Articles

Sustainable Corporations in Non-Financial Sectors Through Optimal Design of Executive Pay

By David Hansen[*]

A. Introduction

It is commonplace in current legal scholarship that pay packages for executives that were not tied to the impact of these executives' policies on shareholder wealth maximization often caused harm to shareholder interests and their companies, especially in the long term. The no-pay-without-performance postulate is as old as the first global economic crisis of the 20th century – the deep depression.[1] Since then, this postulate has been repeated and substantiated innumerous times by the majority of experts in corporate law and business economics, but without real success.[2] There are, however, commentators who deny the existence of a link between skewed incentive pay, excessive risk-taking, and financial losses. They instead insist on the superiority of the traditional director-centric model of corporate governance,[3] which would allegedly preserve the balance that has generally worked well between the limited role and limited liability of shareholders and the active role, fiduciary duties, and potential liability of managers, which allegedly renders additional executive pay regulation unnecessary.[4]

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[1] *See* Harwell Wells, *No Man Can Be Worth $1,000,000 a Year: The Fight Over Executive Compensation in 1930s America,* 44 U. RICH. L. REV. 689 (2010).

[2] *See* Karl Okamoto & Douglas Edwards, *Risk Taking*, 32 CARDOZO L. REV. 159 (2010); Kristin Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J. L. REFORM 55 (2011-2012); Lucian Bebchuk & Holger Spamann, *Regulating Bankers'Pay*, 98 GEO. L.J. 247 (2010); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, (Emory Public Law, Research Paper 10-93, 2010), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract-id=1546229 (last accessed: 27 June 2013).

[3] *See e.g.*, Andrew Schwartz, *The Perpetual Corporation*, 80 GEORGE WASH. L. REV. 764, 770 (2011-2012).

[4] *See* Andrew Lund & Gregg Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 686, 715, 727 (2011-2012), arguing that, given the recent progress of corporate governance reforms, structures, monitoring and control mechanisms, the overemphasizing on incentive pay contracts is likely to be counterproductive and exceedingly costly because of its complementarity with the newly

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It was only after the 2008 financial crisis that lawmakers and regulators were ultimately convinced that they should act on the basis of the theory that flaws in compensation schemes created incentives for executives and other financial industry employees to take on excessive risk, which in the aggregate led to the creation of systemic risk that posed an immeasurable threat to the US and world economies.[5] The 2008 crisis is ongoing and its negative effects on the world economy are persistent and grave. In this uncertain environment, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in July 2010, which addressed numerous problems including executive compensation in and outside the financial industry.[6] In the EU, the European Commission made recommendations, and many EU countries passed legislation, that contained provisions concerning executives' pay packages similar to the Dodd-Frank Act. However, the rules in the Dodd-Frank Act pertaining to managerial pay in the financial industry entail much more regulatory intervention than the relevant provisions for all other business sectors.

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reformed corporate governance mechanisms. This view certainly underestimates the potential of powerful agents such as company executives to exert influence on other company officials/agents and to neutralize the general checks and balances that have been put in place; Ira Kay, *CEO Pay for Performance: The Solution to Managerial Power Symposium on Bebchuk & Fried's Pay without Performance*, 30 J. CORP. L. 785 (2004-2005); John Olson, *Professor Bebchuk's Brave New World: A Reply to the Myth of the Shareholder Franchise Essay,* 93 VA. L. REV. 773, 783 (2007), stating that Professor Bebchuk's "concerns about [issues such as] executive compensation excesses can best be addressed by greatly enhanced disclosure requirements within the present director nominations and proxy regime, rather than by fundamentally altering the balance between directors and shareholders"; Norman Veasey, *Stockholder Franchise is Not a Myth: A Response to Professor Bebchuk, the Essay*, 93 VA. L. REV. 811, 811-12 (2007), arguing that "[w]hat is not needed at this juncture is a lurching change in the name of 'reform' that might upset the existing balance of law and culture"; Martin Lipton, *Memorandum of Martin Upton from Wachtell, Lipton, Rosen & Katz to clients*, DIRECTORS FACE-TO-FACE MEETINGS WITH INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE POLICIES AND PRACTICES (June 28, 2007), available at: http://www.realcorporatelawyer.com/pdfs/wlrk062907.pdf (last accessed: 27 June 2013), stating that "[t]here is no justification for revolutionizing corporate law and corporate practices so that shareholders replace directors as the fundamental arbiters of corporate policy"; Martin Lipton & William Savitt, *Many Myths of Lucian Bebchuk, the Essay*, 93 VA. L. REV. 733 (2007).

