REGULATING EXECUTIVE COMPENSATION IN THE WAKE OF THE FINANCIAL CRISIS

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INTRODUCTION

After it was revealed that Wall Street executives rewarded themselves with nearly twenty billion dollars in bonuses for their 2008 performances, President Obama admonished that such behavior "is the height of irresponsibility. It is shameful. And part of what we're going to need is for folks on Wall Street who are asking for help to show some restraint and show some discipline and show some sense of responsibility."[1] Although the majority of Americans may agree with President Obama's assessment, Senator Christopher Dodd perhaps more closely reflected the public's true sentiment when he observed that "'this infuriates the American people.'"[2]

Executives at publicly traded companies, however, have proven quite resilient to previous attempts by Congress and the Securities Exchange Commission (SEC) to reign in sky-rocketing levels of compensation. These efforts, which have focused on tax penalties for unreasonable compensation[3] and increased disclosure of compensation methods and amounts to the public[4] have both had unintended, and sometimes perverse, results. Much of the reason for the failure of previous

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1. Remarks Following a Meeting with Economic Advisers and an Exchange with Reporters, 2009 DAILY COMP. PRES. DOC. 00034, at 1 (Jan. 29, 2009), *available at* http://www.gpo.gov/fdsys/pkg/DCPD-200900034/pdf/DCPD-200900034.pdf.

2. Sheryl Gay Stolberg & Stephen Labaton, *Banker Bonuses Are 'Shameful,' Obama Declares*, N.Y. TIMES, Jan. 30, 2009, at A1, *available at* http://www.nytimes.com/2009/01/30/business/30obama.html?_r=3&scp=1&sq=Obama%.

3. *See* I.R.C. § 162(m) (West 2009).

4. *See* 17 C.F.R. § 229.402 (2008).

regulatory attempts is that they inadequately addressed the true causes of current compensation levels.[5]

The political pressure that resulted from outrage caused by events such as the 2008 Wall Street bonuses,[6] as well as a desire to protect taxpayer assets in light of losses from the first round of disbursements under the Troubled Assets Relief Program (TARP),[7] prompted both the Obama Administration[8] and Congress[9] to place additional restrictions on the executives of companies participating in TARP. This is in addition to restrictions enumerated in the TARP legislation itself,[10] and the regulations subsequently promulgated by the Treasury Department under the Bush Administration.[11] While early attempts at regulating executive compensation after the financial collapse were riddled with loopholes and light in substance, subsequent refinements have brought the interests of executives in line with those of taxpayers, and proposals for broader reform are, for the most part, focused on the areas most in need of attention.

This note seeks to evaluate the post-collapse executive compensation regulations and the proposals for broad reform in light of the prevailing theories regarding the causes of excessive compensation and the role compensation practices may have had in bringing about the financial crisis. First, a background of the causes of executive compensation growth will be provided, along with an overview of the pre-economic col-

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5. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard Univ. Press 2004).

6. *See* Stolberg & Labaton, *supra* note 2 ("The pressure reflects the substantial disparities between pay increases for senior executives, the low rate of wage growth for workers and the frequent disconnect between compensation and the long-term strategic success or failure of corporations.").

7. *See generally* Emergency Economic Stabilization Act of 2008 (EESA) §§ 101–136, 12 U.S.C.A. §§ 5211–5241 (West 2008) (TARP legislation) (current version at 12 U.S.C.A. §§ 5211–41 (West 2009)).

8. *See* U.S. DEP'T OF THE TREASURY, TG–15, TREASURY ANNOUNCES NEW RESTRICTIONS ON EXECUTIVE COMPENSATION (Feb. 4, 2009), *available at* http://www.treas.gov/press/releases/tg15.htm [hereinafter TREASURY GUIDANCE].

9. American Recovery and Reinvestment Act (ARRA) of 2009, Pub. L. No. 111–5, sec. 7000–02, 123 Stat. 115, 516–21 (amending EESA §§ 111, 302(a) (2008)).

10. *See* EESA § 111, *amended by* ARRA sec. 7001; I.R.C. § 162(m)(5) (West 2009) (enacted by EESA, Pub. L. No. 110–343, sec. 302(a), 122 Stat. 3765, 3803–05).

11. *See* 31 C.F.R. § 30 (2008), *amended by* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009); I.R.S. Notice 08–94, 2008–44 I.R.B. 1070–76, *available at* http://www.irs.gov/pub/irs-irbs/irb08–44.pdf.

lapse regulatory framework. Following that will be a discussion of how the design of executive compensation packages was a contributing factor to the financial crisis. Next, an analysis of the recent legislative and regulatory efforts will lead to the conclusion that although they may temporarily relieve the political pressure brought on by media coverage of excessive executive pay, they are unlikely to result in a significant reduction of total compensation, nor are they fully adequate to address the manner in which compensation structure contributed to the financial collapse.

I. THE DEBATE OVER THE CAUSE OF EXCESSIVE EXECUTIVE COMPENSATION

Scholarship concerned with executive compensation has focused primarily on the managerial power and arm's-length bargaining models of executive compensation, which compete to explain the internal workings of the pay-setting process; however, recent research has brought the role of psychological mechanisms in board decision making into focus as well. The traditional arm's-length theory holds that the board, as an effective fiduciary to the shareholders, will negotiate an optimal contract with its executives, thus securing the best talent for the dollar.[12] In contrast, the managerial power theory attacks the traditional view of the board of directors as a means to control the agency costs implicit in the American scheme of corporate governance, which in a large public company results in a crevasse between diffuse shareholder ownership and the concentration of power over day-to-day affairs in the company's officers.[13] Psychological research complements these views by modeling the board as a decision-making group and applying theories of social and cognitive psychology to its inner workings.[14] The following section will demonstrate that while the arm's-length bargaining model can be cast aside somewhat easily, the most plausible explanation of executive compensation is that psychological processes render the board

12. *See* John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1160 (2005). For an overview of the arm's-length bargaining model, see *id.* at 1159–67; BEBCHUK & FRIED, *supra* note 5, at 15–22.

13. *See* BEBCHUK & FRIED, *supra* note 5, at 15.

14. *See infra* text accompanying notes 46–62.

of directors relatively inert, thus enabling management to exert power over the board and, consequently, the corporation and its resources.

A. Arm's-Length Bargaining

A normative concept in the American system of corporate governance, as it applies to publicly held companies, is that the board of directors represents the interests of shareholders.[15] Because shareholders are too diffuse to exert any power over management, the board acts as their fiduciary to reduce the agency costs that would otherwise result.[16] This theory is borne out in the arm's-length bargaining model, which holds that, as rational and detached actors, the board and management will arrive at compensation packages that best represent the interests of both shareholders and the managers.[17] There is a plethora of reasons that discredit this theory, which include the existence of windfalls in incentive compensation structures,[18] the close personal and professional ties between management and the board of directors,[19] the existence of gratuitous golden parachute packages,[20] and Congress's[21] and the SEC's implicit recognition of the failures of the model.[22] Many of these reasons will be explored in the course of examining the managerial power model.

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15. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2009) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

16. *See* BEBCHUK & FRIED, *supra* note 5, at 18.

17. *See id.*

18. *See, e.g.*, *id.* at 144–46.

19. *See, e.g.*, *id.* at 29–33.

20. *See, e.g.*, *id.* at 88–92.

21. *See, e.g.*, Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 884, 892 (2007) ("[Section] 162(m) is not grounded in tax policy considerations . . . . Rather, the provision is simply a penalty that is administered through the tax code. . . . Under [the arm's-length] model, the amount and mix of compensation would generally be optimal without any intervention by policymakers." (footnotes omitted)).

22. *See* Roel C. Campos, Comm'r, Sec. & Exch. Comm'n, Remarks Before the 2007 Summit on Executive Compensation (Jan. 23, 2007), http://www.sec.gov/news/speech/2007/spch012307rcc.htm (explaining that "the so-called free market for CEOs is anything but").

B. Managerial Power

The sources of managerial power are numerous, but can be briefly summarized in three points. First, and most importantly, is the desire of individual board members to be re-elected; because the CEO chooses the slate of nominees for election to the board, sitting board members have strong incentives to remain in favor with the CEO.[23] The second source of managerial power over the board is the control the CEO exerts over the financial resources of the company.[24] Because the CEO can direct resources such as charitable contributions, as well as business and consulting contracts, to friendly board members and their affiliates, individual board members have significant financial incentives to remain on good terms with the CEO.[25]

The third significant source of managerial power over the board's compensation decisions is the widespread use of compensation consultants,[26] who have very strong incentives to please executives.[27] Their bias toward the interests of the executives arises because the primary source of most consulting firms' company-specific income is generated by work unrelated to executive compensation advising.[28] These consultants recommend the structure and size of compensation packages to the compensation committee and, in the past, were usually chosen by the CEO via the human resources department;[29]

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23. *See* BEBCHUK & FRIED, *supra* note 5, at 25–26.

24. *See id.* at 27–31.

25. *See id.* at 27–28.

26. The widespread use of compensation consultants to determine the size and structure of executive pay packages has its roots in the Delaware Supreme Court's decision, *In re Walt Disney Co. Derivative Litigation*, which had the practical effect of eliminating directors' liability for claims of waste of corporate assets if they used compensation consultants. 906 A.2d 27, 56 (Del. 2006).

27. *See, e.g.*, BEBCHUK & FRIED, *supra* note 5, at 37–39.

28. *See* Sean M. Donahue, *Executive Compensation: The New Executive Compensation Disclosure Rules Do Not Result in Complete Disclosure*, 13 FORDHAM J. CORP. & FIN. L. 59, 76 (2008); REP. OF MAJORITY STAFF OF H.R. COMM. ON OVERSIGHT & GOV'T REFORM, 110TH CONG., EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS 9 (Dec. 2007), (Prepared for Chairman Henry A. Waxman) (copy on file with author) (finding that many compensation consultants earn the vast majority of their company-specific revenues from contracts other than their compensation consultation, and that many of these conflicts of interest were not disclosed by companies in their SEC filings); *see also* Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323, 343–44 (2007) (discussing the role of cross-selling audit services in the Enron scandal).

29. *See* BEBCHUK & FRIED, *supra* note 5, at 38.

however, recent regulations require that the compensation committee of the board of directors disclose whether it selects compensation consultants directly,[30] thus mitigating management's potential role in the selection process. Even if consultants are chosen by the compensation committee, it is likely that they will remain beholden to the CEO because of the prospect of future business in areas under management's control.[31] Moreover, compensation consultants' influence over the board's decision is exacerbated by the relatively small amount of time a compensation committee devotes to its task, which results in consultants being the only significant source of the committee's information and advice about compensation decisions.[32]

As evidence for their theory, Lucian Bebchuk and Jesse Fried—the foremost proponents of the managerial power theory—point to the close relationship between objective indicators of managerial power and executive pay.[33] One of these indicators is the independence of the board. For example, a form of social loafing can be expected of larger boards,[34] and the authors note that performance sensitivity is inversely proportional to the size of the board.[35] Similarly, interlocking directorships, the case of two executives sitting on each other's boards,[36] are correlated with higher levels of pay.[37] The presence of antitakeover protections is also correlated with both higher pay and lower managerial equity ownership.[38] Evidence of managerial influence can be more forthright; the 2006 expansion of proxy disclosure rules has at times resulted in di-

30. *See* 17 C.F.R. § 229.407(e)(3)(iii) (2008).

31. *See* Donahue, *supra* note 28, at 76–77.

32. *See* BEBCHUK & FRIED, *supra* note 5, at 36–37 (noting that a "prominent law firm" advised compensation committees to meet only three times annually); *see also* American Recovery and Reinvestment Act (ARRA) of 2009, Pub. L. No. 111–5, sec. 7001, § 111(c)(2), 123 Stat. 115, 519 (requiring the compensation committees of TARP recipients to meet semiannually).

33. *See* BEBCHUK & FRIED, *supra* note 5, at 80–86.

34. *See* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 11 (2002) (theorizing that individual directors are less likely to be motivated to monitor management activities as board size increases).

35. *See* BEBCHUK & FRIED, *supra* note 5, at 81.

36. *See id.* at 29–30. The problem caused by interlocks is the risk of mutual deferral to CEO wishes. *See id.*

37. *See id.* at 30.

38. *See id.* at 83–84.

rect admissions of management's influence over its pay.[39] Finally, Bebchuk and Fried note that the existence of a large outside shareholder is correlated with lower executive pay.[40]

This last point is closely related to the only meaningful restraint on executive pay—outrage.[41] Bebchuk and Fried claim that directors can only be expected to assert their statutory authority over management when public fury about the level of executive pay rises to the point that they risk "criticism or ridicule from the social and professional groups whose opinions they value . . . ."[42] Executives are also affected by outrage; reputational damage in the managerial community is predicted to hinder future employment opportunities and make shareholder disapproval more likely to manifest in a meaningful way.[43] Avoidance of such outrage costs leads to one of the primary effects of managerial power, which is camouflage of executive pay.[44] Because it is only the perception of outsiders that has an impact on managerial power, executives can be expected to favor, and boards to adopt, compensation packages that have low disclosed values and that are more easily justified if questioned.[45]

C. Group Dynamics Theory of Executive Compensation

Although recognition of the great power that management holds over the board is crucial to a proper understanding of the nature of the executive compensation problem, psychological factors such as group dynamics and cognitive dissonance also play a large, and often understated, role in board decision making. Many psychological mechanisms render boards less able to fulfill their statutory obligation to oversee

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39. *See* Am. Int'l Group, Inc., Proxy Statement (Form DEF 14A), at 29 (Apr. 4, 2008) ("Based on recommendations from Mr. Sullivan [AIG's CEO], the Committee established annual performance objectives for 2007 . . . . and, based on his recommendation, awarded the other named executives . . ." an average of $580,000 in cash bonuses.).

40. *See* BEBCHUK & FRIED, *supra* note 5, at 82–83.

41. *See id.* at 64–65.

42. *Id.* at 66.

43. *See id.* at 64–66.

44. *See id.* at 67.

45. *See id.* ("[U]nder the managerial power approach, managers will prefer compensation practices that obscure the total amount of compensation, that appear to be more performance based than they actually are, and that package pay in ways that make it easier to justify and defend.").

corporate management; those mechanisms with the greatest impact will be examined here.

