vest until after passage of a set period of time (often a number of years), *see id.*, employees who leave their employment *before* the award vests are generally not entitled to payment of the award upon their departure. That core feature of deferred incentive-based compensation is at the heart of the present dispute.

II. The District Court's Decision Threatens Deferred Incentive-Based Compensation Programs Throughout The Financial Sector.

As Appellants have explained in detail, the district court was wrong to conclude that deferred incentive-based compensation programs are "employee pension benefit plans" subject to ERISA's anti-forfeiture rule. OB38-55. In brief, the statute is clear that such a plan is established where a "plan, fund, or program ... by its express terms or as a result of surrounding circumstances ... results in a deferral of income by employees for periods extending to the termination of covered employment or beyond." 29 U.S.C. § 1002(2)(A)(ii). That is to say, the

hallmark of an employee pension benefit plan is providing benefits for the end of employment. As the regulations clarify with respect to incentive-based compensation, "the term[] … 'pension plan' shall not include payments made by an employer to some or all of its employees as bonuses for work performed, unless such payments are systematically deferred to the termination of covered employment or beyond, or so as to provide retirement income to employees." 29 C.F.R. § 2510.3-2(c). As courts and regulators have consistently concluded, contingent deferred incentive-based compensation in the financial industry constitutes a "bonus," not an earned commission. OB50-52. And the foregoing discussion of deferred incentive-based compensation programs makes clear that such programs, while deferred by some period of years to allow for a longer time horizon to assess performance, are not *systematically* deferred to termination; to the contrary, if employees leave employment before the deferred compensation award has vested, they are generally not entitled to payment. *Supra* § I.

The district court's decision that deferred incentive-based compensation programs *are* employee pension benefit plans subject to ERISA's anti-forfeiture rule, left undisturbed, threatens more than a

decade of progress in better aligning financial-sector compensation with the long-term health of financial institutions—and indeed the long-term health of the economy writ large. As discussed above, the reason deferred incentive-based compensation "reduces incentives for risk taking and risk shifting," Mehran & Tracy, *supra*, 22 Econ. Pol'y Rev. at 67, is that incentive-based compensation can be adjusted downward if a longer time horizon yields a different assessment of an employee's performance. *Supra* at 6-8. That kind of adjustment, however, is not permitted in the context of an ERISA employee pension benefit plan. *See* 29 U.S.C. § 1053(a) (requiring that "pension plan" benefits be "nonforfeitable"). Thus, the district court's order places in jeopardy the very essence of deferred incentive-based compensation programs throughout the financial sector.

The threat is particularly acute given that the order emanates from the Southern District of New York—the heart of the American financial sector. While extensive out-of-circuit precedent holds that deferred incentive-based compensation programs are *not* employee pension benefit plans under ERISA, *see* OB41-42, the decision below is the only decision in *this* Circuit to address the question. And as

Appellants note, employees seeking to challenge reductions or forfeitures of deferred compensation will undoubtedly present the district court's decision in support of their challenges. OB20-21; *see also Milligan v. Merrill Lynch*, No. 24-cv-00440 (W.D.N.C.) (copycat lawsuit against Merrill Lynch relying substantially on the district court's ERISA analysis). How other adjudicators respond to the district court's analysis remains to be seen. More significant, however, is the negative impact of the court's decision *beyond* the outcome of individual employee-employer disputes. The district court's decision puts financial institutions in the position of choosing between rolling the dice that they can convince an arbitration panel that an esteemed jurist in the Southern District of New York was wrong about whether deferred incentive-based compensation programs are employee pension benefit plans—or changing their deferred compensation programs in response to the district court's flawed analysis. For example, the particular focus here is Morgan Stanley's humanitarian exceptions to deferred compensation cancellation. Not only are such exceptions commonplace, but they have even been endorsed by regulators. *See, e.g.*, Notice of Proposed Rulemaking, "Incentive-Based Compensation Arrangements,"

supra (permitting the acceleration of vesting to pay deferred incentive-based compensation "in the case of death or disability"). But if the district court's decision stands, financial institutions may face pressure to eliminate these humanitarian exceptions to deferred compensation cancellation to ensure that payments are *never* deferred to "periods extending to the termination of covered employment or beyond." 29 U.S.C. § 1002(2)(A)(ii). Such changes would deprive employees of substantial benefits without advancing the purposes of ERISA one iota.

CONCLUSION

The destabilizing effects of the district court's order threaten deferred-compensation programs throughout the financial sector. SIFMA takes no position on the parties' procedural disputes regarding appellate jurisdiction and other matters, but asks that this Court, in assessing the parties' arguments, take account of the significant harm the district court's order would inflict on the financial industry as a whole and the investing public if left intact.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B)(i) and Second Circuit Local Rule 32.1(a)(4) because this brief contains 2,346 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(f).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word in Century Schoolbook 14-point font.

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