[5] *See* Lynne Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance,* 37 J. CORP. L. 265, 267-68 (2011-2012)*;* Ben Bernanke, Speech at the Independent Community Bankers of America's National Convention and Techworld, (20 March 2009), available at: http://www.federalreserve.gov/newsevents/speech/bernanke2009O320a.htm (last accessed: 27 June 2013),; Press Release, U.S. Dep't of the Treasury, Statement by Treasury Secretary Tim Geithner on Compensation (10 June 2009), available at: http://www.ustreas.gov/press/releases/tg163.htm (last accessed: 27 June 2013).

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, PUB. L. NO. 111- 203, 123 Stat. 1376 (21 July 2010).

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This article is divided into three parts. In part B, I will show that the provisions of the Dodd-Frank Act concerning corporate governance do not suffice to effectively address the problem of excessive executive pay and the subsequent skewed incentives, which encourage excessive risk-taking and short-term managerial thinking.[7] Although I will initially examine and show that the provisions for executive pay packages in the financial industry have not yet been adequately implemented to achieve the legislative goal of preventing excessive risk-taking and systemic risks[8] that can induce economic crises in the future,[9] the main focus of the article will be on executive pay in other business sectors.

In part C, I will show that there is need for corporate governance regulation of the same quality both in the financial and other business sectors since great recessions can equally originate in failures of non-financial businesses. Moreover, by pursuing regulatory intervention in the compensation policies of all types of publicly held corporations, two major drawbacks can simultaneously be remedied: the prevention of systemic crises and the pay without performance fallacy. It will be shown that, because of the Act's incapability of reaching its declared goals for all sectors of the economy, it has to be explored whether part or all of the financial sector remedies should be adopted for other business sectors as well and if, why, and to what extent there should be a differentiated regulatory intervention in these sectors in contrast to the financial sector.[10]
In part D of this article, I will show that contrary to Dodd-Frank's authorization of financial regulatory Agencies to approve of, amend, and even reject individual incentive plans of financial institutions, a less interventionist but equally effective way of incentive pay regulation is feasible for all other business sectors. Dodd-Frank does not authorize the SEC to directly intervene and examine incentive plans on a case by case basis. Dodd-Frank provides the foundation for the establishment of extensive disclosure duties. I will therefore suggest that the SEC should start by issuing guidelines to establish minimum requirements for the design of incentive pay programs. This form of regulation also includes the obligation of firms to disclose in all detail whether they adhered to these

[7] MICHAEL PORTER, CAPITAL CHOICES: CHANGING THE WAY AMERICA INVESTS IN INDUSTRY, 42-49 (1992); Brian Bushee, *Do Institutional Investors Prefer Near-Term Earnings Over Long-Run Values?*, 18 CONTEMP. ACCT. RES. 207, 213/14 (2001), revealing in their studies that managerial short-termism is induced by transient institutional investors who seek almost exclusively short-term rents.

[8] *See* Steven Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193 (2008-2009) (for a comprehensive analysis of the term "system risk"); WILLIAM CARNEY, CORPORATE FINANCE: PRINCIPLES AND PRACTICE 119 (2010), viewing market systematic risk and institutional systematic risk as factors jointly causing financial crises.

[9] *Cf.* Kristin Johnson, *supra* note 2, at 55.

[10] *Cf.* Christine Hurt, *Regulating Compensation,* 6 OHIO ST. ENTREPREN. BUS. L. J. 21, 60 (2011).

guidelines or why they have chosen a different path to reduce skewed managerial incentives that encourage excessive risk-taking. The criteria and the appropriate design for these guidelines and minimum requirements are fully specified in this last part of my article.