Cognitive dissonance is a powerful psychological phenomenon wherein an individual will tend to interpret his environment and develop beliefs in a way that will not contradict past beliefs or behaviors.[46] Because many directors who serve on compensation committees are current or former executives themselves, they will tend to see no problem with lavish compensation arrangements because they are, or used to be, the beneficiaries of such packages.[47] While cognitive dissonance is important in its own right, it is also crucial to the operation of other processes that affect board decision making.[48]

Another powerful psychological phenomenon that applies well to corporate governance is groupthink—"a dysfunctional mode of group decision making characterized by a reduction in independent critical thinking and a relentless striving for unanimity among members."[49] Groupthink typically occurs in groups that are characterized by a high level of cohesiveness and a lack of cognitive conflict.[50] Cohesion, as the term is used in social psychology, carries its common meaning, and cognitive conflict can be conceptualized as the willingness of a group or individual to consider minority points of view.[51] In a review of the relevant literature and a theoretical application of their findings to characteristics common to boards, researchers determined that three characteristics make boards particularly susceptible to groupthink: their large size, "elite" composition, and intermittent meetings.[52] Factors contributing to cohesiveness are abundant in corporate boardrooms; these include collegiality, prestige, and lack of diversity in back-

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46. *See, e.g.*, George A. Akerlof & William T. Dickens, *The Economic Consequences of Cognitive Dissonance*, 72 AM. ECON. REV. 307, 308–09 (1982).

47. *See* BEBCHUK & FRIED, *supra* note 5, at 33. This is related to the issue of interlocking directorships. *See supra* notes 36–37 and accompanying text.

48. *See, e.g.*, *infra* text accompanying note 56.

49. Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-making Groups*, 24 ACAD. MGMT. REV. 489, 496 (1999). Groupthink has been blamed as a contributing factor to decision making disasters from the Enron scandal, *see* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1238–39 (2003), to the Bay of Pigs invasion, *see* PETER GRAY, PSYCHOLOGY 541 (Catherine Woods ed., Worth Publishers 3d ed. 1999).

50. *See* Forbes & Milliken, *supra* note 49, at 496–97.

51. *See id.*

52. *See id.* at 492.

grounds.[53] Lack of diversity also leads to reduced cognitive conflict,[54] as do long tenures of board members.[55] Lack of cognitive conflict can also be attributed to the great cognitive dissonance a compensation committee member would experience if he were to seriously question the suitability of a pay package similar to one he used to receive.[56]

A related, but independent, psychological concept that helps to explain compensation decisions is the social cascade.[57] Social cascades occur when an uninformed decision-maker can look to the results arrived at by previous groups or individuals who have been presented with the same or a similar dilemma.[58] The result is that, even though the previous decisions may not have been correct, they are adhered to so long as the current decision-maker remains uncertain about the correct choice.[59] Compensation committees are particularly susceptible to social cascades for two reasons. The first reason is that committee members typically lack personal knowledge about the factors that should influence compensation decisions;[60] these gaps in personal knowledge are filled in by compensation consultants, who draw the majority of their information from the decisions of other boards.[61] Second, SEC disclosure rules, which have vastly increased the availability of information about other boards' decisions, have perpetuated the social cascade.[62]

The managerial power and group dynamics theories are not necessarily at odds with one another; it is likely that they both contribute to the problem of ineffectual and compliant

53. *See* Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2038–39 (2007); *see also* Bainbridge, *supra* note 34, at 10 ("[M]embers of a production team often develop idiosyncratic working relationships with one another.").

54. *See* Dorff, *supra* note 53, at 2039.

55. *See* Forbes & Milliken, *supra* note 49, at 499.

56. *Cf.* Dorff, *supra* note 53, at 2045–46 (discussing the role of cognitive dissonance in establishing social cascades).

57. *See id.* at 2042–52.

58. *See id.* at 2047.

59. *See id.* at 2048.

60. *See* BEBCHUK & FRIED, *supra* note 5, at 38.

61. *See* Dorff, *supra* note 53, at 2047–48.

62. *See infra* text accompanying notes 141–49.

boards.[63] The key component in the application of groupthink and social cascades to board decisions about executive compensation is the board's lack of time to evaluate other options and relative paucity of information with which to do so.[64] This, coupled with the high levels of cohesion common among boards, leads them to accept the status quo. Their acceptance is legitimized by decisions previously made by peers and the executives themselves, whom they have every reason to please for the reasons outlined in the managerial power model. The board's primary source of information in setting compensation packages is the compensation consultant, who is truly beholden to management. Thus, having been intellectually disabled by various psychological processes, the board is left vulnerable to the suggestions of management and compensation consultants.

II. FORMS OF EXECUTIVE COMPENSATION AND THEIR RELATIONSHIP TO PERFORMANCE

Executive compensation packages consist of several basic components: base compensation, incentive compensation, and perquisites (perks). Incentive compensation includes forms of pay which vary with some measure of performance, be it objective or subjective. Base pay consists of any payment that is guaranteed and static in value, and is usually composed of an executive's salary. Perks include everything else of value which the executive receives; examples range from gym membership and child care to personal use of corporate aircraft, limousine services, and home security systems. While base compensation and perks are important for social and political reasons, incentive compensation was a contributing factor to the financial crisis, and as such will be afforded greater attention here.

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63. *See* Dorff, *supra* note 53, at 2070; *see also* Charles M. Yablon, *Is the Market for CEOs Rational?*, 4 N.Y.U. J. L. & BUS. 89, 110–15 (2007) (considering the relationship between managerial power and social and psychological factors).

64. *See* Dorff, *supra* note 53, at 2045.

A. Stock Options

Stock options are a grant to an employee of the right to purchase company stock at a later date for the market price on the date of the grant.[65] The notion behind the use of stock options as a form of incentive compensation is that they align the executive's incentives with those of the shareholders, because both will profit from an increase in stock price.[66] Stock options typically vest upon the passage of time,[67] and expire after ten years.[68] While stock options, in theory, appear to be an efficient way to eliminate the agency costs inherent in corporate management, there are several aspects of conventional option plans that give pause for thought.

The two problems most frequently cited with stock option plans—that they permit executives to benefit from market conditions beyond their control and that they do not punish management for poor performance—have to do with their true performance sensitivity.[69] The first problem can be seen most clearly in the context of a booming industry sector; if an executive in such a sector underperforms industry peers, but the stock price still climbs because of the rising market, the executive receives a windfall despite his poor relative performance.[70] Thus, the design of this element of a compensation plan is not maximally efficient because there are alternatives, such as options whose strike price is indexed to an industry benchmark, which can provide the same incentivizing effects at a lower cost to shareholders.[71] The second problem is not as readily apparent as the first, because it appears that an executive's downside with an option plan would be a lack of value when

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65. For an excellent source of background information on stock options and their use in the 1990s, see Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, J. ECON. PERSP., Summer 2003, 49, at 50–54.

66. *See id.* at 49.

67. *See id.* at 50.

68. Ten-year terms originated with a tax code provision that forbids deductions for stock options with greater expiration terms. *See* I.R.C. § 422(b)(3) (West 2009).

69. *See, e.g.*, BEBCHUK & FRIED, *supra* note 5, at 138–40.

70. *See id.* at 139–40. *But see* Polsky, *supra* note 21, at 921 (Section 162(m) of the Internal Revenue Code "provides a tax 'excuse' to use [conventional] options, thus making it harder to prove the claim that their universal use is a symptom of poor corporate governance."); *infra* notes 112–14 and accompanying text.

71. *See* BEBCHUK & FRIED, *supra* note 5, at 140–42. Other alternatives include performance-conditioned and performance-accelerated vesting. *Id.* at 142–43.

the market price falls below the strike price—such options are described as being "under water."[72] However, due to the widespread practice of "backdoor repricing"[73] options when stock price falls, executives have come to expect that their options will never truly be under water.[74]

Although these features of stock option plans are worth noting insofar as they sometimes provide pay without any significant ties to performance, the more troublesome aspect of stock options is that they have the potential to incentivize strategies that are not in the best interests of the company and/or shareholders. For example, because stock options myopically incentivize management to focus exclusively on stock price, they do not cause management to consider the cost of equity capital to the firm when crafting corporate strategy.[75] Furthermore, an executive holding stock options is likely to favor reducing dividend payments because keeping excess cash within the corporation will increase stock price.[76] In a similar vein, executives will prefer stock buyback programs regardless of their true value to the company and shareholders.[77]

Most fundamentally, the expected value of an option is proportional to market volatility; this is simply due to the fact that an executive whose options have vested but not yet expired is exposed to a greater amount of potential upside when the market price of his shares is likely to spike frequently.[78] This is

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72. *See, e.g.*, Hall & Murphy, *supra* note 65, at 59–60.

73. Whereas repricing options in light of falling stock value was common in the 1990's, the practice of backdoor repricing—granting new options at a lower strike price—became the norm when accounting standards required firms to expense repriced options. *See* BEBCHUK & FRIED, *supra* note 5, at 165.

74. *See id.* at 166.

75. *See* Michael C. Jensen, *How Stock Options Reward Managers for Destroying Value and What To Do About It* 1–3 (Harvard Bus. Sch. Negotiation, Orgs. and Mkts. Unit, Research Paper No. 04–27, 2001), *available at* http://ssrn.com/abstract=480401.

76. *See* Hall & Murphy, *supra* note 65, at 60; *see also* Letter from Warren E. Buffett, CEO, Berkshire Hathaway, Inc. to Shareholders (Mar. 4, 1986), *available at* http://www.berkshirehathaway.com/letters/1985.html ("Many stock options in the corporate world have worked in exactly that fashion: they have gained in value simply because management retained earnings, not because it did well with the capital in its hands.").

77. *See* Hall & Murphy, *supra* note 65, at 60.

78. *See* Polsky, *supra* note 21, at 909 ("[T]hese options still often have significant value at grant because they allow the holder to participate in share price gains without the necessity of putting any capital at risk. This benefit, referred to as the option privilege, increases as the volatility of the underlying stock increases and as the term of the option increases." (footnote omitted)); *see also* BEBCHUK & FRIED, *supra* note 5, at 139.

closely related to the problem of an executive whose firm is entrenched in a bubble market. Many have noticed that traders in a bubble market, even when its values are clearly overstated, are incentivized to maintain their holdings.[79] The incentives that apply to traders correlate well to managers. Similar to the manner in which executives face pressure to manipulate earnings if their peers are doing so, executives are also incentivized—by both the value of their options and a desire to outperform peers in the near term—to direct their company to ride a bubble until it bursts.[80]

B. Restricted Stock

A trend in executive compensation practices over the past several years has been to replace stock options with restricted stock.[81] Like stock options, restricted stock vests after a certain amount of time has elapsed or the executive has attained certain performance targets, although requiring both is common because of tax treatment of restricted stock grants.[82] Restricted stock is unlike options, however, in that the executive does not need to pay the company anything to acquire the shares; a share of restricted stock is essentially equivalent to an option to buy the same share, but at an exercise price of zero dollars.[83] The official explanation for the move to restricted stock is that, because the shares are never truly under water, there is no need to alter compensation packages to assure that the executive is properly incentivized.[84]

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79. *See, e.g.*, Patrick Bolton, José Scheinkman & Wei Xiong, *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 729 (2005) (citing, as reasons for this behavior, a desire to maximize earnings while asset values are still rising as well as avoidance of being dismissed for exiting a market that continued to rise, even though the decision to exit may have proved correct).

80. *See id.*

81. *See* Joseph E. Bachelder, *Executive Employment Agreements: Selected Issues and Developments*, *in* HOT ISSUES IN EXECUTIVE COMPENSATION 2008 143, 149 (Practising Law Institute 2008); Harry Levitt & Bill Gardiner, *Phantom Stock vs. Restricted Stock for Executive Wealth Accumulation and Diversification*, 3 J. COMPENSATION & BENEFITS 7, 7 (2004); *see also, e.g.*, Lehman Bros. Holdings, Proxy Statement (Form DEF 14A), at 21 (Mar. 5, 2008).

82. *See* Treas. Reg. § 1.162–27(e)(2)(i) (1996).

83. BEBCHUK & FRIED, *supra* note 5, at 171.

84. *See, e.g.*, Hall & Murphy, *supra* note 65, at 60 ("Requiring top executives to hold company stock provides relatively stable incentives regardless of stock price, whereas with stock options the incentive value of options depends on the market price of the stock relative to the exercise price.").

Some commentators, however, have offered alternative explanations for the move to restricted stock. Bebchuk and Fried note that as the problems with stock options began to draw increasing media attention, management preferred restricted stock and its zero-dollar exercise price to performance-conditioned stock options.[85] The authors criticize the proffered explanation for using restricted stock by noting that it would be much more efficient for shareholders to simply index stock options to the bottom segment of the industry average (to address the problem of options falling under water) or to condition the vesting of options on the passage of an extended period of time (to align long-term incentives).[86] Another possibility is that management preferred restricted stock to more efficient varieties of stock options because of its inclination to camouflage the value of its compensation;[87] management may have also predicted more shareholder support for equity incentive programs centered on restricted stock because of the damaged stock option "brand."[88]

Use of restricted stock does appear to eliminate some of the more troubling aspects of stock options, regardless of the reasons for the move. First, restricted stock is less likely to leave an executive un-incentivized after a fall in market price.[89] This has the indirect effect of discouraging the excessively risky behavior that underwater stock options induce executives to pursue.[90] Restricted stock is also advantageous in that it does not encourage an executive to favor stock buyback or reduced

85. *See* BEBCHUK & FRIED, *supra* note 5, at 170–71.

86. *See id.* at 171–73.

87. *See id.* at 68–70.

88. Shareholder approval of virtually all equity incentive plans became a requirement with the 2003 amendments to the NYSE and NASDAQ listing requirements. *See* NYSE, Inc., Listed Company Manual § 303A.08 (2009); NASDAQ, Inc., NASDAQ Stock Market Rules § 5635(c) (2009); *see also* BEBCHUK & FRIED, *supra* note 5, at 48–50 (discussing shareholder voting on equity incentive plans). Even before market listing requirements were adopted, § 162(m) made shareholder approval a prerequisite to claiming a deduction for performance-based compensation. Treas. Reg. § 1.162–27(e)(4) (1996); *see also* BEBCHUK & FRIED, *supra* note 5, at 49–50. In addition, equity plans require that new shares be issued, which typically requires a charter amendment, and thus shareholder approval as per most state incorporation statutes. *Id.* at 49.

89. *See supra* note 84 and accompanying text.

90. *See* Hall & Murphy, *supra* note 65, at 60.

dividend plans;[91] thus, restricted stock eliminates many of the most prominent flaws found in conventional stock options.

Despite its clear advantages over conventional stock options, restricted stock is not without its flaws. First, it is not clear that tying compensation to stock price is the most efficient method of measuring an executive's contribution to firm value.[92] Although the obvious alternative of conditioning incentive compensation on attaining desirable accounting figures has been criticized for encouraging numbers manipulation, there is no reason to expect that unsavory executives will not manipulate earnings in attempts to boost stock price under an equity incentive plan.[93] Moreover, the practice in compensation structure has generally been to permit executives to sell their vested equity compensation at will, thereby allowing them to capitalize on short-term gains in share value.[94] Thus, restricted stock fails to address the most significant flaw of equity compensation programs—their lack of focus on long-term firm value.

