Financial Institutions, the Market, and the Continuing Problem of Executive Compensation

J. Robert Brown, Jr.

Introduction

The financial crisis of 2008 occurred in part because of excessive risk taking by financial institutions.\(^1\) Compensation formulas at some of these institutions contributed to the collapse by encouraging the maximization of short-term revenues.\(^2\) As one report noted, compensation systems in the financial services industry were inadequately designed and “provided incentives to take imprudent risks.”\(^3\)

Excessive risk, however, was not the only problem associated with compensation that surfaced during the crisis. Payments often seemed unrelated to actual performance. Compensation formulas could result in amounts disproportionate to the services provided and could include lavish perks.\(^4\) The practices raised broad concerns about the role of the board of directors in the corporate governance process.

The source of the problem was—and remains—surprisingly clear. Compensation has traditionally been a matter left to the discretion of the board of directors. Directors in turn have a fiduciary obligation to act in the best interests of shareholders. In the abstract, the duties would seem sufficient to require boards to develop formulas that avoided excessive risk and linked incentives to the long-term performance of the company.

In fact, fiduciary obligations impose no meaningful restraints on the type or amount of executive compensation authorized by boards. Instead, executive compensation is left to the “market” to regulate. Yet as the recent downturn shows, the market has not proved up to the task.

Congress in the new millennium has expressed dissatisfaction with the compensation process and has intervened on several occasions. The Sarbanes-Oxley Act required top officers to reimburse improperly paid compensation in certain circumstances.\(^5\) The legislation also sought to prevent abuses in the compensation process by prohibiting loans to directors and executive officers.

During the financial crisis, temporary restraints were imposed on the compensation practices of financial institutions receiving funds under the Troubled Asset Relief Program (TARP) of 2008.\(^6\) Permanent reforms, however, had to wait until the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.\(^7\) It authorized financial regulators to prohibit compensation practices that encouraged inappropriate risk taking. In addition, Congress sought to force corporate boards to adopt more rigorous processes for determining compensation and to give shareholders a permanent role in compensation determinations.
These efforts, although productive, represented a patchwork of changes that left the underlying problems in place. Even under proposed rules by bank regulators, boards largely remained free of meaningful limits in determining compensation. As a result, for years after the adoption of the Dodd-Frank Act, the dynamics that contributed to the financial crisis remained mostly unchanged.

**Compensation without Limits: The Dearth of Regulation under State Law**

The problem of executive compensation has foremost been a failure of state law. The board of directors determines executive compensation. Traditionally, decisions on CEO compensation were subjected to an exacting standard of review. Under the duty of loyalty, directors had an obligation to establish that the form and amount of compensation was “fair” to shareholders. Directors could be held personally liable to the extent that compensation might be “unfair.” The standard meant that boards had to engage in rigorous review of the type and amount of compensation and the impact of compensation practices on the company.

By the 1990s, however, the standard had changed. Executive compensation for the most part ceased to be subject to an obligation of fairness. Instead, decisions were reviewed under the duty of care, a process oriented standard. The shift occurred with little analysis but with profound consequences. As long as companies used “proper” process, the amount and form of compensation ceased to be part of the analysis. The approach resulted in compensation without limits.

The problem was exacerbated by a judicial refusal to make the process meaningful. Compensation had to be approved by a board with a majority of “independent” directors. Director independence was, however, interpreted in a porous fashion. Directors who had obvious ties to the CEO or significant business relations with the company were accepted as independent by courts. They drew arbitrary lines and used excessive pleading standards to prevent shareholders from adequately exploring the issue.

Similarly, efforts in Delaware to heighten the involvement of directors in the oversight of risk taking at financial institutions proved unsuccessful. Shareholders brought an action alleging that the board of Citigroup failed to adequately oversee the bank’s involvement in the subprime mortgage market. The court viewed the claim as little more than an attempt by shareholders to recover from a business decision that “turned out poorly” and dismissed the case.