B. Provisions for compensation schemes applying to all business sectors

The Dodd-Frank Act has not interfered with the freedom of the governing bodies of a publicly held company to design, develop, and implement a compensation scheme for its managers and other employees in a leading position, nor has it interfered with the managers' and the company's liberty to contract.

In Section 954, the Dodd-Frank Act provides for the right of a company to apply a clawback policy to recoup a portion of executive bonuses, which were paid on the basis of false or fraudulent accounting statements that were subsequently restated. Certainly this is not a restriction of the liberty to contract but rather an expression of the right to restitution. For the analysis to follow, it has to be emphasized that the Dodd-Frank Act does not provide remedies for excessive compensation in spite of long-run company underperformance.[11] It is up to the companies' governing bodies, that is, the board of directors and its compensation committee, to design and implement managerial compensation schemes (Section 952 Dodd-Frank Act). By establishing a company's duty to install an independent compensation committee the Dodd-Frank Act introduced organizational provisions into company law with a view to helping companies to make better-informed and grounded decisions about pay package design during negotiations with perspective managers.[12]

Shareholders have a say on managerial compensation but this is restricted to a non-binding vote (Section 951 Dodd-Frank Act), by which they can disapprove of misguided incentive schemes in the future. This allegedly gives shareholders a powerful opportunity to hold executives accountable, and a chance to reject their practices when they diagnose specific kinds of misguided incentive schemes that threatened individual companies and in turn the broader economy in the past.[13]

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[11] *Cf.* Steve Bradford & David Skeel on the Dodd-Frank Act, BUSINESS LAW PROF BLOG (25 Jan. 2011), http://lawprofessors.typepad.com/businesslaw/2011/01/davidskeel-on-the-dodd-frank-act.html (last accessed: 27 June 2013), describing corporate governance provisions of Dodd-Frank as "a very minor part of the Act".

[12] *Cf.* CCH ATTORNEY-EDITOR STAFF, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: LAW, EXPLANATION AND ANALYSIS 420-21, 423 (2010).

[13] *See e.g.* Jill Barclift, *Governance in the Public Corporation of the Future: The Battle for Control of Corporate Governance*, 15 CHAP. L. REV. 1, 8-9 (2011-2012).

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The policies of the Dodd-Frank Act can be thus summarized as:

(1) Enhanced compensation disclosure obligations, which is the Federal Government's traditional and favorite policy, since it is an indirect and less interventionist way to compel boards to implement changes to their governance processes,

(2) The installation of independent compensation committees, and

(3) The possibility of shareholders to react and disapprove of managerial compensation schemes *ex nunc*.

The European Corporate Governance Forum recommended in 2009 that disclosure of remuneration policy and individual remuneration should be made mandatory for all listed companies and highlighted that a binding or advisory shareholder vote on remuneration policy as well as greater independence for non-executive directors involved in the design of remuneration packages would be beneficial from a corporate governance perspective.[14] The Dodd-Frank Act and the respective initiatives in the EU did not create a legal basis for regulatory intervention on a case-to-case basis to ensure that executive pay packages provide appropriate incentives, which foster performance and long-term value creation by listed companies,[15] and to suggest improvements, require changes of, or even enjoin certain compensation policies.

C. Divergent Regulation of Managerial Compensation in the Financial Sector

One of the main differences underpinning the classification of financial companies as high risk-profile institutions is related to the fact that financial firms ultimately do not bear the risk of poor decisions.[16] In that way moral hazard[17] is avoided not only by its executives but

[14] European Corporate Governance Forum, *Statement of the European Corporate Governance Forum on Director Remuneration* (2009), available at: http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-remuneration_en.pdf (last accessed: 27 June 2013).

[15] Natalie Mizik, *The Theory and Practice of Myopic Management*, 47 J. MARKETING RES. 594 (2010), stating that according to the results of her empirical studies, the stock premium earned by shareholders at the time of short-time fixed firm and/or high risk behaviour of executives and their firms is outweighed by their underperformance in the following four years.

