

Enhancing the Efficiency of Board Decision Making: Lessons Learned from the Financial Crisis of 2008

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- ▶ The opinions expressed in this presentation are solely the author's and are not to be taken as representative of the opinions of any former, current or future employer.

Part I: Background and Goal



Background

- ▶ Financial Crisis of 2008
- ▶ Preceded by sluggish economic growth and deteriorating financial conditions
- ▶ Actually, the whole decade pretty mediocre
- ▶ Wall Street firms, publicly traded companies, shelling out huge cash bonuses in 2006 and 2007
- ▶ What was going on?

The Fake Alpha Story

- ▶ Fake Alpha: Professor Raghuram Rajan (Jan. 2008, Financial Times, FT.com)
- ▶ Executives, traders and investment bankers allegedly in hot pursuit
 - Appearing to create large steady returns
 - However, hidden tail risk
 - Potential for a very rare negative return

Wall Street's Corporate Governance Crisis

- ▶ *Wall Street's Corporate Governance Crisis*, Corp. Gov. Adv., Jan. 2009
 - Fake alpha, clawbacks and BJR (liability for excessively risky decisions, David Rosenberg, *Supplying the Adverb, The Future of Corporate Risk-Taking and the Business Judgment Rule*, Berkeley Business Law Journal (2009))

Result of Fake Alpha's Pursuit

- ▶ Pursuit of fake alpha created false impression (misinformation) regarding value creating abilities of Wall Street employees
- ▶ Boards (independent and disinterested) presumably unaware
- ▶ Massive amounts of capital outflows
- ▶ Aggravated financial stress on Wall Street firms and the financial system in general

Goal of Paper

- ▶ Identify a tool of accountability under corporate law that could be used to help the board of a public company combat the pursuit of fake alpha

The background is a dark blue-grey color with a subtle, light-colored graphic. On the left side, there is a compass rose with a needle pointing towards the top-left. To the right of the compass, there is a line graph with several peaks and valleys, representing data trends. The text 'Part II: The Corporate Governance Story' is centered in the middle of the slide, preceded by a green triangle bullet point.

► Part II: The Corporate Governance Story

What is Different About Wall Street Firms?

- ▶ All firms enter into a multitude of explicit and implicit contracts
- ▶ Explicit contracts are *assumed* to dominate
 - Max. shareholder wealth equals max. social welfare
- ▶ Wall Street firms are unique because implicit contracts dominate
- ▶ Finance like a large public company, compensate like a partnership

Governance Implications

- ▶ Boards must deal with more than one significant residual claimant
- ▶ Boards must divvy up the residual
- ▶ Not just zero sum game
 - Must be done in well or risk losing key personnel
 - Where residual (capital) leaves the firm, potential for financial harm

Shareholder Primacy

- ▶ Adds complexity to board decision making
 - More than one master
- ▶ No longer a simple matter of maximizing the value of shareholder wealth
- ▶ Conclusion: Shareholder primacy no longer workable norm where implicit contracts dominate

Conceptualizing the Loss of Shareholder Primacy

- ▶ Shareholders are indirectly contracting away this norm to the extent the firm enters into implicit contracts
- ▶ Shareholders allow this to happen because they believe they will be better off
- ▶ Shareholders trust that the board will adequately perform its duty as a “mediating hierarchy”

The Board as a Mediating Hierarchy

- ▶ Margaret Blair and Lynn Stout's team production approach to corporate law (*A Team Production Approach to Corporate Law*, Univ. of Va. L. Rev., 1999)
- ▶ View the public company as a team made up of members who make firm specific investments
- ▶ Team members may opportunistically seek rents at the expense of other team members
- ▶ **The solution:** The board acts "as an internal 'court of appeals' to resolve disputes that may arise among the team members"
- ▶ That is, stakeholders, such as executives, traders and shareholders, *trust* the board to divvy up the residual in the most appropriate manner possible

What Firm Specific Investments Do Traders and Investment Bankers Make?

- ▶ The firm-specific investment made by a trader or investment banker takes the form of a limited time commitment to the firm
- ▶ Employee provided an in-the-money non-tradable European call option written by the employer
- ▶ The employee has the expectation, but not the guarantee, of a large bonus at the end of the bonus period—a bonus that only the employer who has written the call option can pay
- ▶ The accrued value of the firm specific investment increases as the bonus period comes to an end

Isolating the Corp. Governance Problem

- ▶ The ability of a board to act as a mediating hierarchy appears to be more difficult than Blair and Stout envisioned
- ▶ Opportunities and incentives for rent seeking behavior
 - Especially, where stakeholders have short time horizons
 - ▶ Again, the pursuit of fake alpha at Wall Street firms