FINANCIAL INSTITUTION EXECUTIVE COMPENSATION: THE PROBLEM OF FINANCIALLY MOTIVATED EXCESSIVE RISK-TAKING, THE REGULATORY RESPONSE, AND COMMON SENSE SOLUTIONS

Jesse D Gossett, University of San Francisco

Available at: https://works.bepress.com/jesse_gossett/1/
FINANCIAL INSTITUTION EXECUTIVE COMPENSATION: THE PROBLEM OF FINANCIALLY MOTIVATED EXCESSIVE RISK-TAKING, THE REGULATORY RESPONSE, AND COMMON SENSE SOLUTIONS

JESSE D. GOSSETT*

ABSTRACT

The year 2008 witnessed the greatest economic downturn in over seventy years. Excessive compensation was often cited as a major contributor to the Great Recession. In response, Congress enacted Dodd-Frank, which contains a handful of compensation-related reforms including a clawback for erroneously paid bonuses. However, none of these reforms does anything to address the true link between executive compensation and the Great Recession: compensation plans that encourage excessive risk taking. Under the current state of the law, Dodd-Frank does nothing to stave off a repeat of that disaster. Fortunately, one aspect of Dodd-Frank, Section 956, offers a glimmer of hope. It requires regulators to create rules that prohibit compensation plans at financial institutions that encourage excessive risk taking. Unfortunately, to date, no such rules have been enacted.

This Article supplies what Section 956 is currently missing. Because all bonuses are ultimately the result of risk-taking decisions, this Article suggests that all financial institution executive compensation plans must contain an ex ante risk assessment that may defer receipt of the bonus. This delay acts as risk to the executive that he or she may never actually receive the bonus and this risk is proportional to the risk taken by the firm to calculate the bonus in the first place. This Article further suggests an ex ante risk assessment to develop a sliding scale between how much of the bonus must be in cash and how much in equity.

If these suggested reforms are implemented financial institution executives would now consider how the risks they take with their firm’s assets directly impact the risks to their own bonuses. The end result would be a reduction in risk at financial institutions and a reduction in the likelihood or severity of the next financial-institution-created economic downturn.

*Jesse D. Gossett, CFA, CFP, J.D. Candidate, 2014, University of San Francisco School of Law. Chartered Financial Analyst Charterholder (CFA) and Certified Financial Planner Certificant (CFP) with 20 years of financial services industry experience. The author thanks Professor Michelle A. Travis for her invaluable guidance. The author also thanks his wife, Stephanie, and his son, Aidan, for their unending support of his law career.
In response to the financial collapse of 2007-09 (the “Great Recession”), on July 21, 2010, President Barack Obama signed into legislation the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). This law seeks to reform the mechanics of the U.S. financial system by establishing more and clearer rules regarding permissible activities, reporting, systemic oversight, and orderly liquidation of failed institutions. The law also seeks to impart some governmental control over what is widely considered to be a root cause of the Great Recession: executive compensation.2

Many critics and commentators have argued that an excessive amount of compensation lavished on financial institution CEOs and other executives was a key driver that led to the Great Recession. 3 There is certainly room for criticism of the levels of executive compensation—particularly considering the disastrous financial performance of many financial firms. For example, before leading his company into bankruptcy, Dick Fuld, former CEO of Lehman Brothers, was paid over $500 million. 4 From 2000 to 2008, Angelo Mozilo, former CEO of Countrywide, was paid over $520 million in compensation (as the negative impact of the toxic mortgages Countrywide made began to be realized, Bank of America bought the firm in a two-part deal in 2007 and 2008). 5 The highest paid CEO in the U.S. in 2007—bringing home $83.1 million in just that one year—was John Thain, former CEO of Merrill Lynch (the next year, in an effort to avoid bankruptcy, Mr. Thain sold Merrill to Bank of America). 6 Robert Rubin, who never even had a clearly defined role at Citigroup—other than being a major champion of that bank’s forays into collateralized debt obligations and other risky investments—made over $115 million from 1999 to 2008 (yet Citigroup shareholders lost over 70% during that same timeframe). 7

---

3 See, e.g., FCIC, supra note 2, at 64 (“SEC Chairman Mary Schapiro told the FCIC, ‘Many major financial institutions created asymmetric compensation packages that paid employees enormous sums for short-term success.’”); Adele Stan, Did Obscene Executive Pay Spark the Financial Crisis?, AFL-CIO NOW (Dec. 13, 2011), http://www.aflcio.org/Blog/Corporate-Greed/D id-Obscene-Executive-Pay-Spark-the-Financial-Crisis (“But at the root of the behavior that led to the 2008 market crash that nearly took down the economy, according to experts who spoke yesterday at a conference at the AFL-CIO in Washington, D.C., is the soaring level of executive pay at the nation’s giant corporations . . . . Consequently . . . excessive executive pay led to excessive risk-taking by CEOs and other top officials in corporations and financial institutions.”); Gail Russell Chaddock, House votes to rein in ‘excessive pay’ for company execs, THE CHRISTIAN SCIENCE MONITOR (Jul. 31, 2009), http://www.csmonitor.com/USA/Politics/2009/0731/house-votes-to-rein-in-excessive-pay-for-company-exec (page)/2 (“‘The perverse system of excessive pay, even for failure, created incentives for foolish risk-taking by major financial institutions,’ said Gerald McEntee, president of the American Federation of State, County and Municipal Employees.”).


7 WALL STREET JOURNAL, ‘No Line Responsibilities’ What Robert Rubin did for his $115 Million, THE WALL ST. J., (Dec. 3, 2008), http://online.wsj.com/article/SB122826632081174473 .html. Prior to joining Citigroup Mr. Rubin served as Treasury Secretary under President Clinton and was a key driver of the Graham-Leach-Bliley Act which served to repeal Glass-Steagall which allowed commercial banks to engage in investment banking activity and vice versa for the first time since the Great Depression. Mr. Rubin was also key in deregulating over-the-counter derivatives by championing the, ironically named, Commodity Futures Modernization Act of 2000.
CEO leading into and during the financial crisis, Ken Lay, retired in 2009 with total compensation estimated at $125 million. Other notable exit pay packages in the wake of the financial crisis include $31.5 million for Citigroup’s Charles Prince, $18.3 million for Washington Mutual’s Kerry Killinger, $14.3 million for Wachovia’s Ken Thompson, and $17.5 million for AIG’s Martin Sullivan. While these examples certainly highlight the disparity between the amount of executive compensation and the poor results the shareholders bought with that money, they minimize (or fail to highlight) the real problem: Executive compensation plans that, purposely or otherwise, encourage excessive risk-taking and, ultimately, lead to poor financial performance with devastating economic collateral damage. This is particularly true when the risks being taken are with other peoples’ (government guaranteed) money.

To address the concern that executive compensation played a part in creating the Great Recession, the U.S. enacted certain provisions of Dodd-Frank which address the issue by requiring, among other things, clawbacks of improperly paid compensation, the disclosure of certain compensation-related information, and a degree of shareholder input in setting compensation. Internationally, in response to large bonuses paid only one year after the Great Recession, Britain enacted a windfall tax of 50% on bank bonuses in excess of £25,000. And recently, the United Kingdom announced a plan to give shareholders the power to reject company director pay plans. Further, the European Union recently enacted a rule limiting bank bonuses to no more than the employee’s salary (1:1 ratio) with the possibility of up to a 2:1 ratio with the approval of a supermajority of the bank’s shareholders. Unfortunately, none of

---

9 Id.
10 See infra Part III.
12 Tim Castle, UK to Give Shareholders Power Over Executive Pay, REUTERS U.K. EDITION (June 20, 2012), http://uk.reuters.com/article/2012/06/20/uk-britain-pay-idUKBRE85J0JZ20120620 (this will only affect director compensation, not non-director executives).
13 Joshua Chaffin, EU Bank Bonus Rules Approved, FINANCIAL TIMES (Mar. 20, 2013), http://www.ft.com/cms/s/0/ca5becf0-91ae-11e2-b4e9-00144feabdc0.html#axzz2FpzLRmqK. The problems with this “solution” should be obvious. First, this will simply result in higher base salaries. See e.g., Kevin Crowley & Jim Brunsden, European Fund Managers Seen Doubling Salaries on Bonus Caps, BLOOMBERG BUSINESSWEEK, (Apr. 19, 2013), http://www.businessweek.com/news/2013-04-19/european-fund-managers-seen-doubling-salaries-on-bonus-caps. Second, talented employees will simply leave banks to work at non-bank financial firms. See e.g.,
these actions actually addresses the real goal: discouraging excessive risk-taking in the first place.

This Article does not examine what is the proper amount of income to be paid or its ratio to other employees’ incomes (if even a proper amount or ratio exists). While reasons may exist to address the size of pay packages (e.g., economic inequality, destabilization of the middle class, etc.), this is a by-product of the real cause of the Great Recession—pay packages that encourage excessive risk-taking. The focus of this paper is on how the design of a common compensation plan incentivizes excessive risk taking.14 Part II defines excessive risk-taking and shows how compensation plans incentivize it. Part III analyzes the current regulatory approach to this issue by looking at the compensation-related components of Dodd-Frank as well as existing rules under the Sarbanes-Oxley Act of 2002 (“SOX”).15 This analysis not only outlines what these acts do; but more importantly, Part IV shows how they largely miss the opportunity to address the underlying problem. Part V then makes recommendations for better aligning financial institution executive compensation with the interests of all stakeholders.

II. REGULATING INCENTIVES FOR EXCESSIVE RISK-TAKING

Dodd-Frank, unfortunately, largely misses the mark in terms of preventing one of the major causes of the Great Recession: compensation plans that encourage excessive risk-taking at financial institutions. To understand why requires a brief overview of the economics of compensation. The first basic economic foundational principal is that risk = reward.16 In other words, the higher the risk of a certain action the higher the potential reward should be.  