III. REGULATORY FRAMEWORK BEFORE THE ECONOMIC COLLAPSE

From the 1990's through mid-2008, the focus of executive compensation regulation was on disclosure and tax treatment. While Congress was trying to stem what it perceived as a tide of excessive compensation that was not closely related to performance,[95] the SEC attempted to provide shareholders with the tools to remedy the situation for themselves through a regime of escalating mandatory disclosure regulations.[96] Although all of the attempts at regulating executive compensa-

91. *See id.*

92. *See id.* at 61; *see also* Roger Martin, *Managers Must Be Judged on the Real Score*, FT.COM, May 11, 2009, http://www.ft.com/cms/s/0/fc3d707c-3e60-11de-9a6c-00144feabdc0.html ("We also need to scrap stock-based compensation alignment theory. Executive compensation should be based entirely on real-market measures such as revenue growth, market share, profits and book equity return.").

93. *See* Hall & Murphy, *supra* note 65, at 61 ("[I]ncentives can sometimes have the problem of motivating too well, rather than too little.").

94. *See* BEBCHUK & FRIED, *supra* note 5, at 176.

95. *See* Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL'Y 383, 384 (2008) ("This disconnect between executive compensation and executive performance led Congress to attempt to curtail executive compensation."); I.R.C. §§ 162(m), 280G (West 2009).

96. *See* 17 C.F.R. § 229.402 (2008).

tion have been well-intentioned, they have had unpredictable, unintended, and sometimes bizarre and counterproductive consequences.[97]

A. Regulation via the Tax Code

Congress has tried to limit excessive compensation through § 162(m) of the tax code.[98] Section 162(m)(1)-(4) provides that no publicly held corporation may deduct compensation in excess of one million dollars paid to any of the four highest-paid executives or the corporation's CEO;[99] it then provides an exception for compensation paid according to objective performance indicators.[100] Although a company may not claim a deduction unless it awards bonuses pursuant to an objective plan, the board may retain negative discretion—the right to reduce the amount of a bonus awarded pursuant to an objective formula—while still claiming the bonus as a deduction.[101]

Because performance-based compensation is riskier than base compensation from an executive's perspective, he must be paid more than would otherwise be required.[102] Also, because the only meaningful restraint on executive compensation is shareholder outrage, the only opportunity an executive has to greatly increase the value of his compensation package is when some externality supplies a pretext for a drastic change in its structure.[103] Thus, many commentators believe that the enactment of § 162(m), instead of limiting the growth

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97. *See generally* Conway, *supra* note 95 (explaining how Congress's attempt to restrain excessive executive compensation through the tax code actually increased compensation for some executives); Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473 (2007) (arguing that mandatory disclosure will sometimes, instead of reducing the prevalence of the targeted behavior, simply shift it to unregulated arenas); Polsky, *supra* note 21 (explaining that § 162(m) of the Internal Revenue Code has had the counterproductive effect of decreasing shareholder wealth).

98. *See* I.R.C. § 162(m) (West 2009), *amended by* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343, sec. 302(a), § 162(m)(5), 122 Stat. 3765, 3803–05. Executive compensation packages are subject to further regulation through I.R.C. §§ 280G (golden parachute payments) and 409A (deferred compensation), among others.

99. I.R.C. § 162(m)(1).

100. I.R.C. § 162(m)(4)(C).

101. *See* Polsky, *supra* note 21, at 886.

102. *See, e.g.*, Hall & Murphy, *supra* note 65, at 55 ("The idea that options cost companies more than they are worth to employee-recipients is not surprising: it stems from the basic concept that individuals demand compensating differentials for bearing risk.").

103. *See* Polsky, *supra* note 21, at 905–06.

of executive pay, actually accelerated its explosion.[104] Those commentators suggest that unlike cash salaries and discretionary bonuses, formulaic bonuses and stock options are notoriously hard to value.[105] Because the total value of executive compensation programs were no longer transparent after § 162(m) was enacted, it became easier for managers to increase the size of their compensation packages while still avoiding outrage costs.[106] This observation is corroborated by the enormous increase in the use of stock options in compensation packages in the late 1990s.[107]

Another unintended consequence of § 162(m) is its impact on companies whose executives make less than the one million deductibility limit; by setting the limit at one million dollars, Congress implicitly gave its approval to any salary up to that amount, thus providing boards with an air of legitimacy when and if challenged by shareholders for approving larger pay packages.[108] Section 162(m) also created incentives for executives with formulaic bonus plans to engage in accounting manipulations;[109] because boards lose discretion over the size of bonuses paid according to a formula, they typically compensate by constricting the formula's range of outputs.[110] This creates an incentive for executives to delay reporting some earnings during an excellent year because, from the financial standpoint of an individual executive, whether the company has a good year or an excellent year makes little difference.[111]

Tax regulations have also discouraged compensation mechanisms that more efficiently link pay and performance.[112] For example, although indexed stock options reduce windfalls

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104. *See id.*

105. *See id.* at 908–11.

106. *See id. But see* CONG. OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM 89 (2009) (Dissenting views of Rep. Jeb Hensarling & John E. Sununu), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf ("[B]y raising taxes on cash compensation, more firms chose to compensate executives with large packages of stock options, resulting in numerous high-profile multimillion-dollar 'pay days' when the options were exercised.").

107. *See* Polsky, *supra* note 21, at 906.

108. *See id.* at 914–15.

109. *Id.* at 923–24.

110. *Id.*

111. *Id.* at 924. Tangentially, Professor Polsky noted that § 162(m) was also poorly designed because it did not take inflation into account. *Id.* at 924–25.

112. *See id.* at 921–23.

to executives and thus save shareholders unnecessary compensation expense, the regulations implementing § 162(m) render compensation paid pursuant to an indexed stock option plan non-deductible.[113] The regulations also affect restricted stock grants by deeming them deductible only if their vesting conditions include some form of performance measure.[114] Although performance-based vesting conditions for restricted stock awards may be desirable, it is somewhat ironic that conventional (non-indexed, at-the-money) stock options are treated more favorably than their restricted stock counterpart.

B. Mandatory Disclosure Regulation

Although disclosure of executive compensation has been a staple in proxy filings since 1938, the SEC undertook its most comprehensive regulatory reform in 2006, mandating the disclosure of an unprecedented amount of information in both tabular and narrative form.[115] The expanse of the new regulations can be observed in the executive compensation disclosure and discussion, which now occupies the bulk of the proxy statements of some companies.[116] While the current level of disclosure certainly provides shareholders with more information, some of the most crucial data is excluded from the regulatory framework,[117] companies have been left with significant loopholes in their presentation of the most outrageous forms

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113. *See* Treas. Reg. § 1.162–27(e)(2)(vi)(A) (1996) ("[I]f the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant . . . none of the compensation attributable to the grant or award is qualified performance-based compensation . . . .").

114. *See id.* Time-vested restricted stock is not qualified under paragraph (e)(2) because, if the price had fallen from the date of grant to the date of sale, the executive would realize gains in his compensation which would not be "based solely on an increase in the value of the stock after the date of the grant." *Id.* The regulation goes on to specifically cite restricted stock as non-qualified compensation unless it vests according to attainment of performance targets. *Id.*

115. *See* Donahue, *supra* note 28, at 66.

116. For example, the executive compensation disclosures consume approximately 54% (28 of 52 pages) of Morgan Stanley's 2008 proxy statement. *See* Morgan Stanley, Proxy Statement (Form DEF 14A), at 11–38 (Feb. 27, 2008), *available at* http://www.morganstanley.com/about/ir/shareholder/Proxy2008.pdf.

117. *See* Donahue, *supra* note 28, at 75–80.

of compensation,[118] and shareholders still wield little actual power to act on the information they are given.[119]

The essence of the SEC's regulatory structure is that the compensation of both executives and directors must be fully disclosed and explained to shareholders in annual proxy statements.[120] The 2006 amendments improved on the previous regulations by mandating numerical display of each component of the executives' pay packages, as well as a sum total.[121] Companies are required to share substantial details of their reasoning behind the amount they pay their executives and their choice of compensation structure.[122] The 2006 amendments also introduced new disclosure requirements in regard to the use of compensation consultants.[123] Although the amendments were certainly an improvement on the previous state of affairs, they did little to address the causes of excessive compensation or to increase shareholders' ability to take action in the face of unreasonable pay.[124]

As noted previously, one of the psychological and organizational reasons for the board's lack of control over executive pay includes managerial power over compensation consultants;[125] the rules failed to ameliorate this issue in several ways. Most notably, because compensation consultants frequently earn a great deal of their revenue from providing other consulting services to management, they are unlikely to be truly independent when advising the board on compensation mat-

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118. *See id.* at 80–82.

119. *See* Lucian Bebchuk, Op-Ed, *Investors Must Have Power, Not Just Figures on Pay*, FIN. TIMES, July 27, 2006, http://www.law.harvard.edu/faculty/bebchuk/opeds/FTjuly06/wFToped.htm.

120. *See* Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,158, 53,159 (Sep. 8, 2006) [hereinafter SEC Release].

121. *See id.* at 53,160.

122. *See id.*

123. *See id.* at 53,205. *See also* 17 C.F.R. § 229.407(e)(3)(iii) (2008) (Compensation consultant disclosure mandates include "identifying such consultants, stating whether such consultants are engaged directly by the compensation committee . . . or any other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement."). As of this writing, the SEC is considering an expansion of the disclosure regime; the proposed changes would not alter the requirements cited with regard to compensation consultants. *See infra* note 344.

124. *See* Donahue, *supra* note 28, at 86.

125. *See supra* text accompanying notes 26–32.

ters.[126] This left compensation consultants in a similar position to auditors before the Sarbanes-Oxley Act, yet the regulations were not nearly as comprehensive as those now imposed upon auditors and audit committees.[127] The rules also assisted the board and management in camouflaging this issue by placing compensation consultant disclosures in the corporate governance section of the proxy statement instead of with the compensation discussion and analysis, where shareholders are most likely to look for it.[128] Shareholders would be better served by more complete information so as to better judge the true degree of independence between management and compensation consultants.[129] This could easily be accomplished by requiring proxy statements to include information about all other fees collected by the compensation consultants.[130]

The 2006 regulations also failed to fully eliminate camouflaged pay packages. For example, the rules require that executive perks be disclosed, but afford an exception for those less than $10,000 in value.[131] Because companies are not forbidden from segmenting one large perk into many smaller ones, it is foreseeable that this is precisely what they will do.[132] This is especially likely because of recent press and congressional attention to the hot-button issue of executive perks; candid disclosure would send outrage costs for all companies to levels approximating those that companies such as Merrill Lynch, Bank of America, and AIG received in early 2009. Because one of the effects of disclosure regulation is to shift compensation from a regulated arena to an unregulated arena,[133] it is likely that the easily-avoided $10,000 limit will result in a greater move of total pay from incentive compensa-

126. *See* Donahue, *supra* note 28, at 76.

127. *See id.* at 75–76.

128. *See* 17 C.F.R. § 229.407(e)(3)(iii).

129. *See* Donahue, *supra* note 28, at 75–77.

130. *See id.* at 82–83 (suggesting that such a disclosure take the form of audit committee reports required by the Sarbanes-Oxley Act). Having taken heed of the role consultants played in the rise of executive compensation, the SEC is beginning to elaborate the relevant disclosure regulations. *See infra* note 344.

131. *See* 17 C.F.R. § 229.402(c)(2)(ix) (2008).

132. *See* Donahue, *supra* note 28, at 81.

133. *See* Manne, *supra* note 97, at 485–88.

tion to perks, resulting in an even greater decoupling of pay and shareholder value creation.[134]

The SEC, in another futile attempt to reduce the camouflage of executive pay, also tackled the practice of spring-loading executive stock options[135] by requiring disclosure of a company's policies for the timing of equity grants.[136] When the SEC released the final version of the amendments, it commented that if a company has "a program, plan or practice to select option grant dates for executive officers in coordination with the release of material non-public information, the company *should* disclose that in the Compensation Discussion and Analysis section."[137] Graef Crystal, a former practitioner and current scholar in the design of executive compensation packages,[138] has noted that the SEC's permissive stance on spring-loaded options has not generated a great deal of disclosure despite the practice's continued prevalence.[139] This is but one additional example of the many ways in which executives can circumvent the disclosure regulations in order to camouflage the true value of their pay packages.[140]

C. The Ratcheting Effect

The combination of § 162(m) and the SEC disclosure regulations has led to a spectacular backfire. In what is perhaps one of the most perverse results of all of these rules and regula-

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134. *See id.* at 496.

135. Spring-loading is the practice of granting stock options immediately before an anticipated spike increase. *See* M. P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1601 (2007). Spring-loading can also be accomplished by delaying the release of information likely to increase stock price until immediately after a scheduled grant. *See* SEC Release, *supra* note 120, at 53,163. Spring-loading is not illegal despite its close relationship to back-dating—the practice of recording the grant date of options as occurring before the grant was actually made—the legality of which is dubious at best. *See* Narayanan et al., *supra*, at 1599–1600, 1606–07.

136. 17 C.F.R. § 229.402(b)(2)(iv).

137. SEC Release, *supra* note 120, at 53,163 (emphasis added).

138. *See* About Graef Crystal, http://www.graefcrystal.com/aboutus.html (last visited Dec. 2, 2009).

139. Graef Crystal, *Opportunistically-Timed Options Are Alive and Well*, CRYSTAL REP., Dec. 1, 2008, at 5, http://www.graefcrystal.com/images/CRYS_REP_OPPOR_TIMING_12_1_08.pdf (coming to his conclusion after an analysis of option granting practices of large public companies).

140. *See* Narayanan et al., *supra* note 135, at 1600 ("Misdating amounts to stealth compensation.").

tions, the regulatory attempts have resulted in a "ratcheting" effect,[141] which explains how the annual rise in executive compensation levels has far exceeded the growth of both national wages[142] and corporate earnings.[143] The ratcheting effect occurred because § 162(m) shifted compensation from easy to understand cash salaries and bonuses to more obtuse and difficult-to-value forms such as stock options, restricted stock, deferred compensation, retirement benefits, and perks.[144] Moreover, the SEC disclosure regulations, as amended in 1992 and again in 2006, made public a large amount of information that was formerly private.[145] Because the effects of groupthink work to suppress suggestions contrary to the accepted norm,[146] and because widely available peer group pay data lends legitimacy to the consultants' suggestions,[147] the compensation committee is left unable to form a view contrary to the status quo. Furthermore, no board wishes to signal to its management, the public, or the rest of the company that the executives in charge are below average; thus, the majority of boards set their executives' pay packages at or above the industry median.[148] Finally, because shareholders are generally powerless

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141. *See* BEBCHUK & FRIED, *supra* note 5, at 71–72; *see also* Charles M. Elson, *The Answer to Excessive Executive Compensation Is Risk, Not the Market*, 2 J. BUS. & TECH. L. 403, 405–06 (2007) (discussing the ratcheting effect in general); Yablon, *supra* note 63, at 114 (discussing the relationship between disclosure regulation and the ratcheting effect).

142. *See* CONG. OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM 37 (2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf ("[T]he ratio of the pay of public company executives to average worker pay [has increased] from 42:1 in 1982 to over 400:1 in the early years of this decade.").