**Compensation with Some Limits: Federal Intervention into the Compensation Process**

The result of the state law approach was a system that did not impose substantive limits on the amount and type of compensation or adequately require boards to weigh the impact of compensation on risk taking. The lack of oversight fueled abuses and
eventually provoked federal intervention. In the aftermath of Enron and Worldcom, Congress addressed the failure of state law to require the repayment of improperly paid compensation. Section 304 of Sarbanes Oxley mandated that the CEO or CFO reimburse the company for “any bonus or other incentive-based or equity-based compensation” that depended upon financial statements later restated due to “material noncompliance” arising from “misconduct.”

The Sarbanes-Oxley Act also addressed the lack of board oversight with respect to loans to top officials. The absence of standards under state law meant that boards could award loans to executive officers on commercially unreasonable terms (uncollateralized and below market rates) and could forego repayment. Rather than elevate the standards applicable to the approval of loans, Congress opted for a more blunt approach. Congress added Section 13(k) of the Securities Exchange Act of 1934 (“Exchange Act”) to simply bar personal loans to executive officers and directors of public companies.

Sarbanes-Oxley, therefore, addressed some compensation issues but in a limited fashion. The obligation to “clawback” incentive based compensation following restatements fell to the Securities and Exchange Commission (SEC) rather than boards of directors. With little incentive to intervene in the internal compensation process of public companies, the SEC rarely applied the provision and mostly used it as an ancillary charge in conjunction with other securities law violations. As a result, the broad underlying problem arising from an absence of meaningful oversight by the board of directors remained in place.

The problems associated with compensation resurfaced in the financial crisis. Compensation formulas at financial institutions often encouraged excessive risk taking through the maximization of short-term earnings. In the bailout that followed, Congress imposed restrictions on compensation practices as a condition of receiving TARP funds. For those receiving “exceptional assistance,” including Citigroup and Bank of America, the Department of Treasury to some degree acted as a second board of directors, reviewing and altering compensation decisions.

Permanent reforms, however, had to await the adoption of the Dodd-Frank Act in 2010. The legislation toughened the procedures used by boards in approving compensation, provided an expanded role for shareholders in the compensation process, and, perhaps most importantly, gave regulators the authority to prohibit compensation practices that resulted in excessive risk taking at large financial institutions.

Section 952 of the Dodd-Frank Act mandated that listed companies employ compensation committees consisting entirely of independent directors. The committee was given the authority to determine its own funding and to hire independent compensation consultants. Most importantly, the SEC received, for the first time, the explicit
authority to set out standards defining director independence in connection with the compensation committee.\textsuperscript{24}

The duty to recover improperly paid compensation was enhanced. Listed companies were required to adopt an explicit policy mandating clawbacks following certain restatements. Specifically, the policy had to provide for the clawback of incentive based compensation from current and former “executive officers” after any “accounting restatement” arising from a “material non-compliance” with “any financial reporting requirement under the securities laws” during the prior three years.\textsuperscript{25}

Congress also authorized a direct role for shareholders in the compensation process through the introduction of “say on pay.” Section 951 of the Dodd-Frank Act gave shareholders an advisory vote on the compensation paid to top executives.\textsuperscript{26} The authority was augmented by increased transparency, particularly the obligation by companies to disclose the ratio of the median of the total compensation of all employees to the annual total compensation of the CEO.\textsuperscript{27}

The most substantive changes, however, occurred in connection with the adoption of Section 956. The provision gave financial regulators authority over “incentive-based compensation arrangements” at “covered financial institutions,” a term that included broker-dealers.\textsuperscript{28} Regulators were instructed to prescribe regulations that prohibited any compensation practice that encouraged “inappropriate risks.”\textsuperscript{29}

**The Path Forward**

The Dodd-Frank Act took a number of important steps. Nonetheless, many of the underlying dynamics that induced congressional intervention into the compensation process remained in place. State law retained the inherent ability to address many of these concerns through the imposition of a stricter standard of review and more meaningful process.

This, however, is not likely to occur. Indeed, since the adoption of the Dodd-Frank Act, the lack of adequate regulation under state law has grown increasingly apparent. Efforts to challenge the compensation scheme of a financial institution that based payments on the percentage of net revenues failed.\textsuperscript{30} Concerns over a $40 million severance package to a CEO was summarily dismissed in part because the “amount alone” was insufficient to sustain a legal challenge.\textsuperscript{31}

Reform of compensation practices will, therefore, require increased federal intervention. In some cases, regulators already have the authority to alter compensation process but have yet to act. Financial regulators have proposed mandatory vesting periods for incentive compensation at some large financial institutions, but they have not yet completed the rulemaking process. By late 2013, the SEC had not proposed rules
implementing the clawback provisions included in the Dodd-Frank Act. In other cases, however, additional reform will require additional action from Congress.