14 While the principals and recommendations in this Article could apply to non-financial institutions without much modification, this Article will only address financial institution compensation. Because of the wording of Dodd-Frank it is unlikely these recommendations could legally apply to non-financial organizations. Additionally, these firms do not pose the same level of risk to the economy that financial institutions pose. However, these recommendations represent sound corporate governance practices that should be considered by all firms.


16 See Capital Asset Pricing Model [hereinafter CAPM] \( E(R_i) = R_f + \beta \left[ E(R_m) - R_f \right] \), where \( E(R_i) \) is the expected return (or reward) from the investment, \( \beta \) is the sensitivity of the investment relative to the market, \( E(R_m) \) is the expected return of the market, and \( R_f \) is the risk-free rate. Under this formula, a higher \( \beta \), or higher risk, will provide higher excess returns, and vice versa. This is applicable to risk taking in all its forms. CFA INSTITUTE, CORPORATE FINANCE AND PORTFOLIO MANAGEMENT, CFA PROGRAM CURRICULUM, LEVEL I, VOL. 4, at 259-60 (2009).
(otherwise, why engage in it?), and vice versa. The second foundational principal is that the promise of future reward will motivate current effort. If an employer pays a fixed amount for a certain quantity of work, the employee will perform that quantity of work and little if anything more. This may be acceptable for the average employee tasked with maintaining the operations, but this would not be acceptable for the leader of the organization tasked with growing it for the benefit of the shareholders. If the shareholders wish to maximize their investment, the leaders of the organization need to be paid to think and work beyond what is expected.

From as far back as the 1950s, executive compensation has been a mixture of cash and stock options (or other equity-linked securities). Originally, the decision of how much of which component was largely driven by tax considerations. Then, in response to wage and price controls imposed by the Nixon administration in 1971, many firms began to adopt “performance-based bonus plans tied to accounting data or revenues.” The theory was that tying a portion of the executive’s compensation to the financial results of the company would better align the interests of executives and shareholders. However, this introduces risk into the equation.

However, unlike the standard risk = reward framework, executive equity- or performance-based compensation is more appropriately stated as \( \lim_{n \to \infty} (\text{risk}) = \lim_{n \to \infty} (\text{reward}) \), where \( n = (\text{base pay} + \text{cash bonuses} + \text{other perks}) \). This new equation acknowledges that while risk is unlimited, executive compensation is

---

17 Alternatively, consider reward as having an inverse relationship with safety represented by reward = \( 1 / \text{safety} \).

18 See Marginal Product of Labor [hereinafter MPL] \( MRP_L = MC_L \), where the marginal revenue product of labor equals the marginal cost of labor. While this principal was developed to manage firm production it is readily transferrable to personal production principals. See CFA INSTITUTE, ECONOMICS, CFA PROGRAM CURRICULUM, LEVEL I, VOL. 2, at 255 (2009) (“[T]he profit-maximizing quantity [of labor] is that at which marginal revenue equals marginal cost.”).


21 Id.

22 Id.


24 See CAPM, supra note 15. If a shareholder’s interests are represented by the CAPM and an executive’s interests are now tied to the shareholder’s then by the transitive property of equalities (if A=B and B=C then A=C) the executive’s interests are now represented by the CAPM. Agency risk exists as well but is outside the scope of this paper. See Cunningham, supra note 22, at 1187.
similarly unlimited on the upside but has a floor on the downside equal to $n$. In other words, executives do not take a loss beyond $n$ even when the firm takes a loss greater than $n$. This represents an asymmetry between gains and losses. If executives know they will be paid more for better financial results and the way to achieve better financial results is to take on more risk, they will begin to consider the risk-taking activities. Add the knowledge that, at worst, they will be paid their salary no matter what happens, the risky moves become exceedingly enticing. This can be euphemistically referred to as “heads I win, tails you lose.”

This is not, in and of itself, a bad thing. Indeed, this is exactly what shareholders pay CEOs and other executives to do: take risks with their money so they can make more money. Specifically, banks and other financial institutions are in the business of risk-taking. Their role as financial intermediaries is to allocate risk in a prudent way. The problem is when the incentive created is to take long-term structural risk to reap short-term rewards. In other words, the danger is when the compensation plan encourages so-called “fat tail” risk.

Most risky projects are analyzed using quantitative analysis (e.g., statistics). The probability of outcomes will be plotted on a distribution curve with the majority of the probable return outcomes falling around some average probable return. Most analysis is based on the standard normal distribution curve; however, the realities of the project might yield a range of probable outcomes that is anything but normal. In other words, the analysis will be deficient if the probability of abnormally high or low returns is higher than assumed. Graphically, the normal standard distribution has a smooth peak at the center of the distribution. However, a distribution with fat-tails will have fewer probabilities around the average, meaning there are a higher number of probabilities at the extremes. The resulting shape is a flatter peak. Therefore, the executive is analyzing the project under the assumption that extreme events are highly unlikely when in fact the opposite may be true. Further, because they are

---

25  This equation also acknowledges that risk has a floor as well; risk can’t be below 0 (negative risk). However, this is irrelevant because under the $risk = reward$ model, if risk were negative, reward would be negative as well.

26  See e.g., http://dictionary.cambridge.org/dictionary/british/heads-i-win-tails-you-lose (defining as “a situation in which you will win no matter what happens.”).

27  Bert Scholtens & Dick van Wensveen, The Theory of Financial Intermediation: An Essay on What it Does (Not) Explain, SUERF THE EUROPEAN MONEY AND FIN. FORUM, no. 1, 2003, at 1, 8 (stating, “[I]t is the transformation and management of risk that is the intermediaries’ contribution to the economic welfare of the society it operates in.”).


29  In this case, the distribution will have kurtosis < 3.0 and is called platykurtic. Conversely, a distribution with a sharp peak will have kurtosis > 3.0 and is called leptokurtic.
considered highly unlikely they are unplanned for. However, this lack of planning makes them devastating when they do occur.

Figure 1. Copied from Theory & Reality: Risk Management, available at http://www.theoryandreality.com/resources/rm_faq1.html

Another way to conceptualize this risk is to analogize to something with which most readers of this paper will be familiar: law school grading curves. Imagine a 1L section of 100 students. The normal grade distribution curve for that group would have 60 students receiving a B-, 15 receiving a C-, 15 receiving a B+, and 5 receiving a D with the final 5 receiving an A.30 However, professors have some discretion. Imagine a professor that enjoys rewarding exceptional work but likewise enjoys “rewarding” abysmal work. This professor may award a few A+s but also a few Fs (perhaps 2 of each). This now changes the distribution by pushing students out of the middle, B-, to either side of the average. The new curve might be 40 receiving a B-, 20 a C-, 20 a B+, 8 a D, 8 an A, 2 an F, and 2 an A+. If a student mistakenly believes this professor will adhere to the normal curve, he may not take preparing for the exam very seriously believing he has a 75% chance of receiving a grade in the range from C- to B-. However, in reality he has a 40% chance of receiving a grade in this range and a 10% “fat-tail” risk of receiving a D or even an F. To return to executive compensation, the risk vs. reward equation is not study time vs. grades but rather the returns (and resulting bonuses) vs. losses from risky investments. If the executive mistakenly analyzes the risks and rewards of the investment using a normal distribution when in fact a fat-tail distribution is more appropriate, he may be over-predicting a normal

30 Technically, the curve should be centered around a C grade with a range from F to A but because most students and their financial backers insist they are above average (see “Wobegon” effect, infra note 104), thus above a C, most law schools key their curves to a B- and rarely, if ever, actually give an F grade.
outcome and under-predicting an extreme outcome. Additionally, unlike the grade curve scenario, the executive is assured that no matter what happens, he will receive his base compensation of \( n \). This combination of unaccounted for fat-tail risk and a floor on compensation provides the means and motivation for excessive risk-taking. Multiply this over dozens or hundreds of projects with multi-year timeframes and the latent and unplanned-for risk becomes extreme.

To further complicate matters, executives, eager to engage in a risky activity (to earn a higher bonus), may misanalyze the skewness of the probability distribution. Skewness measures whether a curve leans, and if it does, which way. Again, most assessments presume the normal distribution, which has a symmetrical distribution of probabilities on both sides of the average. However, as is known, reality is anything but normal. Worse, if skew is presumed, the analysis will more than likely presume a positive skew, meaning the bulk of the assumed probabilities predict a higher likelihood of a positive outcome. This is true because no one would study a project deemed from the beginning to have a high probability of a negative outcome.

Figure 2. Copied from AllPsych Online: The Virtual Psychology Classroom, available at http://allpsych.com/research methods/distributions.html

---

31 In grade curve terms, this is equivalent to a scenario where a student is guaranteed at least a B- but this guarantee comes with the higher risk a fellow student will receive an F. Thankfully, this scenario does not exist in law school.

32 See Brown, supra note 27.

33 See supra Figure 1.

34 Consider the truth that by definition “normal” is merely the average of all abnormalities.

35 This is a form of “selection bias” that exists because of a flaw in the selection process. Here, the desire is to not spend resources analyzing a project that is assumed to be a loser from the beginning. See Sample Selection Basis, INVESTOPEDIA, http://www.investopedia.com/terms/s/sample_selection_basis.asp. Another, related form of bias is “ego-involvement” or “vested interest.” This results because the executive is predisposed to thinking in terms of probability of success, not probability of failure. See Randall L. Schultz, The Role of Ego in Product Failure, UNIV. OF IOWA, 3 (Feb. 2001), available at http://www.theproduct.com/faculty/papers/ego.pdf (discussing in context of marketing decisions but the principals are generally applicable).
Making matters potentially worse is the possibility the executive has committed both errors—very low probability of an extreme outcome and higher likelihood of a successful outcome—when the unfortunate reality is the probability of outcomes has a higher likelihood of an extreme and negative outcome. In other words, there are more probabilities of a higher than normal negative outcome than would be predicted by the analysis. The result is a higher than normal probability of failure. This leads to the ultimate problem of the combination of the asymmetrical monetary enticement to take risky action and improper, if not biased decision-making analytics.