143. *See* Elson, *supra* note 141, at 405 ("This growth [in CEO compensation] is not the result of growth in the Standard and Poor's Index, or the growth of a company's individual value.").

144. *See supra* notes 44–45 and accompanying text.

145. *See* Donahue, *supra* note 28, at 66 ("[T]he Commission adopted amendments to the executive compensation rules in 1992. These amendments abandoned the primarily narrative disclosure approach for a highly formatted tabular one to facilitate the comparison of annual compensation among companies." (footnote omitted)).

146. *See supra* note 49 and accompanying text.

147. *See* Alistair Barr & Matt Andrejczak, *The Executive Pay System is Broken*, MARKETWATCH, May 12, 2009, http://www.marketwatch.com/story/pay-dirt-the-executive-comp-system-needs-fixing ("Outside consulting firms survey what rival companies pay and this information is used to make sure CEOs get more than average. When this is repeated over and over, executive compensation rises inexorably."); *cf.* Yablon, *supra* note 63, at 113–14 (Positive media attention to CEO pay packages "gave boards of companies that had experienced good performance both a justification for increasing CEO pay and a vindication of such pay packages as a compensation strategy.").

148. *See* Elson, *supra* note 141, at 405–06.

to form and/or act upon outrage over skyrocketing pay,[149] the end result is a yearly ratcheting of the sum amount of executive compensation.

IV. EXECUTIVE COMPENSATION AND THE FINANCIAL COLLAPSE

> People with targets, and jobs dependent on meeting them, will probably meet the targets—even if they have to destroy the enterprise to do it.[150]
>
> - William H. Donaldson

Although by no means the cause of the subprime mortgage lending and securitization practices that led to the financial collapse, the structure of executive compensation arrangements did little to discourage them. Equity compensation—especially in the form of stock options—was the primary contributing factor to this, which is ironic considering the degree to which options and restricted stock were touted as engendering a long-term alignment of incentives. Although stock options have fallen out of favor,[151] their standard ten-year expiration terms[152] mean that many options still existed, and thus provided significant incentives, up to and through the beginning of the collapse. As this section is concerned solely with the manner in which pay practices may have encouraged the decisions that led to the financial crisis, it will focus on the compensation schemes used by the firms most exposed to mortgage-backed securities.

A. Moral Hazard

While the media's treatment of the financial collapse has focused on matters such as distributing blame and alternatively criticizing and lauding government involvement, more systematic inquiries have instead focused on the role of moral

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149. *See* BEBCHUK & FRIED, *supra* note 5, at 45, 70.

150. William H. Donaldson, Former Chairman, Sec. Exch. Comm'n, Speech by SEC Chairman: 2005 CFA Institute Annual Conference (May 8, 2005) (quoting W. Edwards Deming), *available at* http://www.sec.gov/news/speech/spch050805whd.htm.

151. *See* sources cited *supra* note 81.

152. *See supra* note 68.

hazard.[153] Moral hazard is most commonly used to describe the effect of assured or implied bailouts on institutional actors; it makes them much less risk-averse.[154] From an *ex ante* perspective, however, moral hazard refers to the misalignment of incentives between investors and those managing the investments on their behalf;[155] it results from the "heads I win, tails you lose" pay arrangements that came to dominate Wall Street. Moral hazard looms especially large in the financial sector because the riskiness of an investment is directly correlated with its return, thus incentivizing asset managers, whose pay is linked perhaps *too* strongly to results, to make excessively risky investments.[156]

The problem of moral hazard has become endemic to the financial sector because, with few exceptions, asset managers and traders rarely have any significant personal downside in the outcome of their decisions.[157] Exacerbating the problem was the practice of paying traders at key investment banks with cash bonuses on an annual basis.[158] Because this sort of compensation arrangement depends exclusively on the trader's results from a single year, the trader has no personal stake in the future performance of his activities beyond the next annual performance review. Thus, it is plainly in the trader's personal interest to choose strategies geared towards producing the most dependable and substantial short-term results re-

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153. *See generally* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183 (2009) (discussing the primary role of moral hazard in the financial collapse and proposing regulatory solutions); John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990's* (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 214, 2003), *available at* http://ssrn.com/abstract_id=373581 (discussing the role of equity compensation in creating moral hazard and leading to the Enron scandal).

154. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 209 (2008).

155. *See* Okamoto, *supra* note 153, at 204.

156. *See id.* at 204–11 (discussing the manner in which moral hazard pervaded the mortgage-backed securities trade).

157. *See* James Dow, *What Is Systemic Risk? Moral Hazard, Initial Shocks, and Propagation*, MONETARY & ECON. STUD. Dec. 2000, at 1, 17 (noting that optimal contract modeling would require payments *to* the firm when a trader underperforms); *see also* Okamoto, *supra* note 153, at 204–05.

158. *See Compensation Structure and Systemic Risk*: *Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 1 (2009) (written testimony of Gene Sperling, Counselor to the Secretary of the Treasury, U.S. Department of the Treasury), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/sperling.pdf; *see also* Joe Nocera, *First, Let's Fix the Bonuses*, N.Y. TIMES, Feb. 21, 2009, at B1, *available at* http://www.nytimes.com/2009/02/21/business/21nocera.html?_r=1. *But see* Dow, *supra* note 157, at 16–17 (cautioning that the expected value of a trader's bonus increases with risk, but is constrained by the trader's appetite for risk).

gardless of the risk of future losses;[159] this is especially true if a future implosion is unlikely to cost the trader his job or affect his chances at obtaining gainful employment elsewhere.[160]

Although somewhat more debatable, the perils of moral hazard can rise past traders, directly up to the executive suite.[161] Some, such as noted economist and compensation scholar Kevin Murphy, have argued that equity compensation internalizes risk for executives by penalizing losses with underwater options and depressed restricted stock prices.[162] While this is largely true, it is a somewhat distorted argument. Executives with underwater options have not been *penalized* for poor performance, they are simply *not being rewarded* for it. Similarly, although an executive with depressed restricted stock holdings has experienced a decrease in net wealth, he will still be able to sell his vested shares for a profit over his zero-dollar investment.[163] Thus, shareholders—whose own money is at stake—are penalized for executive failures to a much greater degree than the executives themselves. This is especially true in light of the prevalence of golden parachute packages,[164] which worsen the asymmetric nature of executive

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159. *See* Sperling, *supra* note 158, at 2 ("Inevitably, these [pay] practices contributed to an overwhelming focus on gains—as they allowed the payout of significant amounts of compensation today without any regard for the possible downside that might come tomorrow.").

160. *Cf.* Okamoto, *supra* note 153, at 226–27 (discussing the effect that the potential to lose one's job has on the decision-making of traders and risk managers).

161. *See* Barr & Andrejczak, *supra* note 147 ("Warren Buffett said this month that the main cause of the current financial crisis was excessive compensation, which encouraged executives at financial institutions to take on too much leverage."); *see also* Dow, *supra* note 157, at 18 ("[E]ach time an individual trader takes excessive risk, there is a failure of management that did not prevent, or may have encouraged, the risk-taking. . . . [T]here may be inadequate incentives for an individual to diagnose and draw attention to problems, and to implement solutions to those problems. This inertia can operate at the level of the firm, or indeed at an industry-wide level."); *see also* Okamoto, *supra* note 153, at 224 ("Both firms and the individuals that make them up have an incentive to take excessive risk and to undervalue the risks they are taking.").

162. *See Compensation Structure and Systemic Risk*: *Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 4–6 (2009) (written testimony of Kevin J. Murphy, Kenneth L. Trefftzs Chair in Finance, University of Southern California Marshall School of Business), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/kevin_murphy.pdf; *see also* Merrill Lynch, Proxy Statement (Form DEF 14A), at 29–30 (Mar. 14, 2008).

163. Although it is admittedly unlikely that an executive would perceive such a sale as a gain, the subjective experience would ultimately be determined by the executive's point of reference. *See* Livio Stracca, *Behavioral Finance and Asset Prices*, 25 J. ECON. PSYCHOL. 373, 390–93 (2004).

164. *See* Sperling, *supra* note 158, at 4 ("While golden parachutes were created to align executives' interests with those of shareholders during mergers, they have expanded in ways

pay by providing for hefty severances even in the case of total failure.[165]

Equity compensation, in addition to not penalizing failure, can also incentivize one to pursue short-term gains, potentially at the expense of long-term sustainability. First consider stock options, which typically vest after a very short period of time, and are exercisable by the holder largely at will.[166] Although, as previously discussed, they do focus executives on stock price, they do not do so for the long term.[167] Even option plans of more recent vintage, which typically vest pro rata over the course of three to five years,[168] do not properly focus on long-term value. Because hedging strategies are generally available to executives,[169] and because they are largely free to unwind their equity compensation at any time after it vests, their incentives are distorted in perverse and ultimately damaging ways.[170] These strategies allow executives to reap the profits of short-term spikes in share value with relative indifference to future performance, thus misaligning their interests with the interests of long-term shareholder wealth, firm growth, and—as recent events have shown—the long-term stability of the greater economy.

Not only does the freedom to unwind equity holdings focus executives on short-term rises in stock price,[171] but the moral hazard created by asymmetric compensation structures also incentivizes them to ride bubbles until they burst.[172] It is al-

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that may not be consistent with the long-term value of the firm, and—as of 2006—were in place at over 80 percent of the largest firms.").

165. *Cf.* Sylvester C.W. Eijffinger, *Crisis Management in the European Union*, CENTRE FOR ECON. POL'Y RES. POL'Y INSIGHT, Dec. 2008, at 3, *available at* http://www.cepr.org/pubs/PolicyInsights/PolicyInsight27.pdf (linking the lack of "downward risks" in compensation structures to poor long-term risk management).

166. *See* BEBCHUK & FRIED, *supra* note 5, at 176.

167. *See id.* at 175–76.

168. *See, e.g.*, Morgan Stanley, *supra* note 116, at 28–30.

169. *See* BEBCHUK & FRIED, *supra* note 5, at 176 ("[E]xecutives often utilize collars and equity swaps to lock in gains on their shareholdings following a stock price increase.").

170. *See id.* at 176–85.

171. *See id.* at 184; *see also* Ben Steverman & David Bogoslaw, *The Financial Crisis Blame Game*, BUS. WK., Oct. 18, 2008, http://www.businessweek.com/investor/content/oct2008/pi20081017_950382_page_4.htm.

172. *See* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 94–95 (Harvard University Press 2009) ("The more generous an executive's compensation and the more insulated his compensation package is from any adversity that may befall his company, the greater will be his incentive to maximize profits in the

most certainly a factor that led the top management of certain investment banks to encourage their traders to engage in risky investments.[173] Another factor which has received scant attention from both the media and academia is that because executives are paid primarily in stock, they receive the benefit of their institutions' leverage without any of the inherent risks.[174] This arrangement heightens the moral hazard for executives—especially from the perspective of the company's creditors and other stakeholders—as it exacerbates the potential for large personal gains with only small personal losses.[175]

B. Equity Retention: A Candle in the Dark

Despite the foregoing, the short-term focus was not systemic, and the banks that effectively incentivized their executive team to focus on the long-term stability and value of the company have been weathering the crisis much better than their peers. Of the five major investment banks,[176] only Goldman Sachs and Morgan Stanley have truly survived.[177] The method used by these institutions to align the interests of their

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short run—especially in a bubble, where the short run is highly profitable but the long run a looming disaster."); *cf.* Schwarcz, *supra* note 154, at 217 n.139 (explaining the causes of individuals' market behavior in a bubble).

173. *See* Nocera, *supra* note 158 ("Executives pushed their subordinates to take more risk because that would yield more profits, and bigger bonuses. Nobody had any incentive to worry about whether those [mortgage-backed] securities would someday 'blow up.' Too much bonus money was at stake.").

174. *See Compensation Structure and Systemic Risk*: *Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 4 (2009) (written testimony of Lucian A. Bebchuk), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/bebchuk.pdf.

175. *See id.* at 4–5.

176. It should be noted that both Goldman Sachs and Morgan Stanley shed their investment bank status in fall of 2008 to better weather the coming financial storm. *See* Ben White & Louise Story, *Titans, After the Fall*, N.Y. TIMES, Sep. 23, 2008, at C1.

177. Bear Stearns survived bankruptcy in March of 2008 only after the Federal Reserve intervened, enabling a fire-sale purchase by JPMorgan. *See* Yalman Onaran, *Fed Aided Bear Stearns as Firm Faced Chapter 11, Bernanke Says*, BLOOMBERG.COM, Apr. 2, 2008, http://www.bloomberg.com/apps/news?pid=20601087&refer=worldwide&sid=a7coicThgaEE. Lehman Brothers was allowed to collapse in September of 2008, and its bankruptcy is widely believed to have precipitated the scale of the financial crisis. *See* Ben White & Jenny Anderson, *A Frantic Weekend That Wall Street Won't Forget*, N.Y. TIMES, Sep. 15, 2008, at C1, *available at* http://www.nytimes.com/2008/09/15/business/15street.html. Merrill Lynch was acquired by Bank of America (whose own fate is uncertain) on January 1 of 2009 amidst midnight bonus and loss-concealment scandals. *See* Greg Farrell & Julie MacIntosh, *Merrill Delivered Bonuses Before BofA Deal*, FINANCIALTIMES.COM, Jan. 21, 2009, http://www.ft.com/cms/s/0/378a38d4-e814-11dd-b2a5-0000779fd2ac.html.

executives with the long-term health of the firm is of great importance for attempts to avert future disasters. The key feature of the compensation arrangements of these two companies was their requirement that executives and senior management hold a significant portion of all equity grants until retirement.[178] Although similar plans are—or were, as the case may be—in place at all five banks,[179] it is the substance of the restrictions that mattered.

Goldman Sachs had the most extensive equity retention program of the five,[180] requiring its chief executives and vice chairmen to retain 75% of their equity awards until retirement; the top tier of management was also restricted from selling 25% of their equity awards.[181] Morgan Stanley's policy applied the same 75% retention rate to its top executives, but had no similar provision for other management.[182] Merrill Lynch's requirements were identical to Morgan Stanley's, with the exception that officers were permitted to breach the policy with permission, presumably granted by the board or compensation committee.[183] Not surprisingly, the firms that failed outright had more lax guidelines. Lehman Brothers applied "liquidity limits" to its CEO, COO, and CLO, which prohibited them from selling more than 20% of their outstanding equity in any given year.[184] Although the 20% limit sounds stricter than a 75% retention minimum, Lehman's policy counted "outstanding equity awards" towards executives' total hold-

178. *See* Morgan Stanley, *supra* note 116, at 9; The Goldman Sachs Group, Inc., Proxy Statement (Form DEF 14A), at 20–21 (Mar. 7, 2008), *available at* http://www2.goldmansachs.com/our-firm/investors/financials/archived/proxy-statements/docs/2008-proxy-statement.pdf.