**Strong Corporate Governance**

Section 956 of the Dodd-Frank Act gave regulators broad authority to prohibit incentive compensation practices that encouraged “inappropriate” risk taking. In the rules proposed to address this provision, the financial regulators recognized that “[s]trong and effective corporate governance is critical to the establishment and maintenance of sound compensation practices.” The proposal, however, contained only cosmetic recommendations with respect to the role of boards.

Regulators should be required to develop standards designed to ensure a more meaningful role for boards in the compensation process. This should entail consideration of a requirement that boards retain the burden of establishing the fairness of the compensation formula. Doing so would impose on boards the obligation to show a relationship between the type and amount of compensation and the performance of executive management. The standard would also require an affirmative demonstration by directors that the compensation scheme did not encourage excessive risk taking.

**The Problem of “Excessive Compensation”**

Section 956 of the Dodd-Frank Act authorized financial regulators to adopt rules prohibiting compensation practices that could “lead to material financial loss.” The proposed rules address this in part through substantive regulation. Certain financial institutions would be required to defer a significant portion of incentive based compensation paid to executive officers.

The provision, however, also instructed bank regulators to prohibit practices that could result in the payment of “excessive compensation.” The proposed rule contains no substantive requirements implementing this provision. Instead, the proposal merely provides that compensation should not be “unreasonable or disproportionate to the service performed” and includes a list of factors to be considered in making the determination.

Regulators should consider the need for substantive guidance on the meaning of “excessive.” Moreover, while providing factors for consideration, the proposal says nothing about the standard of review for directors in making the determination. Nor does the proposal impose any obligation on boards to seek repayment of amounts ultimately deemed excessive.

**Improving the Process Used by Boards**

The Dodd-Frank Act sent a mixed message on the process used by boards in making compensation decisions. The addition of Section 10C of the Exchange Act imposed
additional requirements on compensation committees used by exchange traded companies. At the same time, however, bank regulators interpreted Section 956 of the Dodd-Frank Act to require no meaningful changes to the system of governance in connection with compensation decisions by large financial institutions.

In particular, the existing system of oversight does not adequately ensure that directors involved in compensation decisions are truly independent. Regulators have the authority to address this issue. The SEC could develop a more complete set of factors for boards to consider when assessing independence. Financial regulators could, as part of their supervision of risk, provide guidance on the types of relationships that will disqualify directors from participating in compensation decisions.

A potentially more effective reform, however, would be the implementation of shareholder access. Access allows long-term shareholders to include their board nominees in the company’s proxy statement. Although the number of contests would likely be modest, the mere possibility would provide boards with additional incentive to act in the best interests of shareholders.

Congress encouraged the adoption of shareholder access in the Dodd-Frank Act. The legislation clarified that the SEC had the authority to impose the requirement. The SEC adopted a rule that sought to permit long-term shareholders to include a short slate of nominees in the company’s proxy statement. The U.S. Court of Appeals for the District of Columbia Circuit, however, struck down the provision. The SEC, therefore, can and should revisit the issue.

Enforcement and the Role of Shareholders

For the most part, the Dodd-Frank Act left enforcement to regulators. Regulators, however, have limited resources. Likewise, they have minimal incentive to intervene into the corporate governance of public companies. Finally, as matters such as the London Whale scandal illustrate, regulators may be unaware of violations. One solution would be to provide an increased role in the governance process for shareholders.

The Dodd-Frank Act recognized the importance of shareholder involvement in the compensation process through the institution of “say on pay.” It only provided an advisory vote, however, that could be disregarded by management. Second generation “say on pay” statutes have emerged in other countries. They have been designed to make the role of shareholders more meaningful. In Britain, shareholders are expected to receive the right to a binding vote on compensation policies. In Australia, sufficient opposition to pay packages can trigger a recall vote for the board of directors.