These risk analysis flaws are further exacerbated by the realities of the typical capital structure of the banking industry. Consider a bank that has $100 in assets funded by $10 of equity capital and $90 of liabilities (e.g., FDIC insured deposits). Keep in mind that in the event of liquidation, liabilities are senior to equity. Also keep in mind that the maximum upside for depositors (and other lenders) is limited to the amount of the deposit plus interest. This gives managers and shareholders an incentive to take risk. For example, consider a strategy that would produce a 50/50 chance of increasing or decreasing the value of the bank’s assets. Specifically, imagine the manager must decide whether to pursue a risky strategy with a 50% chance of reducing the value of assets by $20 and an equal chance of increasing assets by X. If X < $20 the risky strategy will have a negative expected value. However, taking the risky strategy would be in the interest of shareholders for some values of X below $20.

The reason for this is that in the event the risky strategy would produce a loss of $20, the shareholders will not solely bear this loss. Rather, their loss is limited to their $10 of invested capital. The remaining $10 loss is borne by the depositors (or, more likely, the government through the FDIC). Conversely, if the risky strategy is successful, the shareholders will capture 100% of the upside. Consequently, for values of X in the range between $10 and $20, even though the strategy has a negative expected value, it is still in the economic best interests of shareholders and management. Another way to consider this is that shareholders and managers are indifferent to any potential losses larger than their invested capital so long as the expected payoff is greater than the potential loss.

To illustrate this indifference, consider the bank with $100 in assets funded by $90 of debt and $10 of equity that can choose between two risky strategies: A and B. Suppose A provides a 90% chance of earning $2 and a 10% chance of losing $10. Further, suppose B provides a 90% chance of earning $3 and a 10% chance of losing $50. Here, A offers a positive expected value and B a

---

37 Recall the risks inherent in this probability analysis. See supra Part II, 7–10.
negative expected value. However, from the manager’s and shareholder’s perspective, B is the superior choice because the odds of losing everything ($10 of equity) are the same while the upside for B is 50% higher than the upside for A. Perversely, financial institution depositors are largely indifferent as well. So long as the FDIC guarantees deposits, depositors have no incentive to investigate whether or not a particular bank is investing in risky strategies with a negative expected value. Layer on top of this the problems of under-estimating fat tails and skew bias in analyzing risky strategies and the result is a recipe for a Great Recession.

In terms of compensation strategies, given $\text{risk} = \text{reward}$, if the amount of a manager’s compensation is determined by certain financial results then the manager will introduce risk in order to improve those results and earn a bigger payoff. This is true whether the compensation takes the form of cash or securities. However, in the case of payments in securities there is incentive to later add additional risk in an effort to increase the value of those securities (and to increase the amount of future bonuses). This is exactly what lead up to the financial crisis. Managers either authorized or turned a blind-eye to increasing levels of firm risk because the allure of a large payoff was too tempting. For example, during testimony, the CEO of Citigroup told the Financial Crisis Inquiry Commission that a $40 billion position in mortgage securities would “not in any way have excited [his] attention.” This mentality is not a relic of the financial crisis. JPMorgan Chase recently lost over $6 billion on a negative carry trade that was ostensibly established to hedge the bank’s credit portfolio but was designed to make money at the same time—something every hedger knows cannot be done. A recent Senate investigation shined a light on the bank’s inability to responsibly manage the risks it was taking and the efforts by top management to cover up the losses. Unfortunately, clawbacks will do nothing to alleviate these situations because they are not the ones clawbacks are designed to alleviate. To remedy this situation will require a rethinking of the goals and economics of compensation.

38 Technically, depositors with balances in excess of the Federal Deposit Insurance Corporation (“FDIC”) insurance limit should be concerned to the extent their deposits exceed this limit. However, during the Great Recession the government either directly bailed out failing banks or structured acquisitions by banks they supported, rendering this excess deposit risk mostly theoretical. The current FDIC insurance limit is $250,000 per depositor, per insured bank, for each account ownership category. See FDIC, DEPOSIT INSURANCE SUMMARY, available at http://www.fdic.gov/deposit/deposits/dis (last updated Oct. 17, 2013)

39 FCIC, supra note 2, at xix.


III. CURRENT REGULATORY LANDSCAPE

To date, the primary, if not only U.S. government response to the financial crisis is the Dodd-Frank legislation. In his statement upon signing Dodd-Frank into law, President Barack Obama highlighted what he saw as one of the goals of this new law: “Shareholders will . . . have a greater say on the pay of CEOs and other executives, so they can reward success instead of failure.” 43 In other words, in the eyes of our government, one of the goals of Dodd-Frank is to reduce the level of outrage over the size of CEO compensation but not the behaviors the compensation plans promote.

The final law is 848 pages long. 44 Eight of those pages are devoted to executive compensation represented by six different sections. 45 These six sections operate primarily in two ways: clawbacks and transparency measures. As will be shown, these provisions will be largely ineffective because they do not regulate any of the behavior and bias that led to the financial crisis in the first place. However, one section may prove useful because it specifically calls for managing risk-taking at certain financial institutions through limited regulation of compensation plans.

A. Clawback Provision

Dodd-Frank is not the government’s first attempt at applying some form of control on executive compensation. In 2002, in response to high-profile corporate accounting scandals (e.g., fraud) at Enron, 46 WorldCom, 47 and Tyco 48 (to name just a few), Congress passed and President George W. Bush signed into law the Sarbanes-Oxley Act of 2002. 49 The stated purpose of the act was “[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws.” 50 SOX provides that “[i]f an issuer is required to prepare an accounting restatement due to the material

44 Dodd-Frank, supra note 1.
45 Dodd-Frank, supra note 1, at 524-31.
49 SOX, supra note 14.
50 Id.
noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws” the CEO and CFO can be required to payback the issuer any bonuses received or profits made from stock sales during the 12 month period following the original issuance of the later restated financial document(s).\footnote{Id. § 304 (codified at 15 U.S.C. § 7243 (2006)).} In other words, Congress sought to control irresponsible and fraudulent behavior by implementing, among other things, so called “clawbacks” of bonuses or profits derived from inaccurate or fraudulent financial disclosures.

The recently enacted Dodd-Frank has a similar provision that requires corporations (1) to disclose their incentive-based compensation plans as they are based on the financial statements that are required to be reported,\footnote{Dodd-Frank, supra note 1, at § 954(b)(1) (codified at 15 U.S.C. § 78j-4(b)(1) (2006)).} and (2) in the event of any accounting restatements for material noncompliance, to recover from any current or former executive officer any compensation received by the executive during the 3-year period preceding the date of the restatement that is in excess of the amount that would have been paid if the original statements had been correct.\footnote{Id. § 954(b)(2) (codified at 15 U.S.C. § 78j-4(b)(2) (2006)).} Again, Congress is attempting to regulate irresponsible and fraudulent actions through clawbacks of compensation earned as the result of inaccurate or fraudulent financial disclosures.

The similarities between these two laws are that (1) the triggering event is a restatement of any of the financial disclosures companies are required to submit and (2) the money at issue is any that was made as a result of the original statement. The differences are subtle: (1) SOX only involves CEOs and CFOs but Dodd-Frank includes all executives, (2) SOX requires misconduct while Dodd-Frank does not require any level of scienter, (3) SOX encompasses any compensation or profits made during the 12 months following the issuance of the original financial disclosure while Dodd-Frank covers the 3-year period preceding the date of the restated financial disclosure, and (4) SOX includes both compensation (whether as cash or equity including equity-linked) and profitable sales transactions but Dodd-Frank only appears to cover incentive compensation including stock options (however, the SEC has not yet defined this term so perhaps it could include profits from open market transactions). Despite these subtle differences, the intent of both laws is the same: To hold those in charge of a publicly traded corporation responsible when they profit from inaccurate or fraudulent financial reporting. As will be shown, this will do nothing to actually reduce the level of systemic risk at financial institutions which means this provision will be largely ineffective at holding off the next financial crisis.
B. Transparency Provisions

Dodd-Frank also provides for additional compensation rules that represent the most significant corporate governance reforms since SOX\textsuperscript{54} including:

1. Say on pay.\textsuperscript{55}

Dodd-Frank requires that shareholders be offered the opportunity to make their views on the compensation of executives known.\textsuperscript{56} It requires that proxy statements include a resolution subject to shareholder vote to approve the compensation of executives.\textsuperscript{57} Shareholders are also empowered to make their own compensation proposals.\textsuperscript{58} However, shareholder votes are non-binding, do not overrule decisions of the board of directors, and this provision absolves the board of liability should the vote go unheeded.\textsuperscript{59}

2. Structure of compensation committees.\textsuperscript{60}

Dodd-Frank requires compensation committees to be composed of only independent directors with very strict requirements for independence.\textsuperscript{61} It also empowers them to hire independent compensation consultants and legal counsel.\textsuperscript{62} It remains to be seen, however, if this independence will eliminate (or even reduce) the problems of executive dominance and suboptimal contracting.\textsuperscript{63}

---


\textsuperscript{56} Id. § 951(a)(1) (requiring a shareholder resolution at least every three years to approve the compensation of executives).

\textsuperscript{57} Id.

\textsuperscript{58} 17 C.F.R. § 240.14a-8 (however, this proposal may be properly excluded under § 240.14a-8(i)(10)–(11)).

\textsuperscript{59} Dodd-Frank, supra note 1, at § 951(c).

\textsuperscript{60} See id. § 952 (codified at 15 U.S.C. 78j-3 (2006)) (section titled Compensation Committee Independence).

\textsuperscript{61} Id. § 952(a)(2)–(3).

\textsuperscript{62} Id. § 952(b)–(e).

\textsuperscript{63} See Cunningham, supra note 22, at 1191–93.
3. Disclosure of pay versus performance. 64

Dodd-Frank requires firms to describe compensation policies and provide data on the relationship between realized executive compensation (including returns on share-based compensation) and realized financial performance of the firm. 65 In addition, firms must disclose total annual CEO compensation, median annual employee compensation, and the ratio between the two. 66

4. Hedging strategies. 67

Dodd-Frank also mandates that the SEC require by rule that each public company disclose in the annual proxy statement whether the employees of the issuer are permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities granted to employees by the issuer as part of an employee compensation package. 68 This requirement simply provides an additional degree of transparency about the executive’s ability to offset firm risk (that he or she may have created) that exists in the executive’s portfolio.