179. *See* sources cited *supra* note 178; The Bear Stearns Cos., Proxy Statement (Form DEF 14A), at 17 (Mar. 27, 2007); Lehman Bros. Holdings, *supra* note 81, at 23; Merrill Lynch, *supra* note 162, at 15.

180. This discussion excludes the restrictions placed on Goldman's executives as a condition of Warren Buffett's investment in the company. *See infra* text accompanying notes 196–201.

181. *See* Goldman Sachs, *supra* note 178, at 20–21; *see also "Hold 'Til Retirement" Requirements for Equity Awards: How to Pick and Implement What's Right for Your Company*, CORP. EXECUTIVE (Executive Press, Inc., Concord, Cal.), Sept.-Oct. 2008, at 3 [hereinafter *HTR Requirements*].

182. *See* Morgan Stanley, *supra* note 116, at 9; *see also* Morgan Stanley Equity Ownership Commitment, http://www.morganstanley.com/about/company/governance/ownershipcommit.html (last visited Dec. 2, 2009) (explaining that the equity retention policy applies to "the Company's Executive Officers and the heads of certain business units").

183. *See* Merrill Lynch, *supra* note 162, at 15.

184. Lehman Bros. Holdings, *supra* note 81, at 23.

ings,[185] which permitted them to sell a greater proportion than one would if only vested shares were tallied.[186] Bear Stearns, the first of the banks to collapse, required its executives to hold a relative pittance: five thousand shares of common stock, towards which vested but unexercised options were counted.[187]

The correlation between the substance and breadth of the equity retention requirements imposed with the degree to which the five investment banks have thus far weathered the subprime mortgage crisis should not be surprising.[188] Although the data is merely anecdotal, it is telling that those firms whose executives stood to lose the most from the subprime mortgage exposure have been the least affected. The lesson that should be taken from the financial disaster, as it pertains to executive pay structure, is that the best way to ensure that the incentives of the executives are aligned with the long-term stability of the financial system is by forcing them, through some version of an equity retention requirement, to have a significant amount of personal wealth at stake.

V. RECENT EXECUTIVE COMPENSATION LEGISLATION (AND ONE PRIVATE INVESTMENT)

The financial meltdown has sparked some truly drastic changes in the executive pay arena. In October of 2008, Berkshire Hathaway invested five billion dollars in Goldman Sachs, and as a term of that investment Goldman Sachs executives accepted some limitations on their ability to liquidate their Goldman stock.[189] Shortly thereafter, Congress imposed executive compensation limits on participants in the Troubled

185. *Id.*

186. *See* BEBCHUK & FRIED, *supra* note 5, at 178 (criticizing the practice of counting unvested awards towards ownership targets).

187. The Bear Stearns Cos., *supra* note 179, at 17.

188. From most to least extensive, the banks' retention policies rank as follows: Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, Bear Stearns. As of early March, 2009, Goldman Sachs' stock was down about 60% from its 2007 high, whereas Morgan Stanley's had fallen approximately 78% from its 2007 high. Yahoo! Finance, http://finance.yahoo.com (stock information can be accessed by typing the company name into the "get quotes" field). Merrill Lynch's exposure to toxic assets forced its sale to Bank of America in early 2009. Lehman Brothers filed for bankruptcy in September 2008, and Bear Stearns was saved from a similar fate earlier that year.

189. *See* The Goldman Sachs Group, Inc., Current Report (Form 8–K), at 2 (Oct. 2, 2008).

Asset Relief Program (TARP),[190] which were more fully delineated in Treasury regulations issued in October.[191] Several months later, newly-elected President Obama and Secretary Geithner announced their intent to significantly amend those regulations,[192] however, Congress mooted the proposals by including strict new rules in the American Recovery and Reinvestment Act (ARRA).[193] After several months of deliberation, the Treasury issued regulations implementing the executive compensation provisions of the ARRA.[194] While doing so, the Treasury also publicized plans to reform executive pay practices for all companies—not just those receiving TARP funds.[195]

While only the ARRA legislation and subsequent regulations remain applicable law, an examination of the previous rules and proposals is useful insofar as it illuminates the wisdom and efficacy of the current rules and the proposals for future reform.

A. Berkshire Hathaway's Investment in Goldman Sachs

On October 1, 2008 Warren Buffett's company, Berkshire Hathaway, invested five billion dollars in Goldman Sachs.[196] In exchange for the cash, Berkshire received 50,000 shares of preferred stock, as well as warrants to purchase a substantial amount of common stock at a price ten dollars below the closing market price on the day of the sale.[197] In order to safeguard his company's investment, Mr. Buffett negotiated an

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190. *See* Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. No. 110–343, § 111, 122 Stat. 3765, 3776–77, *amended by* American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. No. 111–5, sec. 7001, 123 Stat. 115, 516–20; EESA § 302(a), 122 Stat. at 3803–05 (codified at I.R.C. § 162(m)(5) (West 2009)).

191. *See* 31 C.F.R. pt. 30 (2008), *amended by* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009); I.R.S. Notice 08–94, 2008–44 I.R.B. 1070.

192. *See* TREASURY GUIDANCE, *supra* note 8.

193. *See* ARRA sec. 7001 (amending 12 U.S.C.A. § 5221 (2008)).

194. *See* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394, 28,394–423 (June 15, 2009) (interim final rule) (codified at 31 C.F.R. pt. 30). For ease of distinction, the regulations issued by Secretary Paulson's Treasury Department will be referred to as the "EESA regulations," and those issued by Secretary Geithner's Treasury as the "ARRA regulations."

195. *See* U.S. DEP'T OF THE TREASURY, TG–163, STATEMENT BY TREASURY SECRETARY TIM GEITHNER ON COMPENSATION (2009), *available at* http://www.treas.gov/press/releases/tg163.htm [hereinafter GEITHNER ON COMPENSATION].

196. The Goldman Sachs Group, Inc., Current Report (Form 8–K), at 2 (Oct. 2, 2008).

197. *See id.*

equity retention requirement for Goldman's four top executives, under which they are not permitted to in any way dispose of more than 10% of their common stock holdings at the time of the agreement.[198] The restriction extends to each executive's spouse and estate planning vehicles, and remains in effect until the earlier of Berkshire's redemption of its preferred stock or three years from the date of agreement.[199] Additionally, the executives remained bound by the terms of Goldman's equity retention policy,[200] thus preventing them from hedging their holdings.[201]

B. TARP and the Treasury Regulations Under Secretary Paulson

As the Emergency Economic Stabilization Act (EESA) was rushed through Congress in the fall of 2008, the drafters of the bill inserted some limits on the compensation packages for executives of companies that would eventually receive funds under the TARP component of the law.[202] Likely due to the legislation's hastened progress through Congress, the restrictions were rather vague, and the lawmakers deferred many of the specifics to the Treasury.[203] The executive compensation standards applied only to the five highest-paid executives (collectively the senior executive officers, or SEOs) at companies in which the Treasury held equity or debt, and expired upon the Treasury's release of such holdings.[204] The substantive rules added a new subsection to I.R.C. § 162(m), which forbade TARP recipients from claiming more than $500,000 in deductions for each SEO's compensation and eliminated the incentive compensation exception for these companies.[205]

The EESA also imposed three new standards on TARP recipients, the most interesting of which required that the SEOs'

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198. *See id.*

199. *Id.*

200. *Id.*

201. *See* The Goldman Sachs Group, Inc., *supra* note 178, at 21.

202. *See* Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. No. 110–343, § 111, 122 Stat. 3765, 3776–77, *amended by* American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. No. 111–5, sec. 7001, 123 Stat. 115, 516–20; EESA § 302(a) (amending I.R.C. § 162(m) by adding § 162(m)(5)).

203. *See* EESA § 111(b)(1).

204. *See* EESA § 111(b)(1), (b)(3).

205. *See* I.R.C. § 162(m)(5) (West 2009).

compensation packages not include any element that would encourage them "to take unnecessary and excessive risks that threaten the value of the financial institution."[206] The Treasury regulations implementing this provision required the compensation committee of a TARP recipient to promptly meet with risk management officers in order to identify and eliminate any pay package features that could incentivize the SEOs to take unnecessary risk.[207] The remaining two standards addressed the symmetry of compensation packages by requiring a clawback of any compensation predicated on "materially inaccurate" performance criteria[208] and by limiting the availability of golden parachutes.[209]

Thus, the only concrete result of the EESA was a ban on deducting any pay in excess of $500,000 to the top five executives at a firm accepting TARP funds. Although the clawback and golden parachute restrictions did address a key flaw in compensation structure, notable absences from the restrictions included an absolute cap on compensation received or any limit on the executive's ability to unwind equity holdings.

1. *Analysis*

Perhaps because of Secretary Paulson's warnings of imminent financial disaster if Congress did not pass the EESA quickly,[210] there was little meaningful debate in either the House or the Senate over the executive compensation provisions.[211] Rather, Congress was most concerned with ensuring

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206. EESA § 111(b)(2)(A).

207. *See* 31 C.F.R. § 30.3(a)(1) (2008), *amended by* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009).

208. EESA § 111(b)(2)(B); *see also* 31 C.F.R. §§ 30.6–30.7 (2008).

209. *See* EESA § 111(b)(2)(C), 111(c); *see also* 31 C.F.R. § 30.9 (2008).

210. *See Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (Sep. 23, 2008) (statement of Henry M. Paulson, Secretary of the Treasury), *available at* http://banking.senate.gov/public/_files/PAULSON Testimony92308.pdf ("More is needed. We saw market turmoil reach a new level last week, and spill over into the rest of the economy. We must now take further, decisive action to fundamentally and comprehensively address the root cause of this turmoil.").

211. *Cf.* 154 CONG. REC. S10338 (daily ed. Oct. 1, 2008) (statement of Sen. Kerry) ("Once we address the current crisis, we need to have a serious debate on executive compensation . . . ."). As indicated by Senator Kerry, no serious debate took place in the Senate before the EESA was passed. A search of the Congressional Record for "executive compensation" in the House

that taxpayer money would not be used to fund massive golden parachutes for the executives of failed institutions.[212] This was primarily a political concern; a recorded vote for bailout funds that were later used to subsidize hundreds of millions of dollars in golden parachutes would serve as excellent ammunition for future political foes. The clawback provision likely shared a similar origin. Notably, these were the only topics which left the Treasury little discretion in its rulemaking capacity.[213] Political concerns also took life in the addition of § 162(m)(5) to the tax code, but, despite the failures of § 162(m) as enacted in 1993,[214] subsection (m)(5) virtually mirrored the former version. Congress was concerned with protecting taxpayer assets, as evidenced by the "unnecessary and excessive risk" provision of section 111,[215] however, the details received short shrift.

The frailty of the EESA's executive compensation limits was due primarily to Congress's decision to entrust broad interpretive authority to a Treasury Department well known for its deregulatory ideals. A glance at virtually any newspaper printed in January or February of 2009 will quickly reveal that the golden parachute and clawback rules did not insulate the financial institutions from public outrage.[216] Although the majority of the media attention focused on the executives themselves, Congress certainly had its feet to the fire.[217] Much of the public ire spawned from the size of the Wall Street bonuses, which may have been reduced by some degree if Congress had abridged the scope of the Treasury's rulemaking authority. Because the Treasury's implementing regulations per-

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pages returned only eleven results, none of which included any substantive discussion of the incentive effects of compensation.

212. *See, e.g.*, 154 CONG. REC. S10218 (daily ed. Oct. 1, 2008) (statement of Sen. Baucus) ("I don't want Main Street to subsidize severance pay on Wall Street.").

213. *Compare* EESA § 111(b)(2)(C), 111(c) (enacting a blanket prohibition on golden parachute payments), *with* EESA § 111(b)(2)(A)–(B) (providing standards in terms that left substantial discretion to the implementing agency).

214. *See supra* Part III.A.

215. *See* EESA § 111(b)(2)(A).

216. *See, e.g.*, Stolberg & Labaton, *supra* note 2, at A1.

217. *See* 155 CONG. REC. S1652 (daily ed. Feb. 5, 2009) (statement of Sen. Dodd) ("The problem is, if you don't do something about this, we are never going to be able to build the confidence and optimism people need to feel about the larger part of this program. . . . If we are going to convince the American public that what we are trying to do is in their interest, then we have to be certain when it comes to [executive compensation].").

mitted companies to apply the incentive deduction pro rata for the time in fiscal 2008 during which they were not the beneficiaries of public dollars,[218] the corporate tax burden for the SEO's portion of the awards diminished significantly. Although it would have been reasonable for the Treasury regulation to apply the incentive-compensation deduction ban to any bonus *awarded* while a TARP recipient held federal funds, Secretary Paulson, as a former investment bank executive, may have fallen prey to cognitive dissonance in the same manner as board members sometimes do.

The other opportunity for substantive change in the EESA lay in the interpretation of its "unnecessary and excessive risk" clause. Whereas one may have thought it would apply directly to any short-term incentive plan, the Treasury left the matter to TARP recipients, who were expected to self-enforce the provision through a process of compensation committee meetings and certifications.[219] As the experiences of the past two decades indicate, the Treasury rules would have had little impact.[220]

C. The February 2009 Treasury Guidance

After the media ran rampant with stories of bonus scandals at companies receiving bailout funds,[221] the Obama Administration responded by announcing its intent to amend the executive compensation regulations applicable to TARP recipients.[222] Shortly thereafter, the ARRA revised the EESA executive compensation legislation,[223] thus rendering many of the Obama Administration's proposed regulations moot; in the subsequent months the Administration took to calling the proposed regulations the "Treasury Guidance."[224] Nomencla-

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218. *See* 31 C.F.R. § 30.10(c) (2008), *amended by* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009).

219. *See id.* §§ 30.3–30.5

220. *See, e.g.*, Ryan Grim, *Dems Want Auto-Like String Tied to TARP Funds*, HUFFINGTON POST, Jan. 10, 2009, http://www.huffingtonpost.com/2009/01/10/dems-want-auto-like-strin_n_156808.html (discussing TARP's lack of "teeth").

221. *See, e.g.*, Stolberg & Labaton, *supra* note 2, at A1.

222. *See* TREASURY GUIDANCE, *supra* note 8.

223. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111–5, sec. 7001, 123 Stat. 115, 516–21.

224. *See, e.g.*, TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394, 28,395 (June 15, 2009).

ture aside, an examination of the Treasury Guidance remains useful because the differences between it and the ARRA highlight different approaches to the executive compensation issue.

The guidelines distinguished between fund recipients in several ways. First, the new limits would not have applied retroactively; rather, they would have only restricted banks participating in existing TARP programs.[225] Furthermore, the restrictions would have distinguished between institutions receiving funds under "generally available" programs[226] and those receiving "exceptional financial recovery assistance."[227]

The rules for institutions receiving generally available funds would have been rather mild. Such companies would be subject to a $500,000 limit on compensation, with an exception allowing additional payments in the form of "restricted stock or other similar long-term incentive arrangements" that could vest only after government funds were repaid with interest; however, companies fully disclosing their compensation arrangements and submitting to a say on pay resolution would not have been required to abide by this standard.[228] The golden parachute regulations would have been tightened by permitting only a payment equal to one year's compensation,[229] the clawback regulation would have been expanded to the top twenty-five earners,[230] and compensation committees would have been required to develop a policy for executive perks.[231]

The additional restrictions that would have applied to banks receiving exceptional assistance, although significant, were

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225. *See* TREASURY GUIDANCE, *supra* note 8, § II(B), para. 6. The sole exception to this is an extension of the Compensation Committee's compliance responsibilities; the Obama rules would have further required compensation committees to provide an explanation detailing how their executive compensation packages did not encourage the excessive risk prohibited by the EESA. *See id.* § I.