[16] *See* RONALD GILSON & BERNARD BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 244 (1986), noting that stockholders have capped downside but unlimited upside, which makes them more risk-seeking than

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also by the institution itself. Due to their systemic importance financial firms enjoy government and ultimately taxpayer assistance when poor decisions in the aggregate threaten the firm and the economy.[18] Therefore, the firm does not have a strong incentive to align its executives' incentives to create less overall risk. This allegedly justifies more intensive regulation of managerial compensation in the financial sector.[19]

Contrary to the rudimentary intervention in managerial compensation schemes in other business sectors,[20] the Dodd-Frank Act submits management pay packages in the financial sector to specific and detailed regulation. It requires Federal financial regulators to issue and enforce joint compensation rules specifically applicable to financial institutions. On March 29, 2011 the SEC, the FDIC, the Treasury Department, and other agencies (henceforth, collectively, "Agencies") issued a joint proposed rule under Sec. 956 of the Dodd-Frank Act (henceforth, the "Joint Proposed Rule").[21] This requires a financial institution to annually disclose to its corresponding Agency detailed descriptions of its

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debtholders. *See* Frederick Tung, *New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L. J. 809, 824 (2007-2008), describing efforts to extend fiduciary duties to bond creditors "in the zone of insolvency" to reduce the impact of option theory. *See* Frederick Tung, *Bonding Bankers: Notes Toward a Governance Approach to Risk Regulation*, 4 ENTER. BUS. L. J. 465 (2009).

[17] *See* ROBERT MNOOKIN *ET AL.*, BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES 13 (2000);

See STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 196 (2007), "If insured possess complete coverage, the problem will be most serious, for they will then have no reason to avoid losses …"

[18] *See* STANDARD & POOR'S, GLOBAL CREDIT PORTAL: BANKS 48 (2011), stating that it has been empirically proven that a government, which is faced with a financial crisis, will often but not always, provide additional support to protect confidence in its economy, based on the assumption that the cost of this additional support will most probably be less damaging to the overall economy than allowing the whole banking system to fail.

[19]The Interim Final Rule on TARP Standards for Compensation and Corporate Governance served as a model for the Dodd-Frank Act because it represents a general application of the principle underlying the Interim Final Rule on TARP Standards for Compensation and Corporate Governance that all financial firms should avoid excessive risks by i.a. tying pay to long-term performance,

[20] *See* Randall Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties,* 95 MINN. L. REV. 846 (2010-2011); Steve Bradford & David Skeel, *supra* note 11.

[21]Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21170 (proposed Apr. 14, 2011) (to be codified at 12 CFR Part 42).

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compensation plans, without disclosing individual salaries, and explain why the firm does not believe that these plans lead to excessive compensation and subsequent excessive risk-taking.[22]

For the reasons explained below, the establishment of the factors that decrease the likelihood that an incentive plan could lead to material financial loss in the Joint Proposed Rule is more important than the specification of the method, which has to be applied to establish an incentive plans' excessiveness. These factors are:

(1) The right balance of risk and financial rewards, for example

   a. by using deferral of payments,

   b. risk adjustment of awards,

   c. reduced sensitivity to short-term performance, or

   d. longer performance periods;

(2) Its compatibility with effective controls and risk management;

(3) The existence of strong corporate governance, including active and effective oversight by the covered financial institution's board of directors or a committee thereof."[23]

[22]Under the regulations, a plan may lead to excessive compensation depending on the following factors: An incentive-based compensation arrangement provides excessive compensation when amounts paid are unreasonable or disproportionate to the services performed by a covered person, taking into consideration: (i) The combined value of all cash and non-cash benefits provided to the covered person; (ii) The compensation history of the covered person and other individuals with comparable expertise at the covered financial institution; (iii) The financial condition of the covered financial institution; (iv) Comparable compensation practices at comparable covered financial institutions, based upon such factors as asset size, geographic location, and the complexity of the covered financial institution's operations and assets; (v) For postemployment benefits, the projected total cost and benefit to the covered financial institution; (vi) Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and (vii) Any other factors the Commission determines to be relevant. Interestingly, during the financial crisis, one of the most striking revelations was that financial institutions were doing the same things, but very badly, and in the same way. So, to be able to justify a compensation plan on the basis that other similar institutions have similar plans seems to hardly be a way to reduce systemic risk or to police risky compensation schemes.