All of these rules are focused on providing transparency to the area of executive compensation. 69 The idea being that sunshine is the best antiseptic for dangerous pay packages. Only time will tell if that is indeed true.

C. Risk-Taking Provision

One provision specifically addresses the problem of compensation as motivation to engage in excessive risk-taking behaviors:

1. Regulatory oversight of compensation in financial firms.

Specific to financial firms, Dodd-Frank’s § 956 empowers the appropriate regulator to establish rules that mandate sufficient disclosure of incentive compensation arrangements and that prohibit arrangements that encourage

65 Id. § 953(a)(i).
66 Id. § 953(b).
67 Id. § 955 (codified at 15 U.S.C. § 78n(j) (2006)).
68 Id. § 955(j).
69 See Acharya et al., supra note 54, at 499.
inappropriate risk-taking or could lead to material financial losses at these companies.\textsuperscript{70}

To date, no regulators have actually established any rules related to the disclosure or prohibition requirements of this section so it is to be seen what the regulatory response will be.\textsuperscript{71} However, if approached with the goal of discouraging excessive risk-taking through properly constructed compensation arrangements, this provision may provide the strongest tool in Dodd-Frank’s 848 pages in terms of preventing the next financial crisis. Before addressing solutions through § 956, it is important to understand why the clawback and transparency provisions will be largely ineffective.

IV. WEAKNESSES OF THESE REFORMS

While both SOX and Dodd-Frank apply to financial and non-financial firms alike\textsuperscript{72} (with the exception of Dodd-Frank’s § 956), this paper seeks only to review these rules as applied to banks and other financial institutions as they relate to the cause of the Great Recession. The compensation provisions of Dodd-Frank are found in Title IX of that law which is named the Investor Protection and Securities Reform Act of 2010.\textsuperscript{73} The objective of this law is to protect investors\textsuperscript{74} through transparency and clawbacks. However, financial institution risks are not only posed to their shareholders but also to society at large.\textsuperscript{75} Nothing in this law specifically prohibits or discourages financial institutions from taking excessive risk. In fact, shareholders may prefer that banks take excessive risks in the pursuit of higher gains even if to the detriment of taxpayers.\textsuperscript{76}

A. Clawback Limitations

To understand the limitations of these laws, the first question to ask is, “What do these new rules accomplish?” Arguably, the rule with the most force is the clawback provision because it is the only one with a tangible consequence:

\textsuperscript{70} Dodd-Frank, \textit{supra} note 1, at § 956 (codified at 12 U.S.C. § 5641 (2006)).

\textsuperscript{71} In 2011, a consortium of regulators comprised of the Federal Reserve Board, FDIC, SEC, OCC, OTS, NCUA, and FHFA, issued a proposed rule for implementing § 956 of Dodd-Frank. 76 F.R. 21170-01. The proposed rule called for such things as limits on “excessive compensation,” reporting requirements, mandatory deferrals, and defining who was covered. To date, no provisions of this rule have been implemented and comments are still being accepted. See Comments on Proposed Rule: Incentive-Based Compensation Arrangements, \textit{available at} http://www.sec.gov/comments/s7-12-11/s71211.shtml.

\textsuperscript{72} See Acharya et al., \textit{supra} note 52, at 497.

\textsuperscript{73} Dodd-Frank, \textit{supra} note 1, at Title IX.

\textsuperscript{74} \textit{Id}. § 901, Subtitle A.

\textsuperscript{75} Acharya et al., \textit{supra} note 52, at 499-500.

\textsuperscript{76} \textit{Id}. at 500; \textit{see also supra}, Part II, 9–11 (discussing limits to shareholder losses).
violate the rule = lose money. However, there are four major problems with this rule: (1) applicability, (2) ability to manipulate, (3) who it seeks to regulate, and (4) enforcement.

The primary issue is what is required to trigger this rule (e.g., when is it applicable). This provision of the Act is (potentially) violated if a required financial disclosure needs to be restated. This is useful if the goal is to limit the likelihood of careless or deliberate falsification of these disclosures. However, SOX already does that. In other words, the existence of a clawback provision did nothing to avert the Great Recession so why did our lawmakers spend time modifying the existing one? To the extent this provision of Dodd-Frank expands on SOX by (possibly) creating a larger pool of covered persons, (executives rather than only CEOs and CFOs), creates different covered time periods, and lessens the required scienter (from misconduct to nothing), then, perhaps, Dodd-Frank is an improvement on SOX. However, it still begs the questions, “What behavior is Dodd-Frank seeking to regulate and what behavior is it not regulating that it should?”

The next weakness of the clawback provision is that it is susceptible to manipulation. Depending on what financial measurements are used to calculate an executive’s compensation, these measurements can be “massaged” by management without triggering the clawback.77 For example, if a compensation plan rewards high net earnings, the manager can simply instruct the accounting department to use a higher (but not high enough to gather too much attention) assumed rate of return (“ARR”) for pension assets.78 If less firm income is needed to currently fund the plan then more can be kept as earnings. Of course, eventually this money will be needed in the plan (actually, more will be needed because those funds were not invested in the plan earning a return); but in the meantime, the executive has boosted near-term earnings and scored a big bonus. So long as the executive can keep this hidden for at least three years he or she is in the clear in terms of escaping a Dodd-Frank clawback. Further, it is not entirely clear this sort of machination would even trigger the clawback rule in the first place because no restatement of any financial disclosures will be needed.

Or, perhaps the manager is paid based on return on equity (ROE). Because interest payments to creditors are tax deductible but dividend payments

78 Net present value (NPV) = \( \frac{F}{(1+i)^t} \); where \( F_t \) is the future value at period \( t \), \( i \) is the ARR and \( t \) is the time period. See, e.g., CFA INSTITUTE, ETHICAL AND PROFESSIONAL STANDARDS AND QUANTITATIVE METHODS, CFA PROGRAM CURRICULUM, LEVEL I, Vol. 1, at 215 (2009). A higher value of \( i \) will make a larger denominator, which will lower the NPV. Id. at 215-16, Ex. 1. (Citation for this?)
to shareholders are not, a higher leverage ratio (assets \( \div \) average equity) tends to increase ROE. However, at a certain point too much debt increases the risk of default to the point creditors demand a higher risk premium and ROE goes down. But for financial firms, high leverage means higher earnings (and higher ROE). To reduce the effect of too much leverage on the balance sheet the manager may engage in repo transactions near the end of the accounting period. These are effectively loans of assets but are booked as sales (increases earnings). The proceeds are used to pay down debt (reduces excess leverage and increases ROE). The result is the manager scores a big payday. Following the accounting period, the repo is undone (new loan taken out to repurchase the assets) and the firm is back to its over-leveraged self. Once again, it is also not clear these transactions would even trigger a clawback if discovered. These are just a couple of the many ways executives can artificially boost short-term performance results to meet compensation plan targets.

Dodd-Frank appears to be further reaching than SOX because it impacts all “executive officers” rather than just CEOs and CFOs. While this appears to cast a wider net, this may be illusive. While Dodd-Frank does not define “executive officer” it is unlikely to include anyone outside the “C Suite” (those officers designated as Chief of something). However, there is no reason to think including the Chief Technology Officer or Chief Information Officer within the potential clawback grasp will lower excessive risk-taking at financial firms. Indeed, the only officer it makes sense to include aside from the CEO and CFO is the Chief Risk Officer. This officer’s job is to manage risk, not necessarily reduce it. However, the clawback provisions are for restated financial disclosures, so to the extent risk levels are properly disclosed in the first place (to the extent they are required to be disclosed) the inclusion of the CRO in the clawback scheme will have little effect. Therefore, this difference between SOX and Dodd-Frank appears to be a distinction without a difference. This raises the question, “If SOX

---

79 See DuPont Formula, ROE = (net margin) x (asset turnover) x (financial leverage) or \( \left( \frac{\text{net income}}{\text{sales}} \right) \times \left( \frac{\text{sales}}{\text{total assets}} \right) \times \left( \frac{\text{total assets}}{\text{shareholder equity}} \right) \). See, e.g., CFA INSTITUTE, EQUITY, CFA PROGRAM CURRICULUM, LEVEL II, VOL. 4, at 185-86 (2010).

80 See Modigliani-Miller Theorem, With Taxes, Proposition II: \( r_E = r_0 + \frac{D}{E} (r_0 - r_D) (1 - T_C) \), where \( r_E = \) required ROE, \( r_0 = \) unlevered cost of equity, \( r_D = \) cost of debt, \( \frac{D}{E} = \) debt-to-equity ratio, and \( T_C = \) tax rate. See, e.g., CFA INSTITUTE, CORPORATE FINANCE, CFA PROGRAM CURRICULUM, LEVEL II, VOL. 3, at 125 (2010).


was insufficient by covering only CEOs and CFOs, how is Dodd-Frank better by including ‘executive officers’?”

This weakness is further exacerbated by the fact that much of the risk within a financial firm is often not of an executive officer’s deliberate doing. In fact, it may be totally unnoticed by these officers. For example, a trader named Nick Leeson single-handedly took down Baring’s Bank (at the time the oldest merchant bank in England) in 1995 by engaging in speculative futures contracts.

More recently, Société Général was nearly brought down by a $7.2b trading loss by one of its traders, Jérôme Kerviel. M. Kerviel exploited the bank’s systems so he could engage in unauthorized trades and hid them from management. Amaranth Advisors, a $9b hedge fund, was forced to close after one of its traders, Brian Hunter, overcommitted the fund to a natural gas position that, when it turned against him, cost the fund $6.6b. And, of course, there is Long Term Capital Management (LTCM). When this so-called absolute-return hedge fund collapsed in 1998 it nearly took the entire financial system with it (foreshadowing of Lehman?). Importantly, clawbacks would have done nothing to prevent LTCM management from engaging in their trades. Despite the multi-billion dollar bailout needed to save the financial system, the principals behind LTCM went on to start new funds. These are just a few examples of the numerous instances where inexperienced, overconfident, and/or fraudulent traders and other actors within an organization have had as much, if not more of a detrimental impact on the firm than those exposed to SOX or Dodd-Frank clawbacks.