226. *Id.* § II(B).

227. *Id.* § II(A). The release clarified this standard by including within its scope any bank needing more funds than what is available under a general program, and cited AIG, Citi, and Bank of America as examples. *See id.* at para. 4.

228. *See id.* § II(B), para. 2.

229. *See id.* § II(B), para. 4. This provision is still stricter than the previous regulations, which banned golden parachutes to an SEO, 31 C.F.R. § 30.8 (2008), *amended by* TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009), but excluded any payment less than three year's compensation from the definition of a golden parachute, *id.* § 30.9.

230. *See* TREASURY GUIDANCE, *supra* note 8, § II(B), para. 3.

231. *See id.* § II(B), para. 5.

clearly the product of a good deal of deliberation. First, these companies would not have been eligible to exempt themselves from the $500,000 plus restricted stock rule.[232] Also, golden parachutes would have been flatly prohibited for the top ten executives, with the next twenty-five highest-paid being eligible for a golden parachute equal to only one year's compensation.[233] The guidelines also included new rules, such as a mandate for full disclosure of the recipient's compensation structure and submission to a non-binding "say on pay" shareholder vote.[234] The rules regarding clawbacks and perks would have been identical to those for companies receiving generally available funds.[235]

Interestingly, the Treasury Guidance would have incorporated an element of the restrictions Warren Buffett imposed on Goldman executives.[236] The holding requirement announced by Secretary Geithner, similar to Warren Buffett's in kind if not substance, is both more restrictive in its absolute limit on non-restricted-stock compensation, and less in that executives would have been free to unwind benefits conferred before their companies' participation in Treasury programs.

1. *Analysis*

The Treasury Guidance's plan for the majority of TARP recipients reflected political motivations. President Obama said as much when he announced the new rules: "In order to restore trust, we've got to make certain that taxpayer funds are not subsidizing excessive compensation packages on Wall Street."[237] Along the same lines, fairness and a sense of justice

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232. *See id.* § II(A), para. 1–2.

233. *See id.* § II(A), para. 5.

234. *See id.* § II(A), para. 3.

235. *See id.* § II(A), para. 4, 6.

236. This idea is not the only one which the Treasury has borrowed from Mr. Buffett. *See* TIMOTHY G. MASSAD, REPORT TO THE CONGRESSIONAL OVERSIGHT PANEL FOR ECONOMIC STABILIZATION: LEGAL ANALYSIS OF THE INVESTMENTS BY THE U.S. DEPARTMENT OF THE TREASURY IN FINANCIAL INSTITUTIONS UNDER THE TROUBLED ASSET RELIEF PROGRAM 20–21 (2009), *available at* http://cop.senate.gov/documents/cop-020609-report-dpvaluation-legal.pdf ("The CPP standard forms are quite similar to, and appear to be based on, the documentation used by Berkshire Hathaway for its investment in Goldman Sachs.").

237. Remarks on the National Economy, 2009 DAILY COMP. PRES. DOC. 00057, at 1 (Feb. 4, 2009), *available at* http://www.gpoaccess.gov/presdocs/2009/DCPD200900057.pdf.

were central themes in President Obama's announcement.[238] The limits of these motives can be seen most clearly in the Administration's intent that the guidance would not have applied retroactively to former TARP recipients.[239] Furthermore, viewed apart from the additional restrictions imposed by the ARRA, the guidelines would have been ineffectual as to the general body of TARP recipients. There were several major loopholes which, without further regulatory reform, would have prevented and/or punished only the most egregious violations of the public trust.[240]

On the other hand, the guidelines for companies receiving exceptional assistance had features demonstrating a desire to align executive interests with those of the taxpayers. The plan's requirement that top executives maintain their stock holdings until the investments are repaid is similar to an equity retention policy in that it would have fostered the same investment horizon as the government. However, the primary focus was still political, as evidenced by features such as an absolute cap on salary and a requirement that the board adopt a policy on perks.[241]

D. Current Law: The Executive Compensation Provisions of the ARRA and Their Implementing Regulations

The final version of the ARRA contained a last minute addition which, contrary to the wishes of the Obama Administration,[242] placed rather stringent restrictions on executive com-

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238. *See id.* at 2 ("We're asking these firms to take responsibility, to recognize the nature of this crisis and their role in it. We believe that what we've laid out should be viewed as fair and embraced as basic common sense.").

239. *See* TREASURY GUIDANCE, *supra* note 8, § II(B), para. 6.

240. *See, e.g.*, text accompanying *supra* note 228 (discussing exceptions to the $500,000 compensation cap).

241. It is notable that President Obama described the perk disclosure rule in much harsher terms than as it was revealed in the Treasury's press release. For example, he claimed that companies would be required to disclose "all the perks and luxuries bestowed upon senior executives and provide an explanation to the taxpayers." Remarks on the National Economy, *supra* note 237, at 2. However, the rules required only development and disclosure of a policy, without any specification of the amount of detail required. *See* TREASURY GUIDANCE, *supra* note 8, § II(A), para. 6.

242. *See* Edmund L. Andrews & Eric Dash, *Stimulus Plan Tightens Reins On Wall Street Pay*, N.Y. TIMES, Feb. 14, 2009, at A1 (Sections 7001–7002 were "inserted by Senate Democrats over the objections of the Obama administration.").

pensation for both future and former TARP recipients.[243] Although these statutory provisions were mostly in keeping with the principles set forth in the Treasury Guidance, there were substantial deviations which may appropriately be described as paternalistic. However, the ARRA also left the Treasury with a good deal of rulemaking authority, which it used to temper some of the more prohibitive rules while also closing many of the loopholes found in the statutory provisions.

To understand how the ARRA restrictions were influenced by the Treasury Guidance and to gain insight into the probable motives for the ARRA regulations, a brief review of the relevant legislative history is helpful. On the same day that the Obama Administration announced its guidelines, Senator Christopher Dodd introduced the restrictions as an amendment to the Senate version of the stimulus package.[244] The first version of the amendment was prohibitively restrictive; although many of its terms built on the EESA, one of Senator Dodd's provisions would have precluded any TARP recipient from "paying or accruing *any* bonus, retention award, or incentive compensation . . . to at least the twenty-five most highly-compensated employees . . . ."[245] Members of the House also voiced their concern about the perceived excesses of Wall Street.[246] After the stimulus bill came out of conference, the executive compensation amendments were more congruent with the Treasury Guidance, yet still embodied several vast differences.[247]

The relevant section of the ARRA was drafted as a complete replacement for section 111 of the EESA.[248] The ARRA was, however, similar to the existing law in several respects. First, the bill expanded the EESA by extending its clawback provision beyond the senior executive officers (SEOs) to the next twenty highest-paid employees.[249] It also included the next five highest-paid employees in the scope of the golden para-

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243. *See* American Recovery and Reinvestment Act (ARRA) of 2009, Pub. L. No. 111–5, sec. 7000–02, 123 Stat. 115, 516–21 (amending 12 U.S.C.A. §§ 5221, 5219(a) (2008)).

244. *See* 155 CONG. REC. S1530–32 (daily ed. Feb. 4, 2009) (statement of Sen. Dodd).

245. *Id.* at S1531 (Amendment No. 354, sec. 6002(c)(4)) (emphasis added).

246. *See, e.g.*, *id.* at H1014 (statement of Rep. Sherman) (advocating strict limits on executive compensation for TARP recipients).

247. *See* 155 CONG. REC. H1514–15 (daily ed. Feb. 12, 2009) (Conf. Agreement).

248. *See* ARRA sec. 7001.

249. *See id.* § 111(b)(3)(B).

chute ban.[250] Congress retained § 162(m)(5)[251] and the EESA's "unnecessary and excessive risk" standard,[252] but added a potentially expansive prohibition on pay structures "that would encourage manipulation of the reported earnings of" the company.[253] Additional provisions included a requirement that the board permit non-binding shareholder resolutions on executive compensation packages,[254] and a mandate that the Treasury review pre-ARRA compensation packages to ensure compliance with the purpose of the executive compensation rules.[255]

Despite the similarities, the most notable feature of the ARRA—and its most significant departure from the Treasury Guidance—is section 111(b)(3)(D). This provision prohibits TARP recipients from awarding or guaranteeing "any bonus, retention award, or incentive compensation" with the sole exception of "long-term restricted stock"[256] that does not constitute more than one-third the employee's "total amount of annual compensation."[257] Moreover, the restricted stock award may not "fully vest" while the company holds outstanding obligations under TARP.[258] One of the more intriguing aspects of this mandate is that the scope of its application varies with the amount of money the entity has received: companies that received more bailout money were forced to apply the limits to a greater number of their employees.[259]

In June 2009, several months after the ARRA's passage, the Treasury issued regulations which added substance to some legislative provisions that would otherwise be vague and ineffectual. First, it is important to note that the Treasury maintained the distinction, first announced in the February Treas-

250. *See id.* § 111(b)(3)(B)–(C).

251. *See id.* § 111(b)(1)(B).

252. *Id.* § 111(b)(3)(A).

253. *Id.* § 111(b)(3)(E).

254. *See id.* § 111(e).

255. *See id.* § 111(f)(1).

256. *Id.* § 111(b)(3)(D)(i).

257. *Id.* § 111(b)(3)(D)(i)(II).

258. *Id.* § 111(b)(3)(D)(i)(I).

259. *See id.* § 111(b)(3)(D)(ii). The tiers are segregated as follows (by millions of dollars): less than 25, 25 to 250, 250 to 500, and greater than 500. *See id.* § 111(b)(3)(D)(ii)(I)–(IV). Subsection D applies to, respectively by tier: the top executive, the five most highly-paid, the SEOs and the ten next most highly-paid, and the SEOs and the twenty next most highly paid. *See id.*

ury Guidance, between the majority of TARP participants and those receiving exceptional assistance.[260] Those companies that have received exceptional assistance will be closely scrutinized by the newly-created position of "Special Master for TARP Executive Compensation";[261] this review will delve into the compensation structures for the one hundred most highly paid employees,[262] applying criteria such as risk,[263] allocation between types of compensation,[264] ties to performance,[265] and compatibility with compensation practices in similarly-situated companies[266] to determine whether any particular compensation package should be approved.

The ARRA regulations also elaborated on some of the more vague provisions of the legislation. First, the regulations gave broad definitions to the terms "golden parachute" and "bonus," as used in sections 111(b)(3)(B) and 111(b)(3)(D)(i), respectively.[267] In doing so, it made clear that a company cannot create a legal right to a future payment without such a right being counted against the limits applied to the employee's compensation.[268] Also, the restricted stock exception to the bonus limit was eased to some degree by allowing the stock grants to vest ratably with the repayment of TARP funds.[269] Moreover, the regulations clarified that, for the purposes of the ARRA's clawback provision, financial metrics are "materially inaccurate" if an employee knowingly provides errant information or fails to correct such information.[270] Finally, the

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260. *See* TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30.16(a)(3) (2009) (interim final rule).

261. *Id.* § 30.16(a).

262. *See id.* § 30.16(a)(3)(ii). The principles will not, however, be applied to those employees who are already subject to the restrictions of ARRA § 111(b)(3)(D). *Id.*

263. *See id.* § 30.16(b)(1)(i).

264. *See id.* § 30.16(b)(1)(iii).

265. *See id.* § 30.16(b)(1)(iv).

266. *See id.* § 30.16(b)(1)(v).

267. *See id.* § 30.1 (definitions of "bonus" and "bonus payment"); *id.* (definition of "golden parachute payment").

268. *See id.* (definitions of "bonus" and "bonus payment"); *id.* (definition of "golden parachute payment"); *id.* §§ 30.9(a), 30.10(a).

269. *See id.* § 30.1 (definition of "long-term restricted stock"). The stock awards may vest according to the following schedule: 25% after repayment of 25% of TARP funds, 50% after repayment of 50% of TARP funds, 75% after repayment of 75% of TARP funds, and the remainder after all TARP funds have been repaid. *Id.*

270. *Id.* § 30.8. The regulations do not exclude other situations from coming within the scope of the clawback provision. *See id.*

new regulations incorporated an element of the Treasury Guidance[271] into the "unnecessary and excessive risk" and "manipulation of reported earnings" provisions of the regulations; although the application of these standards is still left to compensation committees, the ARRA regulations also require that the company include a disclosure in its annual proxy statement explaining precisely why the compensation structure complies with these rules.[272]

1. *Analysis: the purpose of the rules*

The purpose behind the ARRA legislation is somewhat difficult to ascertain, as it is almost impossible to discover the reasoning behind each legislator's vote. However, there is a substantial record of the statements of Senator Dodd, the primary proponent of the executive compensation amendment. Senator Dodd's motives for attaching the provisions were wholly political; like President Obama, Senator Dodd was attempting to subdue the outrage of the American public.[273] Support for the amendment in the House was founded on similar considerations, as well as principles of fairness.[274] Interestingly, the moral hazard implicit in distributing government bailouts also generated support for the amendment.[275]

The ARRA regulations, although not accompanied by debate records or grandiose speeches, do have a clearly discernable purpose when laid in contrast to the February Treasury Guidance. Because President Obama was opposed to some of the more oppressive restrictions embedded in the ARRA legislation,[276] the new regulations provided TARP recipients with a

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271. *See* TREASURY GUIDANCE, *supra* note 8, § II(A), para. 3, § II(B), para. 2 (proposing that TARP recipients be required to disclose the manner in which their compensation practices are in accord with sound risk management).

272. *See* 31 C.F.R. § 30.4(a)(4).

273. *See* 155 CONG. REC. S1652 (daily ed. Feb. 5, 2009) (statement of Sen. Dodd) ("[I]t is infuriating to people when they watch taxpayer money go into an institution and then they read where top executives walk away with multimillion dollar bonuses or contracts.").

274. *See* 155 CONG. REC. H1014 (daily ed. Feb. 4, 2009) (statement of Rep. Sherman) ("Executives who have driven their companies into the ditch so badly that they need a Federal bailout shouldn't be receiving enormous salaries.").

275. *See id.* ("[O]ur economy demands that we be tough with those who are coming to Washington for bailouts, because otherwise every executive and every industry is going to be coming here asking for a bailout.").