Shareholders could also be given increased authority to enforce existing provisions. Currently, only financial regulators can police the requirements of Section 956. Likewise, the enforcement of the clawback provisions in Section 304 of the Sarbanes-
Oxley Act is limited to the SEC. Allowing shareholders to seek enforcement of the requirements would likely ensure greater compliance.

Conclusion

Executive compensation is not adequately bounded by legal standards under state law. Efforts to address these concerns by Congress have been useful but remain incomplete. The system as it currently exists does not ensure that compensation will be based upon actual performance or that the approach will not encourage excessive risk taking. Only with additional reforms can these issues be addressed.

Endnotes


9. See J. Robert Brown, Jr., Returning Fairness to Executive Compensation, 84 N.D. Law Rev. 1141, 1149-1154 (2009). See also Randall S. Thomas & Harwell Wells, Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers’ Fiduciary Duties, 95 Minn. L. Rev. 846, 848 (2011) (noting that courts have historically regulated compensation through the “confines of the waste” but that doctrine “is much too weak to lead to meaningful scrutiny in most cases.”).


11. The court viewed the presence of a majority of independent directors as eliminating the taint of the conflict of interest. The approach, however, did not require that actual removal of the interested influence. Thus, the compensation decision was entitled to review under the business judgment rule even when the CEO participated in the debate or even voted on the matter. See Brown, supra note 10, at 1150.


13. See In re Goldman Sachs Group, Inc. Shareholder Litigation, 2011 WL 4826104 (Del.Ch. Oct. 12, 2011) (director independent despite allegations that company “invested at least $670 million in funds managed by” the director; court found the allegations inadequate because “the complaint does not allege that [the director] relies on the management of these funds for his livelihood”); see also In re Goldman Sachs Group, Inc. Shareholder Litigation,
34. Section 956 did indicate that the standards adopted under the provision should be "comparable" to those contained
32. The actions taken by the SEC on the governance provisions of Dodd-Frank are here: http://www.sec.gov/spotlight/
30. See In re Goldman Sachs Group, Inc. Shareholder Litigation, 2011 WL 4826104 (Del.Ch. Oct. 12, 2011) (director independent despite allegations that he was the CEO and chairman of a company where Goldman arranged financing in the "billions of Euros" and provided loans "in the aggregate amount of 464 million euros"; the court reasoned that "Goldman is an investment bank and the "fact [t] hat it provided financing to large ... companies should come as no shock to anyone. Yet this is all that the plaintiffs allege.").
14. In re Citigroup, Inc. Shareholder Derivative Litigation, 964 A.2d 106, 124 (Del. Ch. 2009) ("When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plain
15. See Section 304 of Sarbanes-Oxley (codified as 15 USC §7243). The requirement of reimbursement applies even where the CEO and CFO have not been alleged to have participated in the misconduct. See SEC v. Baker, 2012 WL 5499497 (W.D.Tex. Nov. 13, 2012) ("A CEO need not be personally aware of financial misconduct to have received additional compensation during the period of that misconduct, and to have unfairly benefitted therefrom.").
17. Section 402 of Sarbanes-Oxley (adding Section 13(k) to the Exchange Act, 15 USC §78m(k)).
18. The provision effectively transformed the SEC into a collection agency on behalf of the company. Any payments obtained under the Section were simply returned to the company. See In re Navistar International Corp., Exchange Act Release No. 62653 (admin proc Aug. 5, 2010) ("If the CEO and CFO do not voluntarily reimburse the issuer, the Commission can bring an enforcement action to compel reimbursement.").
19. SEC v. Baker, 2012 WL 5499497 (W.D.Tex. Nov. 13, 2012) ("For reasons best known to the SEC, the Commission has been historically reluctant to utilize § 304 in the ten years since Sarbanes—Oxley was enacted."). The SEC settled the first case using § 304 in 2008, see SEC v. UnitedHealth Group, Inc., Litigation Release No. 20836 (D. Minn. Dec. 22, 2008) (noting that pending settlement was "the first with an individual" to clawback compensation under Section 304), and brought the first "stand alone" case under the section in 2009. See SEC v. Jenkins, Litigation Release No. 21149 (D Ariz. July 23, 2009) (describing case at "the first action seeking reimbursement under Section 304 from an individual who is not alleged to have otherwise violated the securities laws.").
20. SEC v. Baker, 2012 WL 5499497 (W.D.Tex. Nov. 13, 2012) (noting that most SEC claims under Section 304 were generally "ancillary" and stood "alongside more traditional securities causes of action").
24. The SEC was authorized to define the "factors" used in determining director independence. See Section 10C, 15.
26. Section 951 of Dodd-Frank (adding Section 14A to the Exchange Act, 15 USC §78n-1). The SEC implemented the requirement in 2011. See Rule 14a-21, 17 CFR § 240.14a-21. Say on pay, by regulating the voting rights of shareholders, represented the most obvious and significant intrusion into what had traditionally been an exclusive purview of state regulation.
27. See Section 953(b) of Dodd-Frank. The SEC has proposed a rule designed to implement this requirement. See Exchange Act Release No. 70443 (Sept. 18, 2013).
28. Section 956 of Dodd-Frank. The restrictions did not apply to covered financial institutions with assets of less than $1 billion. Section 956(f).
29. Section 956(b) of Dodd-Frank.
30. See In re Goldman Sachs Group, Inc. Shareholder Litigation, 2011 WL 4826104 (Del.Ch. Oct. 12, 2011) ("The decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment.").
31. See Zucker v. Andreessen, 2012 WL 2366448 (Del.Ch., June 21, 2012) ("Be that as it may, the size of executive compensation for a large public company in the current environment often involves large numbers; and amount alone is not the most salient aspect of director compensation" for purposes of a waste analysis.").
32. The actions taken by the SEC on the governance provisions of Dodd-Frank are here: http://www.sec.gov/spotlight/
34. Section 956 did indicate that the standards adopted under the provision should be "comparable" to those contained in the Federal Deposit Insurance Act. See 12 U.S.C. 2 1831p–1. Subjecting the board to an increased standard of review would seem consistent with this obligation.
9 USC §78j-3. The rules ultimately adopted by the SEC did not adequately ensure the independence of the committee. Rule 10c-1 left some control over the funding of the committee with the board. 17 CFR §240.10c-1. The Rule provided only that the compensation committee receive adequate funding “for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser retained by the compensation committee.” 17 CFR § 240.10c-1(b)(3). This can be compared with the listing standards for audit committees. In addition to the authority to determine reasonable fees for consultants, the audit committee has the right to fix a budget that also includes “ordinary administrative expenses” that are “necessary or appropriate in carrying out its duties”. 17 CFR § 240.10a-3(b)(5). As a result, the full board retains significant financial control over the budget of the compensation committee.