The final weakness of the Dodd-Frank (and SOX) clawback is enforceability. If a restatement triggers a clawback, the law makes no provision

---

83 This raises the issue of director and officer negligence in failing to maintain an appropriate monitoring system but that is outside the scope of this Article.
87 While this term has no technical definition, a popular understanding is a fund whose “returns are positive (as in absolute value) and always (or at least mostly) better than the market.” M. Barton Waring & Laurence B. Siegel, The Myth of the Absolute-Return Investor, 62 FIN. ANALYST J., at 14, 15 (Mar./Apr. 2006).
88 FCIC, supra note 2, at 56-59.
for actually securing that the money is indeed paid by the executive back to the firm. First, principals of indemnification may shield an officer from being liable. Many corporate charters (and state laws) indemnify officers when good-faith decisions lead to a loss. In essence, the corporation could shield the officer from liability to the corporation. This may not be a successful strategy because, as a case applying § 304 of SOX showed, the CEO and CFO could pass their liability off to the corporation and “suffer no penalty at all.” Based on this precedent, it is at least reasonable to believe courts would make similar findings under Dodd-Frank. However, SOX requires misconduct while Dodd-Frank does not. If it is found the original disclosures, despite being restated, were originally issued in good faith, a court may reasonably allow the corporate charter to shield the executive.

Another way to avoid liability would be for an officer to tap the corporation’s Director’s and Officer’s (D&O) liability insurance policy. D&O policies provide liability insurance for directors and officers for actions stemming from their activities connected to their corporate positions, particularly in cases where indemnification is not offered. Many of these policies provide direct coverage for “wrongful acts”, meaning, an officer can tap this policy if the corporation does not offer indemnification. Fortunately, this may fail because Dodd-Frank (as opposed to SOX) does not require a showing of misconduct. Without this showing, the insurer may reject the claim. Otherwise, the ability to tap insurance could frustrate the purpose of Dodd-Frank.

Dodd-Frank’s greatest weakness in this regard is that the clawed-back money owed by the officer to the company is essentially a debt of the officer. As with any debt, it can be avoided by personal bankruptcy. Given the dollar amounts involved, it is not a far-fetched concern that an executive officer would

---

91 Id. at 1229-30; see, e.g., CAL. CORP. CODE § 317; DEL. CODE ANN. tit. 8, § 145; N.Y. BUS. CORP. LAW § 722 (demonstrating state laws that allow officers indemnity for good faith losses).
92 Cohen v. Viray, 622 F.3d 188, 195 (2d Cir. 2010).
95 Gallogly, supra note 88, at 1251.
seek personal bankruptcy to avoid returning his erroneously paid compensation. For example, in a case enforcing SOX § 304 the SEC sought to clawback $186 million. In another § 304 matter the former CEO agreed to return more than $400 million to his former company as part of a settlement agreement. Given these sums it is at least reasonable to acknowledge an executive may seek personal bankruptcy as a way of avoiding repayment.

Under the bankruptcy laws, most personal debt is dischargeable. Fortunately, § 523 of the U.S. Bankruptcy Code provides two potentially applicable exceptions to this general rule. The first exception comes under § 523(a)(19), however, two conditions must be met. First, the debt was the result of a securities law violation or fraud in connection with the purchase or sale of a security. Second, the debt must be set forth in a judicial or administrative order or settlement agreement. Because Dodd-Frank § 954 has been codified within the Securities Exchange Act of 1934 as Section 10D, violations of this provision probably meet the first condition of Bankruptcy Code § 523(a)(19).

The second exception comes from § 523(a)(4) of the U.S. Bankruptcy Code. Here, personal debt is exempt from dischargeability if it is the result of “fraud or defalcation while acting as a fiduciary.” There are three circuit splits regarding the level of intent needed to establish defalcation. Depending on the court involved, § 954 debt may or may not be dischargeable.

Further, there are numerous other ways to make money inaccessible including placing it in retirement funds, within a life insurance policy, a properly drafted irrevocable trust, or qualified education accounts, to name a few.

---

96 Cohen, 622 F.3d at 192.
106 Gallogly, supra note 88, at 1255.
107 Id. at 1256.
110 11 U.S.C. § 541(c)(2); see also In re Brown, 303 F.3d 1261, 1265 (11th Cir. 2002) (discussing irrevocable trust exempt from bankruptcy estate).
few. Of course, there could also be offshore holdings outside the grasp of the U.S. legal system.\textsuperscript{112} With no way to secure the funds up front there is at least some probability\textsuperscript{113} the funds will never be returned.

\textbf{B. Transparency Limitations}

The majority of the Dodd-Frank rules focus on providing information to investors and, perhaps, providing shareholders some voice in setting compensation policy. Presumably, this is in the hope the investment community will push boards into adopting responsible compensation plans. However, there is no evidence this will be the case. In fact, from its earliest days in the 1930s, the SEC has mandated executive compensation disclosures.\textsuperscript{114} However, there is serious discussion that this has only led to a ratchet or Wobegon\textsuperscript{115} effect in setting executive compensation levels. This effect is the pernicious cycle where compensation committees, convinced that they have hired above-average managers, look widely at peer companies’ compensation disclosures and, using them as norms, pay their managers above the group average. Accordingly, when enough firms follow this mistaken belief, and the majority of managers are somehow above average, the net effect is to steadily ratchet up pay for all executives.\textsuperscript{116}

It will remain to be seen whether these transparency provisions will have any effect on executive compensation. Some academics opine, “transparency can be fruitful, improving the governance of executive compensation [because] it increases the awareness of shareholders.”\textsuperscript{117} Further, these disclosures would “diminish[] the costs borne by active shareholders who incur less expense to analyze executive compensation packages” thereby “mak[ing] it easier for them to react to inappropriate schemes.”\textsuperscript{118} Another stated benefit of forced disclosure

\begin{footnotes}
\footnote{Richard C. Ausness, \textit{The Offshore Asset Protection Trust: A Prudent Financial Planning Device or the Last Refuge of a Scoundrel?}, 45 DUQ. L. REV. 147, 152 (2007).}
\footnote{The distribution of this probability most likely has “fat tail” risk. \textit{See supra} Part II, 7–9.}
\footnote{In 1938, the Commission adopted Regulation X-14, the predecessor of current Schedule 14A, which set forth specific disclosure requirements for proxy statements. Item 7(b) of these regulations required specified disclosure of compensation received by nominees if action was to be taken for director elections or other officials. \textit{See} Securities and Exchange Commission Release Notice, S.E.C. Release No. 1823, 1938 WL 33169 (Aug. 11, 1938).}
\footnote{Rashid Bahar, \textit{Executive Compensation: Is Disclosure Enough?}, CENTRE DE DROIT BANCAIRE ET FINANCIER, UNIVERSITÉ DE GENEVE 41 (Dec. 2005) (“Lake Wobegon is the fictitious Minnesota town in Garrison Keillor’s ‘A Prairie Home Companion’ radio show, where ‘all the children are above average.’”).}
\footnote{Daniel Jurow et al., \textit{Executive Compensation: How Does Pay Influence Decisions and Governance?}, 17 (on file with EMBA Student Leadership and Ethics Board, Columbia Business School); \textit{see also} Bahar, \textit{supra} note 114, at 41.}
\footnote{Bahar, \textit{supra} note 114, at 34.}
\footnote{\textit{Id.}}
\end{footnotes}
Financial Institution Executive Compensation

is “a broader audience of investors becomes aware of the scandalous compensation packages awarded to certain managers.” The disclosure of egregious packages would create an “outrage cost” on managers and directors. From this perspective, transparency increases outage costs and makes it a stronger constraint on managerial power.

However, the argument that transparency will lead to inefficient remuneration through less transparent structures is equally strong. For example, boards could lavish executives with various perks such as use of the company jet, apartments and other housing, club memberships, and a professional car and driver, to name a few. Not only would some uses of these perks escape disclosure, those uses that would be required to be disclosed are hard to value making them particularly attractive.

Perversely, these disclosure requirements may ultimately lead to more compensation through stock options and manipulation of the stock price at the time of issuance of those options. Stock option plans, unlike exchange-traded options, are not assignable or saleable and carry no independent value of their own. Further, these options often represent a sizeable portion of an executive’s assets and income. Accordingly, the executive will demand more options to compensate for this additional risk.

Further, when a company issues options to an employee it must account for the current “cost” of the options. Many companies use the Black-Scholes stock option valuation model. Under Black-Scholes, a key driver of the value of an option is the underlying volatility of the stock. The higher the volatility of the company’s stock, the higher the option’s value (and cost to the company). Conversely, the lower the volatility of the underlying stock the lower its value (and cost to the company). Accordingly, in order to report the lowest possible cost to the company and the lowest possible value of the option grant to the executive, management can engage in market manipulation strategies geared

---

119 Id.
120 Id.
121 Id. at 36.
122 Id. at 36-37.
124 The standard Black-Scholes formula for determining the value of a call option is $C(S, t) = S_0N(d_1) - Ke^{-r(T-t)}$, where $N(\cdot)$ is the cumulative distribution function of the standard normal distribution, $T-t$ is the time to maturity, $S_0$ is the spot price of the underlying stock, $K$ is the strike price of the option, and $r$ is the risk-free rate. See CFA INSTITUTE, DERIVATIVES AND PORTFOLIO MANAGEMENT, CFA PROGRAM CURRICULUM, LEVEL II, VOL. 6, at 199-200 (2010).
125 In the Black-Scholes formula, $d_1 = \frac{\ln(S_0/K) + (r + \sigma^2/2)(T-t)}{\sigma\sqrt{T-t}}$ and $d_2 = d_1 - \sigma\sqrt{T-t}$, where $\sigma$ is the volatility of returns of the underlying stock. See id. at 200.
toward reducing the stock’s volatility near issuance of the options. For example, a company may defer releasing material information because overly positive or negative news will have a corresponding effect on the volatility of the company’s stock. Conversely, a company may issue a press release designed to dampen the effects of market speculation thereby reducing volatility. Or, a company may defer taking an action, such as acquiring a new technology, in order to keep the news from increasing the stock’s volatility until after the options grant.