276. *See* Andrews & Dash, *supra* note 242.

good deal of latitude. For example, the $500,000 cap on base pay, one of the primary features of the February Guidance, was jettisoned in the regulations;[277] the provision allowing stock awards to vest pro rata with repayment of government funds also afforded TARP recipients some breathing room.[278]

In addition to fixing perceived legislative missteps, the new regulations also reflect a more forward-thinking approach to executive pay than did the February Treasury Guidance. Relieved of the responsibility of creating executive pay rules from scratch, the Treasury had time to consider the criticisms of previous approaches along with its broader regulatory agenda when it issued the new regulations. This opportunity can be seen most clearly in the provisions of the new regulations that were absent in the February Treasury Guidance, such as the creation of the Special Master's position and his mandate to delve into the compensation practices for a relatively large portion of each company.

2. *Analysis: efficacy*

Because the ARRA provisions are so restrictive, they are likely to succeed in quelling public anger over payments covered by the law.[279] Many companies, finally coming to the realization that paying exorbitant sums to their executives while also receiving taxpayer funds is bad public relations, awarded little to nothing in the way of bonus money for fiscal year 2008.[280] However, it is quite possible that some compensation committees will inflate executive salaries in an attempt to make up for the loss of bonus money.[281] Even so, boosting salaries a "mere" several hundred thousand dollars is unlikely

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277. *See generally* 31 C.F.R. pt. 30 (lacking any cap on pay).

278. *See id.* § 30.1 (definition of "long-term restricted stock").

279. However, the non-retroactivity provision found in subsection (b)(3)(D)(iii) resulted in a media firestorm over contractual cash retention bonuses paid to the AIG employees responsible for the company's downfall. *See, e.g.*, Jay Newton-Small, *The AIG Bonuses: Getting Mad and Getting Even*, TIME.COM, Mar. 18, 2009, http://www.time.com/time/politics/article/0,8599,1885977,00.html.

280. *See, e.g.*, Bank of Am. Corp., Proxy Statement (Form DEF 14A), at 21 (Mar. 19, 2009).

281. *See* DealBook, *Union Said to Ask Morgan Stanley to Reverse Pay Increases*, NYTIMES.COM, June 24, 2009 (Andrew Ross Sorkin, ed.), http://dealbook.blogs.nytimes.com/2009/06/24/union-asks-morgan-stanley-to-reverse-exec-pay-hikes-report-says/ (listing Morgan Stanley, Bank of America, UBS, and Citigroup as banks that have or are planning to increase salaries to compensate for reduced bonuses).

to trigger the same kind of public response as AIG's retention awards.[282] Moreover, despite the fact that § 162(m) has generally been a failure, new § 162(m)(5), when combined with the shareholder precatory resolutions set to be introduced in the 2010 proxy season,[283] will probably prevent TARP recipients from raising executive salaries by a substantial degree. Thus, the ARRA is likely to keep executive compensation from dominating the headlines, at least insofar as TARP recipients are concerned.[284]

Although the ARRA will likely address constituent demands, it does not truly serve the interests of justice. From the public's perspective it will appear that justice has been done; the executives who drove the financial sector into the ground will no longer be paid exorbitant sums. However, for companies receiving large amounts of assistance, the caps on pay have the potential to reach further than may be wise. With the exception of those companies receiving exceptional assistance, the bonus limitations extend to the SEOs and the next twenty highest-paid employees; even in the ARRA regulations, the Treasury did not specify whether it may require the limits to extend to a greater number of employees.[285] Thus, the ARRA has the potential to extend the caps on pay to high-performance traders who had no hand in the subprime debacle, thereby over-inclusively punishing those who deserve no reprobation.

In regard to the concerns of some Congressmen who supported the amendments to dissuade further bailout requests, the fruit of their concerns may have the ironic effect of working too well. Some, such as Roger Altman, Treasury Undersecretary during the Clinton Administration, believe that the new restrictions could have the effect of unwinding many of the benefits TARP funds were supposed to confer by encour-

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282. *See* Newton-Small, *supra* note 279.

283. *See* Shareholder Approval of Executive Compensation of TARP Recipients, Exchange Act Release No. 60,218, 74 Fed. Reg. 32474, 32478 (July 8, 2009).

284. Goldman Sachs and Morgan Stanley, two of the earliest institutions to return TARP funds, quickly made headlines with plans to increase compensation to at-or-above 2007 levels, and in much the same form. *See, e.g.*, Aaron Lucchetti, *Big Pay Packages Return to Wall Street*, WALL ST. J., July 2, 2009, at C1, *available at* http://online.wsj.com/article/SB124649352055183157.html.

285. *See* 31 C.F.R. § 30.10(b)(1)(i)–(iv) (2009) (interim final rule) (The Treasury simply copied the text of ARRA sec. 111(b)(3)(D)(ii)(I)–(IV) into the new regulations.).

aging executives to direct their banks to repay government funds before their institutions are fully prepared to do so.[286] Although the Treasury attempted to respond to this concern in its definition of "long-term restricted stock,"[287] many banks returned TARP funds as early as June 2009, and it remains possible that others will follow suit.[288] Although early return of taxpayer money would be beneficial standing alone, the benefit would certainly be nullified if closely followed by further troubles in the finance industry.

The ARRA limitations may also damage taxpayer investments in another respect. The most commonly cited potential unintended consequence of the ARRA restrictions is a "brain drain" of talent from the public finance companies.[289] The cap on bonuses larger than half an employee's annual compensation may be lethal in this regard; even if an employee subject to the ARRA rules were paid $1.5 million in salary, the employee's bonus would still be capped at $750,000. While some may argue, perhaps correctly, that executive pay should be brought down from its astronomical levels, the fact remains that executives and managers have employment opportunities at institutions not accepting TARP money[290] and in organizations such as private equity or hedge funds.[291] Additionally, even if one were to assume that a change of executive management at many of these institutions would be desirable, the provisions for companies receiving large amounts of assistance have the potential to reach beyond the upper tier of management.[292] Thus, a focus on corporate hierarchy may

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286. *See* David Gillen, *The Brain Drain Defense*, N.Y. TIMES, Feb. 22, 2009, at WK1. *See also* American Recovery and Reinvestment Act (ARRA) of 2009, Pub. L. No. 111–5, sec. 7001, § 111(g), 123 Stat. 115, 520 (permitting early withdrawal from TARP).

287. *See* 31 C.F.R. § 30.1 (definition of "long-term restricted stock").

288. *See* Stevenson Jacobs & Daniel Wagner, *Banks to Return $68 Billion in Bailout Money*, THE ASSOCIATED PRESS, June 9, 2009, http://abcnews.go.com/Business/wireStory?id=7792120 (mentioning executive compensation restrictions as a reason for the early return); *see also* Lucchetti, *supra* note 284.

289. Gillen, *supra* note 286; *see also* Knowledge@Wharton, *Outrage over Outsized Executive Compensation: Who Should Fix It and How?*, Feb. 4, 2009, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2151; Nocera, *supra* note 158.

290. *See* Nocera, *supra* note 158 (observing that several traders left Merrill Lynch for Deutsche Bank, which has not accepted any TARP money).

291. The availability of well-paying private equity positions actually contributed to the ratcheting effect of compensation packages before the financial crisis. *See* Andrew Ross Sorkin & Eric Dash, *Private Firms Lure C.E.O.'s with Top Pay*, N.Y. TIMES, Jan. 8, 2007, at A1.

292. *See* Gillen, *supra* note 286.

have been a more prudent approach for Congress to have taken; even a more individualized assessment, such as that the Treasury devised for companies receiving exceptional assistance, would have probably foreclosed the development of such a situation.

Even if all of Congress's concerns were adequately addressed by the ARRA, the question of whether they address the true problems with executive compensation remains. Assuming that the shareholder primacy norm survives the economic crisis,[293] most would agree that the size of executive compensation packages, though perhaps problematic for social reasons, did not lead to the risky behavior that permeated the banking industry; rather, it is the fact that executive pay is detached from long-term performance.[294] Instead of focusing on the same aspects of pay that the media does, such as large bonuses and private jets, the reforms should be addressing this critical missing link. The Treasury Guidance came closest to this with its requirement that all compensation over $500,000 for entities receiving exceptional assistance be in the form of restricted stock that would not fully vest until the government had been repaid.

However, neither the Treasury Guidance nor the regulations as enacted align executive interests with long-term value to nearly the same degree as Warren Buffett's equity retention term with Goldman Sachs executives. Although the regulations prevent restricted stock from fully vesting during times of government assistance, there is no mechanism preventing executives from unwinding the majority of their vested holdings. Moreover, the provision's incentives are under-inclusive with respect to executives whose wealth is already concentrated in company stock. For these individuals, the utility of the additional compensation is marginal, and thus any vesting requirement will not have the same incentivizing effect. As Secretary Geithner was not precluded from issuing a provision

293. *See* Martin, *supra* note 92 (suggesting that "[i]t is time to scrap shareholder value theory").

294. *See, e.g.*, GEITHNER ON COMPENSATION, *supra* note 195 ("Incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage.").

similar to Warren Buffett's in the regulations,[295] he would have been wise to include one which froze the vast majority of the executives' future *and* current holdings.[296]

VI. SYSTEMIC REFORM: AN OPPORTUNITY FOR MEANINGFUL CHANGE

All of the new laws and regulations discussed thus far apply only to specific companies—either those that have received TARP funds, or, in the case of Berkshire Hathaway, to Goldman Sachs executives. On numerous occasions the Treasury has set forth pieces of its greater plan for regulatory reform,[297] and Congressional leaders have also indicated their desire to enact legislation that would apply to all public U.S. corporations.[298] If broad reform is indeed set in place, it should be focused on truly aligning the interests of corporate executives with long-term stability and growth. Moreover, Congress and the Treasury should heed the lessons of SEC disclosure regulations, tax legislation, and the various methods corporations have used to circumvent the intended effects of these regulatory actions.

A. The Administration's Plan

On the same day that the Treasury released the interim final regulations for TARP recipients, Secretary Geithner also announced a set of guiding principles for compensation practices at all companies and two legislative proposals,[299] which were

295. *See* American Recovery and Reinvestment Act (ARRA) of 2009, Pub. L. No. 111–5, sec. 7001, § 111(b)(2), 123 Stat. 115, 517 ("The Secretary shall require each TARP recipient to meet appropriate standards for executive compensation and corporate governance.").

296. Because of the provision in the ARRA allowing early repayment of TARP funds, *see id.* § 111(g), it may also have been wise to extend a retention requirement for one or two years beyond repayment.

297. *See* TREASURY GUIDANCE, *supra* note 8, § III; GEITHNER ON COMPENSATION, *supra* note 195; *see also* U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION, 29–30, 73 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter FINANCIAL REGULATORY REFORM] (discussing the future role of other federal regulators in setting executive compensation standards for financial institutions).

298. *See, e.g.*, 154 CONG. REC. S10338 (daily ed. Oct. 1, 2008) (statement of Sen. Kerry) ("Once we address the current crisis, we need to have a serious debate on executive compensation . . . .").

299. *See* GEITHNER ON COMPENSATION, *supra* note 195.

later refined into a bill the Administration submitted to Congress.[300] The first component of the bill is standard say on pay legislation;[301] it seeks to provide shareholders with a non-binding advisory vote on compensation practices as disclosed in proxy materials.[302] It goes further than traditional proposals, however, in that it requires enhanced disclosure of golden parachute packages, and affords shareholders a separate advisory vote on those arrangements.[303] The second element of the bill draws from the Sarbanes-Oxley Act by heightening independence standards for compensation committees. Not only would the independence criteria for committee members be greater than in the past,[304] but it also provides committees with the authority to independently retain and pay consultants and outside counsel.[305] The legislation also seeks to give the SEC authority to establish independence standards for compensation consultants themselves.[306]

Secretary Geithner's guiding principles, purportedly the influence behind the legislative proposals, consist of five related insights into the distortions that have emerged in current compensation schemes. First, he observed that there should be an appropriate link between pay and performance, and that stock price should not be the exclusive indicator of an executive's performance.[307] The second principle is that compensation should be structured to account for the time horizon over which risk might materialize; while Secretary Geithner was careful to state that "directors and experts should have the flexibility to determine how best to align incentives in different settings and industries," he did suggest that holding requirements and clawbacks may be good tools for achieving

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300. *See* Investor Protection Act of 2009, sec. 941–942 (proposed legislation), *available at* http://www.treas.gov/press/releases/reports/titleixsubtdexeccomp%20.pdf.

301. *See* U.S. DEP'T OF THE TREASURY, TG–219, FACT SHEET: ADMINISTRATION'S REGULATORY REFORM AGENDA MOVES FORWARD: SAY-ON-PAY, (July 16, 2009), *available at* http://www.treas.gov/press/releases/tg219.htm. It is also worth pointing out that when President Obama was a United States Senator, he introduced such a bill; however, the bill died in committee. *See* S. 1181, 110th Cong. (2007).

302. *See* Investor Protection Act of 2009, sec. 941(a), § (i)(1) (proposed legislation).

303. *See id.* § (i)(2).

304. *See id.* sec. 942, § 10B(b).

305. *See id.* § (d)–(f).

306. *See id.* § (c).

307. *See* GEITHNER ON COMPENSATION, *supra* note 195.

this goal.[308] Moreover, in elaborating upon this principle Secretary Geithner implicitly recognized that compensation practices should be monitored for a greater proportion of the company.[309]

The final three principles—that compensation practices should be aligned with risk management, that golden parachutes should be used judiciously, and that transparency and accountability should be emphasized—are all closely related. Secretary Geithner noted that a greater emphasis on risk management may have averted the crisis, that golden parachutes may have drifted from their original function of aligning executive and shareholder interests in the face of a potential takeover, and that current disclosure may be somewhat lacking in "clarity."[310]

These principles would not be imposed directly; rather, their application would be left to each corporation's shareholders and directors through the proxy process. While Secretary Geithner did not explicitly state that such a scheme may be inadequate for systemically important financial institutions, commentators have,[311] and Secretary Geithner implicitly recognized this by proposing that the Federal Reserve, along with other regulators, be given the authority to more closely monitor compensation practices at institutions within its purview.[312] While this aspect of the proposal is somewhat lacking in detail as of this writing,[313] it appears that the Federal Reserve would be expected to adopt an individualized approach similar to that of the Special Master for Compensation.[314]

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308. *Id.*

309. *See id.* ("[F]irms should carefully consider how incentives that match the time horizon of risks can extend beyond top executives to those involved at different levels in designing, selling and packaging both simple and complex financial instruments.").

310. *Id.*

311. *See, e.g.*, Joe Nocera, *Geithner's Plan on Pay Falls Short*, N.Y. TIMES, June 13, 2009, at B1, *available at* http://www.nytimes.com/2009/06/13/business/13nocera.html?_r=l&emc=tnt&tntemail1=y.

312. *See* FINANCIAL REGULATORY REFORM, *supra* note 297, at 29.

313. *See* Nocera, *supra* note 311 ("Mr. Geithner stressed the importance of coming up with a compensation system that accounted for risk . . . ," but "[n]either he, nor anyone else in government, has yet figured out what to do about it.").