36. See Rule 10c-1, 17 CFR §240.10c-1.

37. In adopting Rule 14a-11, the SEC estimated that there would be approximately 45 contests under the Rule. See Exchange Act Release 62764, at n. 806 (Aug. 25, 2010). This is in a population, according to one estimate, of 15,000 public companies. See Exchange Act Release No. 53385 (Feb. 28, 2006).

38. Section 971 of Dodd-Frank (adding subsection (2) to Section 14(a) of the Exchange Act, 15 USC 78n).


J. Robert Brown, Jr.

J. Robert Brown, Jr., is a Professor of Law and Director of the Corporate Commercial Law Program at the University of Denver Sturm College of Law where he has taught corporate and securities law for more than two decades. He has authored numerous publications in the area, including recent pieces on the DC Circuit’s decision on shareholder access and on the requirement in Dodd-Frank that companies disclose compensation ratios. A number of his articles have been cited by the US Supreme Court, including one in Basic v. Levinson, the leading securities case on the issue of materiality. He has also written amicus briefs on behalf of law professors that were filed in Matrixx v. Siracusano and Merck v. Reynolds, two recent securities cases heard by the US Supreme Court. Professor Brown has advised foreign governments on corporate and securities law reform, most recently in the West Bank. He is an arbitrator for FINRA, the Secretary to the SEC’s Investor Advisory Committee, and sponsors the corporate governance blog, The Race to the Bottom (www.theracetothebottom.org). Among his outside activities, Professor Brown is the chairman of the board of directors of the Colorado Coalition for the Homeless.