Companies can also turn to alternative forms of compensation such as over-funding key person life insurance policies under a so-called split-dollar arrangement, deferred compensation plans, and overly-generous pension plan contributions. It is unclear whether any of these alternative arrangements would be subject to disclosure under Dodd-Frank’s transparency provisions. Further, the law of unintended consequences may dictate the spawning of novel methods of evading transparency.

As for the so-called say-on-pay provision found in § 951, it is less having a say on pay and more having a say on say on pay. To have a say on pay implies your say counts for something. However, § 951 makes it explicitly clear that a shareholder vote on pay (or golden parachutes) “shall not be binding on the issuer or the board of directors of an issuer.” Further, the Act states the shareholder vote “may not be construed (1) as overruling a decision by such issuer or board of directors; (2) to create or imply any change to the fiduciary duties of such issuer or board of directors;” or “(3) to create or imply any additional fiduciary duties for such issuer or board of directors.” In other words, shareholder say does not necessarily say anything.

While it is yet to be seen what impact any of these transparency provisions will have on executive compensation, it is evident that they do not squarely address the challenge of managing risk-taking behavior. The potential benefit, of avoidance of outrage costs will have little effect if, as within the Wobegon effect, a majority of firms engage in the same compensation practices. In other words, it will not be deemed outrageous if everyone else is doing it.

---

126 See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 227 n. 4 (1988) (finding that defendant board issued several press releases denying they were in merger negotiations, thereby reducing the volatility of the company’s stock).
129 Dodd-Frank, supra note 1, at § 951(c) (codified at 15 U.S.C. § 78n-1(c) (2006)).
130 Id.
131 See supra note 113.
V. SUGGESTIONS

The goals of the Dodd-Frank provisions are their weaknesses. As discussed, the only substantive provision is the clawback whose goal appears to be fewer error-prone financial statements in the first place. But, once again, this does nothing to manage actual risk. And, as we saw, the transparency provisions provide minimal and speculative promise of affecting any actual change. To remedy this situation requires a rethinking of the goals and economics of compensation and applying this to the risk-taking provision of Dodd-Frank. 132

This Article argues for two fundamental requirements that every compensation plan must contain in order to satisfy the requirements of Dodd-Frank. First, include an *ex ante* risk-assessment into the typical bonus calculation methodology. Then, align the manager’s objectives with both shareholders and creditors by adopting a cash/securities sliding-scale system.

A. *Ex Ante* Risk Assessment

This first concept is analogous to the mandatory two-week vacation financial firms make executives take each year. The idea behind this requirement is that if there is any wrongdoing (e.g., misappropriation of funds), two weeks would be a sufficient time for the conduct to come to light or for others to find it. 133 Similarly, the recommendation here is a delay in the executive’s ability to receive a bonus to give any excessive risk-taking a chance to come to light.

The first task should be to include an assessment of risk into the typical bonus calculation. This does not mean using a risk measurement as a means of reducing the bonus. Remember, financial firms make money by taking risk, which is, acting as suppliers of credit and risk management techniques for their clients. Further, the amount of the bonus in the first place is a reflection of the risk being taken by the firm through improved financial performance. The better way to incorporate risk measurement is into a formula for determining when, if at all, the manager will take possession of the money.

This Article will not address the myriad ways risk can be measured. Indeed, depending on the nature of the individual employee’s position, different risk measurement techniques may be more appropriate than others. However, for simplicity, and perhaps most appropriately for a CEO and other similar executives, two risk measurements used in conjunction would suffice: leverage and Beta.

---

Leverage is, essentially, the ratio of the amount by which assets exceed capital.\textsuperscript{134} For a bank, the leverage is the amount of borrowed funds (e.g., deposits) that are used to acquire assets (e.g., loans).\textsuperscript{135} If a bank has lent all of its deposits it can borrow additional funds (e.g., commercial paper) and use them to acquire additional assets.\textsuperscript{136} The earnings on the borrowed funds in excess of the cost of funds (commonly referred to as the spread) are earnings that accrete to shareholders. Leverage can also take the form of providing financial guarantees to third parties with little or no funds actually backing the guarantee (e.g., AIG’s CDS business\textsuperscript{137}). As previously discussed, higher leverage typically translates to higher ROE and higher CEO bonuses. However, higher leverage also translates into much higher risk to the firm. If depositors begin demanding their money or if the value of a bank’s assets are called into question (e.g., subprime CDOs), the firm may have trouble meeting its obligations to its creditors.\textsuperscript{138} Currently, a CEO is incentivized to take on the maximum sustainable level of leverage; however, there is no governor\textsuperscript{139} on this incentive and there is simply a hope the bank will be able to meet its obligations in a crisis (or that taxpayers will bail out the institution). Therefore, tying access to the bonus to the amount of leverage a firm takes on will add incentive to a CEO to keep leverage at responsible levels.

Beta is another useful risk measurement. Beta is a backwards-looking measurement of the volatility of a firm’s excess return relative to some index, usually the S&P 500.\textsuperscript{140} It is backwards-looking because it is calculated using actual return data.\textsuperscript{141} A detailed description of Beta and its calculation is outside the scope of this Article but an example will help illustrate. If a firm has a Beta of 1.2 then this means the excess return is 20% more volatile than the S&P 500.

\begin{align*}
\text{Financial Leverage} &= \frac{\text{total assets}}{\text{shareholder equity}}. \quad \text{See supra note 77 (DuPont Formula).} \\
\text{Beta} &= \frac{\text{cov}(r_a, r_m)}{\text{var}(r_m)}. \quad \text{Illustrating that Beta of an asset is the covariance of the actual returns of that asset with the actual returns of the market over the variance of the actual returns of the market.}
\end{align*}

\textsuperscript{134} Financial Leverage = \frac{\text{total assets}}{\text{shareholder equity}}. \quad \text{See supra note 77 (DuPont Formula).}

\textsuperscript{135} Because the FDIC insures the bulk of deposits, these funds come at little or no cost to the bank.

\textsuperscript{136} Because the government bailed out institutions deemed “too big to fail,” the concern is that there is an implicit government guarantee on this source of funds making their cost to the bank much less than the market would otherwise demand, resulting in a tax-payer subsidy to the bank. See FCIC, supra note 2, at xxx, 50, 134, 139-42. See generally Credit Default Swaps and Bank Leverage, NAKED CAPITALISM (Apr. 16, 2008), available at http://www.nakedcapitalism.com/2008/04/credit-default-swaps-and-bank-leverage.html.


\textsuperscript{138} Michael Grynbauam, Greenspan Concedes Error on Regulation, N.Y. TIMES (Oct. 23, 2008), http://www.nytimes.com/2008/10/23/business/worldbusiness/23iht-24greenspan.17202367.html?_r=0 (“I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms.”).

\textsuperscript{139} Beta is defined as \[ \beta_a = \frac{\text{cov}(r_a, r_m)}{\text{var}(r_m)} \] where \( r_a \) is the return on the asset and \( r_m \) is the return on the market.
the S&P experienced a 10% return in the last year then the firm’s return would have been 12%.\textsuperscript{142} If a firm has a Beta of 0.8, then that same stock would have returned 8% over the year.\textsuperscript{143} Beta is used in the Capital Asset Pricing Model to measure the systemic risk of a stock.\textsuperscript{144} If a company takes on more risk its stock will, by definition, have a higher Beta. Beta is appealing because it is implied by the market. It is the result of continuous price discovery. In other words, it is not subject to manipulation like leverage and other financial measurements that, to varying degrees, are within the control of the executive. It tells us how the market has judged the risk a firm has been taking on. The challenge with Beta is selecting the index with which to compare the firm. If we compare a financial firm with the broader market (e.g., S&P 500) this may not be illustrative of the different types of risk different industries must take on. However, if we choose to compare a financial firm with other financial firms (e.g., S&P Financials Sector Index) we could experience a herd mentality where all firms are taking on equal amounts of risk so their Betas in relation to each other will tend towards 1.0. In the end, because we also seek to align a manager’s incentives with society’s objectives the broader market S&P 500 Beta is probably more appropriate.

Next, we assign a delay period to each of these measurements. For example, a modest leverage rate for a bank would be 8.\textsuperscript{145} At this rate a manager would experience no delay in receiving his bonus. Between 8 and 10 a manager would have to wait 1 year. Leverage rates from 10 – 11, 2 years, etc.

\textsuperscript{142} This is not exactly true because it does not account for the impact of the risk-free rate but this is of little importance here. See supra note 15 (full CAPM formula).

\textsuperscript{143} Id.

\textsuperscript{144} $\beta_a = \frac{\text{Cov}(r_a, r_m)}{\text{Var}(r_m)}$. Illustrating that Beta of an asset is the covariance of the returns of that asset with the returns of the market over the variance of the returns of the market. This leaves the systematic, or non-diversifiable risk of the asset relative to the market. See CFA INSTITUTE, CORPORATE FINANCE AND PORTFOLIO MANAGEMENT, CFA PROGRAM CURRICULUM, LEVEL I, VOL. 4 at 259-60 (2009); JAMES R. HITCHNER, FINANCIAL VALUATION: APPLICATIONS AND MODELS 231 (2006).

\textsuperscript{145} By way of comparison, Lehman Brother’s leverage ratio was believed to be as high as 44:1 in August, 2007. Dominic Crossley-Holland, Lehman Brothers, the Bank that Bust the Boom, THE TELEGRAPH (London) (Sept. 6, 2009), http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6143297/Lehman-Brothers-the-bank-that-bust-the-boom.html
Next, we do the same for Beta. If a firm has a Beta less than 1.0 there is no delay in receiving a bonus. From 1.0 to 1.1 there is a 1-year delay. From 1.1 to 1.2, a 2-year delay, etc.