314. *See* FINANCIAL REGULATORY REFORM, *supra* note 297, at 29–30 ("[S]tandards on compensation for financial firms . . . will be fully integrated into the supervisory process.").

B. Risk Aversion and Compensation Practices

The Obama Administration's framework for executive compensation reform, while taking many of the key ideas about executive compensation's role in the financial crisis to heart, is somewhat lacking in its application of those ideas to a comprehensive solution. The Administration is correct that it is not only top executives' compensation structures that should be subject to regulation.[315] Because the industry-wide compensation policies that led to the subprime mortgage crisis pervaded every rung of the corporate ladder and spread throughout the real estate industry, a narrow focus on the individuals receiving media attention will not suffice to prevent another similar episode in the future.[316] Nevertheless, executives are those most able to influence corporate strategy, therefore, any regulatory structure that emerges should not ignore the capacity of incentive compensation to misalign corporate strategy and long-term value. Hence, it is imperative that the personal interests of executives be to foster long-term, stable, economic expansion.

The Treasury recognized in its February Guidance that "[o]ne idea worthy of serious consideration is requiring top executives at financial institutions to hold stock for several years after it is awarded."[317] In subsequent months the Administration, perhaps realizing that such a notion could be beneficially applied beyond the financial sector as traditionally conceived,[318] incorporated the idea into its guiding principles.[319] While the idea's conceptual underpinnings are sound, the details demonstrate significant shortsightedness. For ex-

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315. *See supra* note 309 and accompanying text; *see also* TREASURY GUIDANCE, *supra* note 8, § III, para. 1.

316. *See generally* Okamoto, *supra* note 153, at 224–36 (discussing possible regulatory reforms to address pervasive moral hazard).

317. *See* TREASURY GUIDANCE, *supra* note 8, § III, para. 3.

318. For example, although Enron's collapse was largely due to the type of wizardry that led to the current fiasco, it was technically an energy company. Also illuminating is AIG's escape from regulation in the derivatives market, which subsequently permitted European banks to effectively avoid their own regulatory schemes. *See* Interview by Terry Gross with Gretchen Morgenson, Financial Reporter, N.Y. Times, in Phila., Pa. (Mar. 16, 2009), *available at* http://www.npr.org/templates/transcript/transcript.php?storyId=101936770 ("[W]hat these foreign banks bought from AIG was . . . a structured investment vehicle that allowed them to have a lower capital cushion on their books, and so it was . . . a way for them to circumvent capital requirements.").

319. *See* GEITHNER ON COMPENSATION, *supra* note 195 (second principle).

ample, requiring stock retention for only a few years will only foster the proper horizon for the first several years of an executive's tenure. If an executive is free to sell stock without restriction after it begins to vest, there is a substantial likelihood that we will see the same kinds of accounting and strategy manipulations that became disturbingly common after the emergence of equity compensation as the corporate norm.

There are two aspects to this problem's solution. Abandoning equity incentives altogether would be too blunt an approach;[320] it is holding horizon and sale timing that are at the heart of the issue. Mr. Buffett's approach with Goldman executives is well-tailored for these sorts of purposes. By limiting the ability of executives to liquidate their wealth until after Berkshire's investment horizon, Mr. Buffett effectively aligned his incentives with those of the executives.[321] Thus, the proper focus is not on the time stock is held after it vests, but rather on what percentage is held until after the investment horizon. This raises the issue of framing the investment horizon for broader reform. While institutional shareholders have frequently been accused of having short investment horizons,[322] the individuals who were most hurt by the recent stock market collapse—for example, those relying on individual retirement plans—have an investment horizon that is measured in decades, not years. Therefore, the most prudent method of aligning such a long-term horizon with executive interests is by forbidding executives from unwinding their holdings until they no longer have influence over the corporate agenda.[323] Setting the threshold at the time the executive leaves the company would be insufficient; it would still be feasible for an executive to profit from manipulations simply by quitting before

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320. *See* BEBCHUK & FRIED, *supra* note 5, at 137 ("We should emphasize at the outset our strong support for the general idea of equity-based compensation."); Graef Crystal, *There's Still a Case to be Made for Stock Options*, CRYSTAL REP., Dec. 15, 2008, at 4, http://www.graefcrystal.com/images/CRYS_REP_OPTIONS_12_15_08.pdf (advocating unconventional stock options).

321. Alternatively, it could be said that he prevented them from pursuing goals contrary to his own.

322. *See* Sanford M. Jacoby, *Finance and Labor: Perspectives on Risk, Inequality, and Democracy*, 30 COMP. LAB. L. & POL'Y J. 17, 23–25 (2008) (discussing the short investment horizons and high risk tolerance of institutional investors and private equity funds).

323. *Cf. HTR Requirements*, *supra* note 181, at 4 ("HTR [Hold 'Til Retirement] requirements strongly counterbalance any perception that executives can inappropriately time market sales.").

he predicted a sharp decline in stock price. Rather, forbidding significant unwinding until approximately two years after the executive's departure would be a surer standard.[324]

The second aspect of the solution would be to ensure that executives could not dispose of a great portion of their unrestricted holdings at any one time.[325] Permitting such behavior has motivated executives to generate volatility in share prices, the upward variations of which are of great financial benefit to the executive who can time his sales properly.[326] The rule would also prevent more invidious forms of corporate manipulation. Scholars have observed that insider trading laws, which prohibit executives from profiting from material information, are insufficient to prevent gains from the accumulated effect of many immaterial bits of knowledge.[327] Moreover, SEC regulations that have provided a safe harbor for insider trading liability through adherence to a timed sale program have largely been ignored.[328] Mandating executives to abide by such a program would further reduce their incentive to manipulate short-term stock prices.[329] A second solution, although somewhat inferior, would require executives to announce their sales several days or weeks before they took place.[330] Although this would theoretically arm the broader market with more information, whether the disclosures would reach a sufficient percentage of market participants before the sale took place is questionable.

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324. *See* Barr & Andrejczak, *supra* note 147; *cf.* BEBCHUK & FRIED, *supra* note 5, at 178 (noting that executives might be permitted to unwind some of their equity compensation to meet diversification and liquidity needs, but generally advocating restrictions on their freedom to unwind at will); *HTR Requirements*, *supra* note 181, at 8 (endorsing Exxon-Mobil's approach of vesting equity compensation 50% at five years after grant and 50% at *the later of* ten years after grant or the executive's retirement); Eijffinger, *supra* note 165, at 3 ("The reward structure should be more aimed *at the long term*, and both the upward and downward risks should be *symmetric* and stretch beyond their term in office.").

325. *Cf.* BEBCHUK & FRIED, *supra* note 5, at 191 (suggesting, as a potential solution to the "perverse incentives" created by executive freedom to time stock sales, that executives be required to disclose details of their sales before they are made).

326. *See supra* text accompanying notes 78–80, 170–73.

327. *See* BEBCHUK & FRIED, *supra* note 5, at 179.

328. *See id.* at 180.

329. *See id.* at 183–85. For example, requiring managers to file their intent to sell a certain number of shares, and then do so ratably over the course of several months to a year, would eliminate their ability to profit from price spikes that occur on a shorter timeframe than the course of the sale plan.

330. *See id.* at 180.

This solution is not without criticisms. For instance, a long-term holding requirement might be inadequate as applied to executives who occupy the extremes of the wealth spectrum.[331] Perhaps this situation could be addressed by a practice similar to private equity's tradition of demanding a significant co-investment from management,[332] or by selling discounted stock options to executives as a form of compensation.[333] A more compelling criticism is that holding requirements may excessively discourage risk taking.[334] While this solution would certainly discourage risk more so than in the past, it is not as if executives would be facing criminal sanctions or personal bankruptcy for pursuing a risky strategy. Rather, a holding requirement should keep just enough of an executive's wealth in the company to discourage excessively risky behavior, while still encouraging a comfortable level of risk.[335]

Another objection, propounded by the noted scholars Lucian Bebchuk and Jesse Fried, is that predicating an executive's release from an equity retention policy on circumstances under the executive's control will have the effect of encouraging the executive, once he has amassed a sufficient amount of wealth in company equity, to cause his release from the requirement and thereby liquidate a great proportion of his own net worth.[336] In the case of a mandate that the executive hold equity until retirement, this would have the effect of encouraging the most successful and longest-serving executives to retire.[337] However, an equity retention policy can counter these objections in several ways. First, by not releasing the execu-

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331. *See* Okamoto, *supra* note 153, at 230 (addressing "the very complicated questions of how to design 'skin in the game' for every context").

332. *Id.* at 229–30.

333. *See* Jensen, *supra* note 75, at 8–9. Jensen proposed that management purchase options with an in-the-money exercise price for the difference between fair market value on the date of grant and the exercise price, which would serve two purposes. *Id.* at 8. First, it would put management's skin in the game, and second, it would serve as an excellent self-selection tool when seeking a new management team. *Id.* at 8–9.

334. *See* Okamoto, *supra* note 153, at 229–30 (discussing the difficult "balancing act" implicit in eliminating moral hazard while not discouraging optimal risk taking).

335. *See id.* (noting that the "two and twenty" structure common among private equity and hedge funds generally addresses this issue, but can falter if the assets under management grow too large, thus excessively discouraging risky behavior).

336. *See* Lucian Bebchuk & Jesse Fried, Opinion, *Equity Compensation for Long-Term Results*, WALL ST. J., June 16, 2009, *available at* http://www.law.harvard.edu/faculty/bebchuk/opeds/06-16-09_WSJ.pdf.

337. *See id.*

tive from his retention commitment until several years *after* retirement, it encourages the executive to remain with the company in some capacity, perhaps as a director or consultant. This is simply because the self-interested executive would not wish to leave his personal wealth entirely in the hands of a newcomer, regardless of the level of trust between the two. The problem can also be addressed by requiring that equity be held until the longer of two years past retirement, or ten years from the date of grant.[338]

C. Excessive Pay and Social Justice

The equity retention requirement discussed herein only serves to align executive incentives with long-term, stable growth; it does not address the political and social justice concerns inherent in the size of executive compensation packages. Requiring a nonbinding shareholder vote on compensation packages, as the Obama Administration intends to do,[339] is an excellent start towards reigning in the level of executive compensation.[340] However, this approach is similar to treating the symptoms of a cold, whereas it would be more effective to develop a vaccine.[341]

Such a corporate vaccine would need to focus on the process by which the compensation committee determines pay levels. The best way to do so would be to require that the source of the committee's information—compensation consultants—be completely independent of management. In this respect, the Obama Administration's plan to increase the independence standards for compensation committees is an excellent start. While the plan calls for a comprehensive approach, the reforms that focus on the consultants will have the greatest impact, as consultants play a crucial role in both the managerial power and group dynamics models of executive compensation.

As a possible solution, future regulations could require that the compensation consultant render no other services to the

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338. *See* sources cited *supra* note 324.

339. *See* U.S. DEP'T OF THE TREASURY, *supra* note 301.

340. *See* BEBCHUK & FRIED, *supra* note 5, at 52 (noting that reasonable shareholder resolutions have an effect on executive compensation by increasing outrage costs).

341. *Cf. id.* ("But voting on such resolutions, as well as on option plans, cannot effectively prevent departures from arm's-length contracting.").

corporation which hired it.[342] This would address the causes of high executive pay by arming the compensation committee with independent, reliable information. Moreover, in contrast to the rigid and sometimes patently ridiculous proposals offered in Congress,[343] it reserves flexibility for the committee to set pay levels at amounts appropriately tailored to its corporation's needs. There is an indication that the SEC may adopt this approach, as it is focusing its scrutiny on consultants under existing rules[344] and has expressed concern over the same sorts of conflicts of interest when enacting regulations under the Sarbanes-Oxley Act.[345]

Finally, the Administration and Congress should be careful to not simply layer new rules on top of old. The provisions of the Internal Revenue Code discussed earlier have not only contributed to the problem of excessive and distorted executive compensation, but have also prevented companies from experimenting with pay packages that more closely align pay and performance. When considering changes to the current regulatory scheme, Congress should draft a replacement for § 162(m) that does not penalize companies for adopting compensation methods such as indexed options, and should at least entertain the idea of repealing § 162(m) and returning to

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342. *Cf.* Donahue, *supra* note 28, at 82–83 (suggesting that proxy disclosures include the fees paid to compensation consultants for their compensation work as well as all other work).

343. For an example of a rather ill-considered proposal, see 155 CONG. REC. S1446–47 (daily ed. Feb. 3, 2009) (S. Amendment No. 125 to H.R. 1), which would have capped the total annual compensation of TARP recipient executives to the value of the President's salary—$400,000. For an excellent critique of this amendment, see Graef Crystal, *I'll Take It, Senator McCaskill!*, CRYSTAL REP., Jan. 30, 2009, http://www.graefcrystal.com/images/CRYS_REP_CAP_2_1_30_09.pdf.

344. In July 2009, the SEC proposed rules that would require that all companies—not just TARP recipients—disclose whether a consultant provided any non-compensation services, and if so, the nature of all services performed, the fees paid for compensation consulting, and the fees paid for all other consulting. *See* Proxy Disclosure and Solicitation Enhancements, Securities Act Release No. 9052, Exchange Act Release No. 60280, Investment Company Act Release No. 28817, 74 Fed. Reg. 35,076, 35,108 (proposed July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270, 274).

345. *Cf.* Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47654, Investment Company Act Release No. 26001, 68 Fed. Reg. 18,788, 18,796 (Apr. 16, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 274) ("The auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. This may occur if the auditor views management as its employer with hiring, firing and compensatory powers. Under these conditions, the auditor may not have the appropriate incentive to raise concerns and conduct an objective review.").

an individualized assessment of what constitutes "reasonable," and thus deductable, compensation.[346]

CONCLUSION

The structure of executive compensation programs at top financial institutions not only failed to align executive interests with sound risk management, but also directly encouraged the short-term behavior and speculation that has led America into the financial crisis we face today. Congress and the SEC have attempted to reign in the levels of pay in the past, and both have contributed to the problem rather than solving it. Congress's attempts to further regulate the issue via the EESA and ARRA have both painted with too broad a brush; its most recent legislation may prove to harm taxpayer assets to a greater extent than it protects them. Going forward, Congress and the President should address constituent demands carefully by providing shareholders with an advisory vote on pay packages and ensuring the independence of compensation committees and consultants from management. However, to truly foster an appropriate degree of risk aversion in executives, it would be wise to adopt an approach similar to that of a man who has earned billions of dollars over the course of decades. Requiring executives to adhere to a long-term equity retention policy, as Mr. Buffett required of Goldman Sachs executives,[347] is the best solution that will not leave companies with sufficient room to escape the standards.

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346. I.R.C. § 162(a)(1) (West 2009).

347. Mr. Buffett has also noted that stock ownership is common among Berkshire Hathaway management. *See* Buffett, *supra* note 76 ("Obviously, all Berkshire managers can use their bonus money . . . to buy our stock in the market. Many have done just that . . . .").