To remove any noise and potential for period-end window dressing in calculating both leverage and Beta, we would take the daily average of each over the measurement period (e.g., year). Some critics might suggest a time-weighted

---

average would be more appropriate; however, using the simple average would give equal weight to all days over the period, thereby, encouraging consistency.

We then calculate the arithmetic average of the two to determine how long an executive must wait to take actual possession of the bonus. For example, let’s imagine a CEO’s bonus for the year is $5m. At the time of the bonus, suppose the daily average leverage was 13 and the daily average Beta was 1.4. Based on the charts above the leverage delay is 4 years and the Beta delay is 5 years. This means the executive would have to wait 4.5 years to receive the bonus for the current year.

Remember, this calculation has nothing to do with the size of the bonus in the first place. What this step achieves is linking an executive’s risk in receiving the bonus with the risk the firm engaged in for him or her to earn it. In essence, the executive can strive to earn a bigger bonus by taking on more risk but will be forced to wait longer to actually receive it. If during that time the risks turn out to be disastrous for the firm the executive will ultimately forfeit some, if not all of the bonus. Conversely, an executive who prefers to be paid sooner could minimize risk and be satisfied with a more modest bonus.

**B. Risk Alignment**

Under typical pay-for-performance compensation structures, a CEO is akin to a shareholder. When equity-linked securities are given as compensation the analogy is obvious. However, even under a cash structure this is still true. The CEO is investing effort (capital) into the firm and receiving cash compensation (dividend). However, the executives of a financial firm are responsible to both shareholders and creditors.147 Because of the high levels of leverage, this is particularly true for financial firms. In these cases, the creditors may take on most of the risk while the potential for the upside from the risk accretes to the shareholders in the form of higher dividends and stock prices. Of course, if creditors fear too much risk then it is bad news for everybody. One need not look any further than Bear Sterns148 and Lehman Brothers149 as ready examples. As noted, firms with higher leverage tend to have a higher ROE but also higher risk. It is this risk to creditors that can negatively impact financial markets. Risk to equity capital is borne by the shareholders alone. However, when creditors, usually other banks, are at excessive risk levels this could make their ability to

---

147 See Francis v. United Jersey Bank, 87 N.J. 15, 35 (1981) (acknowledging in certain cases, like banking, the board may also have a fiduciary duty to creditors).


meet their own obligations tenuous. This equates to risk borne by the creditor’s creditors—and so on, and so on.\textsuperscript{150} To bring a manager’s incentives more in line with creditors, and society at large, an equity / cash sliding scale should be used to determine the composition of the bonus. Firms with lower leverage can pay their managers mostly in equity-linked securities. However, firms with higher leverage must pay their managers predominantly in cash.

The obvious question becomes, “How does this align management with creditors?” If a firm has high leverage then, as discussed previously, there will be a delay in receiving the funds. In essence, what is being suggested is a deferred compensation plan. Deferred compensation is essentially an I.O.U. from the company to the employee and the obligation becomes another general obligation of the firm.\textsuperscript{151} This necessarily places the CEO in the exact same position as every other general creditor of the firm for the time period of the compensation delay (of course, in the case of recurring annual bonuses this places the CEO in the position of permanent creditor).

Figure 5.

\begin{center}
\includegraphics[width=\textwidth]{cash_equity_ratio.png}
\end{center}

\begin{center}
\textbf{Cash/Equity Ratio}
\end{center}

\begin{center}
\textbullet\ Equity
\end{center}

\begin{center}
\textbullet\ Cash
\end{center}

\begin{center}
Leverage
\end{center}

\begin{center}
8 10 11 12 13 14 15
\end{center}

\begin{center}
0 20 40 60 80 100 120
\end{center}


To pick back up with our previous example, based the leverage ratio of 13 and the chart above, the CEO’s $5m bonus would be $3m cash and $2m equity-linked securities and both would be deferred for 4.5 years.

This also accomplishes another goal. Typically, if a manager’s compensation is in the form of restricted (time-delayed) equity-linked securities the incentive for the manager is to maximize the value of those securities. This implies a perverse double risk incentive. First, it encourages the manager to take on excessive risk to maximize the amount of the bonus in the first place. Second, it perpetuates (or even increases) that excessive risk in order to maximize the value of these bonus shares. However, if excessive risk taking is rewarded with cash there is no incentive to perpetuate that risk-taking because it would put the CEO, as a general creditor, at even greater risk of loss.

C. Widening the Net

As previously discussed, at times it is an employee much lower down the food chain that has the bigger impact on the risk a firm undertakes.152 These same compensation principals discussed will continue to be applicable but may need to be modified for the realities of their roles.153 More precise measurements may be more appropriate such as volatility, tracking risk, various variations of Value at Risk (VaR or MVaR), kurtosis (fat-tail) risk, stress testing, Monte Carlo simulation, and leverage, to name a few.154 In practice, some combination of several risk measurements should be employed and steps taken to develop new ones that better capture the day-to-day risks a fund manager and other employees take.

Another departure from the discussion surrounding CEO and other executive compensation would be the ratio between cash and equity-linked securities. To the extent possible, a portion of the ratio should include an investment (or tracking security) in the underlying portfolio the trader or manager is responsible for. This ensures that some portion (e.g., 20%) of this manager’s bonus is subject to the specific risks to which he or she is subjecting the firm in addition to the risk that exists in the firm’s stock options (or other equity-linked securities).

152 See supra Part IV.A.
153 Dodd-Frank’s § 956 allows for regulation of “employees” in addition to executive officers. It also allows for regulation of compensation of “principal shareholders” which could include hedge funds and the like making this an extremely powerful provision of the Act. Dodd-Frank, supra note 1, at § 956(a); See also infra Part VI.
D. Hedging

Hedging is the process of making a separate investment to offset potential adverse price movements of an asset.\(^{155}\) For example, if a person owns shares of XYZ company and is concerned about a drop in the price of shares but is also not currently willing to sell those shares (e.g., to avoid incurring a short-term capital gains tax),\(^{156}\) this person can buy puts on that stock. Puts give the buyer the right to sell those shares to the seller of the put at some predetermined price, such as the current market price, for a certain amount of time (e.g., 6 months). If XYZ falls below this price the puts will be exercised; meaning, the underlying shares of XYZ will be sold to the seller of the puts at the predetermined higher price. Here, this person has effectively hedged against any drops in the value of XYZ for the duration of the put option.

In many cases the suggestions in this Article involve requiring executive compensation to be locked up with the company for many years. Again, this is desirable because it will align the executive’s risks with the risks the firm took on to earn the bonus in the first place. Obviously, this creates an extreme incentive for the executive to hedge away the risk to this bonus while it is tied-up at the company. Hedging can take many forms\(^{157}\) including shorting the stock,\(^{158}\) buying puts,\(^{159}\) equity swaps,\(^{160}\) and paired trades.\(^{161}\) As discussed, some compensation


\(^{156}\) For example, for tax reasons.

\(^{157}\) See supra, Part III.B.

\(^{158}\) Shorting is borrowing shares now and immediately selling them in the hopes of buying them back at a future lower price, thereby keeping the difference between the current market price and the future lower price as profit. In other words, sell high, buy low. E.g., CFA INSTITUTE, EQUITY AND FIXED INCOME, CFA PROGRAM CURRICULUM, LEVEL I, VOL. 5, at 25 (2009). However, substantial liability for short-swing profits may arise under what is commonly known as 16(b) of the ’34 Act. See 15 U.S.C. § 78p(b) (describing a short-swing profit as “any profit realized by him from any purchase and sale, or any sale and purchase . . . within any period of less than six months).

\(^{159}\) A put is the right to sell a stock at a predetermined price (termed the “strike price”) within a relatively short, predetermined time period (e.g., 3 months). E.g., CFA INSTITUTE, DERIVATIVES AND ALTERNATIVE INVESTMENTS, CFA PROGRAM CURRICULUM, LEVEL I, VOL. 6, at 78, 79, 85 (2009). If the current stock price falls below the strike price the put becomes more valuable because the holder of the put can purchase the stock at the lower current market price and immediately sell at the higher strike price. In other words, this is a way to profit when a stock goes down in value. This is represented by the equation \( P_0 \geq \text{Max}(0, X - S_0) \). Id. at 103.

\(^{160}\) Entering into a private agreement to a future exchange of the total return on a specific security (or index) for a fixed (or variable) interest rate or the total return of another security (or index). Id. at 136-39. For example, a person can agree in two years to exchange 100 shares of XYZ for someone else’s 100 shares of ABC. At the point of entering that agreement this person is inoculated from any future drops or gains in the value of XYZ. However, substantial liability for short-swing profits may arise under what is commonly known as 16(b) of the ’34 Act. See 15 U.S.C. § 78p(b) (describing a short-swing profit as “any profit realized by him from any purchase and sale, or any sale and purchase . . . within any period of less than six months).
may be in the form of deferred cash, which is essentially the firm’s credit. Properly motivated managers can hedge this by using instruments such as credit default swaps.\textsuperscript{162}

The problem is, if an executive can simply hedge the risks these reforms place on bonus compensation then the reforms are meaningless. Section 955 of Dodd-Frank requires the SEC to propose and adopt rules regarding disclosure of hedging by employees and directors.\textsuperscript{163} However, as with all of the disclosure provisions, it is unclear this will have any practical effect. To make these reforms meaningful, compensation plans should have a strict limit if not an outright ban\textsuperscript{164} on hedging against drops in the value of the firm’s equity and negative credit events covering the amount of the compensation that is on deferral with the firm at any given time.\textsuperscript{165}

E. Addressing Unintended Consequences

This Article purposely did not address the size of management bonuses because the goal was to de-emphasize this argument to the extent it distracts from the primary goal of compensation regulation: discouraging excessive risk-taking behavior. However, there are two unintended consequences of these proposals: (1) even bigger bonuses to compensate executives for the new risk they may not ultimately receive the money,\textsuperscript{166} and (2) even larger base-line bonuses so executives do not need to take excessive risks to receive outsized amounts.\textsuperscript{167}

The solution to the first problem is to place a modifier in the bonus amount calculation that accounts for the risk taken to initially earn the money. An

\textsuperscript{161} This is a transaction involving going long a security and short another one in the same industry. For example, if the CEO of bank of X has millions of options, the CEO is “long X.” To remove some of the risk, the CEO can short bank Y (or buy puts on Y). While this is not a perfect hedge it will reduce the overall risk from being long X without taking any additional positions on X. \textit{E.g.}, CFA INSTITUTE, EQUITY, CFA PROGRAM CURRICULUM, LEVEL II, VOL. 4, at 30 (2010).

\textsuperscript{162} Credit default swaps (“CDSs”) are, essentially, insurance on the creditworthiness of the firm. Anyone can pay a premium to a seller of CDSs (such as AIG) in exchange for a promise to pay some notional amount should the underlying firm experience a negative credit event such as default or even a ratings downgrade. \textit{E.g.}, CFA INSTITUTE, DERIVATIVES AND PORTFOLIO MANAGEMENT, CFA PROGRAM CURRICULUM, LEVEL II, VOL. 6, at 354 (2010).

\textsuperscript{163} Dodd-Frank, supra note 1, at § 955 (codified at 15 U.S.C. § 78n(j) (2006)).

\textsuperscript{164} From a feasibility standpoint, this could simply be adopted as a requirement for a compensation plan to pass the § 956 requirements.

\textsuperscript{165} Executives would still be allowed to hedge any holdings in the firm’s securities of which they actually have taken possession.

\textsuperscript{166} \textit{See supra} part IV.B (discussing of the issuance of additional stock options to compensate an executive for the inability to sell or assign options during the vesting period).

\textsuperscript{167} \textit{See} \textit{e.g.}, Crowley & Brunsden, \textit{supra} note 12 (reporting EU financial firms are doubling base salaries in response to bonus caps).
appropriate risk-adjustment measurement tool is the ex post Sharpe ratio. The Sharpe ratio characterizes an asset’s excess return over some benchmark relative to the risk taken to earn that return as characterized by the standard deviation of the excess return. For example, if a stock returned 15% for the year and the benchmark returned 5%, the stock’s excess return was 10%. Further, if the volatility of this excess return was 10% (meaning it predominantly fluctuated between 0% and 20% over the time period) then the Sharpe ratio would be 10% / 10% or 1.0. This represents equal risk for the reward received. Clearly then, a Sharpe ratio in excess of 1.0 means the asset is returning more reward relative to its risk and a ratio less than 1.0 means there is more risk than is justified by the reward.

The next question is, “what is the benchmark to be used?” In most financial applications the benchmark would be some index (e.g., the S&P 500) or the risk-free rate. However, these benchmarks are typically used to help investors compare the risk / return profiles of various investment options. Fortunately, we can use any benchmark that best reflects what it is we are trying to measure. Here, we aim to measure the internal risk a financial institution took on to achieve its results. For this reason the suggested benchmark is the bank’s cost of funds (“COF”). The COF is what a bank pays depositors and other lenders – including the Federal Reserve – for the use of the money it subsequently lends to others. There are several advantages to using this as the benchmark. First, it is specific to each institution, which makes the Sharpe ratio truly personalized for each situation. Second, if a bank takes on excessive risk, depositors and other lenders will demand higher returns to keep their money with the bank. This raises the COF, which will reduce the excess returns used to calculate the Sharpe ratio resulting in a lower ratio and, ultimately, a lower bonus for the executive. This incentivizes the executive to stay focused on the market’s perception of the risk the firm is taking on. Third, this is a true picture of the operations of the firm. Using COF as the benchmark rewards executives for delivering superior results in excess of what it costs the firm for its fundamental production input (money). Lastly, this figure is not easy to manipulate because it is market-driven.

The other attractive feature of the Sharpe ratio is that it uses the volatility of these excess returns. Therefore, not only is firm risk captured by using the COF as the benchmark, it is further captured in the volatility figure. However,

\[ S = \frac{(R_a - R_b)}{\sigma_{R_a - R_b}}, \]

where \( S \) is the Sharpe ratio, \( R_a \) is the actual asset return, \( R_b \) is the actual benchmark return, and \( \sigma_{R_a - R_b} \) is the standard deviation of this excess return. See, e.g., CFA Institute, Ethical and Professional Standards and Quantitative Methods, CFA Program Curriculum, Level I, Vol. 1, at 294-95 (2009) (describing formula using the risk-free rate as the benchmark).

Financial Institution Executive Compensation

this risk measurement is slightly different. This measures the dispersion of the difference between the stock’s return and the COF. It does not measure the actual difference. This is important because high volatility of this excess return would imply excessive short-term, high risk-taking activities.

To calculate the Sharpe ratio in this case we would use the actual stock return over the appropriate bonus period (e.g., fiscal year) and the average daily COF over the same period. This ratio would then be applied as a modifier to the computed bonus under the terms of the employment contract. Similar to the scale used for leverage and Beta, a scale would be developed for a range of Sharpe ratios. The result would be that the lowest ratios would result in the lowest possible bonus (perhaps $0) and the higher ratios would receive the target amount set by the board. Here, the goal is to not just seek superior (short-term) profits but to seek superior long-term, risk-adjusted returns. This will be not only beneficial for shareholders but also for society in general.

Addressing the second unintended consequence of these proposals—higher baseline bonuses—there are several responses. First, at some point shareholders will pay attention and vote with their brokerage accounts. For example, if a bank CEO negotiates a baseline bonus of $100m under normal leverage and Beta conditions resulting in no time delay for receipt, shareholders should react by selling the stock and investing in a company with a more responsible board of directors. Second, the scales I recommend in this paper are easily modified and can even be personalized for each firm. For example, Dodd-Frank § 953 requires firms to disclose, among other things, the ratio of executive pay to average employee pay. Firms with a higher ratio could have more restrictive leverage and Beta scales and firms with lower ratios could have more relaxed scales. Lastly, under any set of proposals, this is a possibility. However, this should not discourage regulators. As was made abundantly clear in 2007–09, the alternative—laissez faire regulation—is not the solution.

VI. CAN THIS BE DONE?

Some may argue that affecting these changes would require amendments to Dodd-Frank and given the current political climate this is highly unlikely. As previously discussed, aside from the clawback provision, most of the new rules are focused on transparency in reporting compensation, compensation committee independence, and allowing shareholders a non-binding say on pay. However,

---

170 This establishes conditions for the ratchet, or “Wobegon” effect. See supra note 113. However, under any scenario this will be a possible outcome so its potential should not deter meaningful regulation.

171 See supra note 64.

172 See supra Part III.B.
the provision that is exclusive to financial firms provides the ability to institute these suggestions without any amendments.

Section 956(b) of Dodd-Frank requires the appropriate regulator to “prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that... encourages inappropriate risks... (1) by providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or (2) that could lead to material financial loss to the covered financial institution.” 173 Unfortunately, this feature of Dodd-Frank only allows the prohibition of compensation plans that encourage inappropriate risk-taking. However, the suggestions in this paper are designed to discourage inappropriate risk-taking. The best way to overcome this challenge is with the double negative. The regulators could easily state that they will not prohibit a plan as encouraging inappropriate risk-taking so long as it includes these features that discourage inappropriate risk-taking. In other words, a plan that discourages inappropriate risk-taking cannot be said to simultaneously encourage inappropriate risk-taking. Based on this, the regulators would be well within their authority to adopt these rules.

Additionally, the provisions of Dodd-Frank aside, some might argue that government regulation of executive compensation runs afoul of Article I, § 10 of the U.S. Constitution which states “[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts.” 174 The argument being the government cannot interfere with the rights of the individuals, or in this case the individual and the firm, from entering into a contract they both deem to be mutually beneficial. However, the United States Supreme Court in Blaisdell established that “the reservation of essential attributes of sovereign power is also read into contracts as a postulate of the legal order.” 175 In other words, the Court has found the interests of society are implicit in every contract. At issue in Blaisdell was a Minnesota statute placing a moratorium on home foreclosures during the Great Depression. The Court found that even though the statute was being applied retrospectively, it did not impair the mortgage contract because it merely delayed the remedy, rather than abolish it. Further, the government had a rational basis for enacting the statute. Likewise here, the suggestions in this paper merely seek to delay certain payments under the contract, not eliminate them. All the government would need is to establish a rational basis for doing so. Certainly the Court would find that society has a sufficient, and rational, interest in avoiding another financial meltdown like the Great Recession. And, certainly this interest would be implicit in any compensation scheme to which the CEO and the Board

173 See supra Part III.C.
174 U.S. CONST. art. I § 10.
agree. Further, these suggestions do not impede the two parties from coming to some sort of agreement on compensation structure. There are no suggestions that CEOs are paid too much (or too little). The only suggestion is that there should be a lag between the actions taken to earn the compensation and constructive receipt of the compensation to give time for the risks of the executive’s actions to be played out.

VII. CONCLUSION

Many critics and commentators have argued that a root cause of the Great Recession was the profound compensation incentive to take excessive, inappropriate risks by banks and other financial institutions. However, much of that criticism has been focused on the size of executive compensation packages. This focus on size is misguided. The attention must be paid to the risks executives are taking in order to realize these amounts under their compensation plans.

The clawback provision of Dodd-Frank is a fundamental tool to recoup erroneously paid compensation resulting from inaccurate or fraudulent financial reports. However, the executive’s risks can be better aligned with the risks carried by shareholders, creditors, and society as a whole, by implementing ex ante systemic risk assessments that serve to delay the receipt of bonus funds along with a cash / equity sliding-scale bonus system. This will encourage executives to be mindful of the risks they are taking with the firm’s assets as well as the risks they are spreading throughout the financial system.