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Under Section 956(b), the Act does not only direct appropriate regulators to promulgate new rules for covered financial institutions to disclose their incentive-based compensation arrangements; it also vests these regulators with the power to determine whether compensation plans are "excessive" and whether they "could lead to material financial loss" in each and every case. The regulators have so far refrained from using their power to intervene in concrete cases, where compensation plans have been proven to be excessive and likely to cause financial loss, and to order the redesign or even prohibition of defective incentive plans,[24] though this is necessary to align bank executives' incentives with the goals of prudential financial sector regulation.[25] Some commentators deem this an impossible task for the regulators to perform, because it seems to presuppose a clear definition of the terms "inappropriate risks" and "excessive" compensation.[26]

In their view, even shareholders or their delegated managers are not in the best position to determine whether their CEO's performance merits her pay, and what kind of risks are inappropriate for the firm to take, even if that firm is systemically important. As a result, if neither the management nor the shareholders can accurately identify which risks are appropriate and which are not, then one cannot presume that the Agencies have additional or even superior expertise with which to make such a decision. Finally, assuming that regulators know which types of risk are inappropriate and can codify them, regulators will have to execute the even more difficult task of pruning away the types of incentive plans that encourage inappropriate risks.

In reality, it is not necessary for the Agencies to codify all kinds of inappropriate risks. On the one hand, there are generally acceptable rules for risk management and capital requirements as well as a list of transactions that have been proven to be extremely

[23] *See* Press Release, Sec. & Exch. Comm'n, *Agencies Seek Comment on Proposed Rule on Incentive Compensation* (30 Mar. 2011), available at: http://www.sec.gov/news/press/2011/2011-77.htm (last accessed: 27 June 2013).

[24] *See* Lynne Dallas, supra note 5, at 361, stating that Dodd-Frank Act "[g]ives regulators jointly the authority to prohibit any type or feature of an incentive compensation arrangement at a regulated financial institution that encourages inappropriate risk taking"; *Cf.* Dodd-Frank Act § 120, which empowers the Financial Stability Oversight Council to recommend to primary regulatory agencies of financial institutions to prescribe an institution's conduct of the activity or practice which could pose significant liquidity, credit or other risks, in specific ways, or to prohibit the activity or practice altogether.

[25] *Cf.* Lucian Bebchuk & Holger Spamann, *supra* note 2, at 281, 287.

[26] *Cf.* Kristin Johnson, *supra* note 2, at 55, 95; *Cf.* Guido Ferrarini & Maria Christina Ungureanu, *Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks*, 64 VAND. L. REV. 429, 451-52 (2011).

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risky.[27] These issues are subject to wide-ranging federal regulation.[28] This regulation prevents financial institutions from making certain investments or loans that are deemed too risky, given the institutions' capital and portfolio, and requires them to maintain certain amounts of capital. Agencies monitor financial institutions' activities and capital reserves to enforce these criteria. Many commentators rightfully assert that even in the frame of this part of financial regulation, determining the riskiness of a financial institution's asset pool and the corresponding appropriate level of capital requires not only an extremely sophisticated understanding of risk modeling, but also intimate knowledge of the financial institution's portfolio of contracts, securities, and other assets. Often regulators cannot process the information they receive in an appropriate and efficient manner due to significant organizational constraints, such as the scarcity of human capital and budgets.[29] In general, however, Agencies and commentators have explored and become aware of the imperfections of the information exchange between financial institutions and their regulators, which cause regulatory distortions.[30] They can probably address these problems by adopting more restrictive regulatory policies based on conservative estimates about the real impact of regulation on market behavior. It thus seems that the taking of inappropriate risks, which can be the result of excessive pay, is an activity covered by the Agencies' general supervision of risk management structures and precautions.

It is imperative to place limits on compensation structures that incentivize risk-taking and not to define all risks that are inappropriate and are associated with a certain managerial compensation scheme, because this would be a double and unnecessary effort of prudential regulation on the part of the Agencies. More importantly, the goal of preventing inappropriate risks that can lead to considerable financial losses can be indirectly achieved through fine-tuned incentive pay regulation.[31] It suffices to link the payment of

[27] *Id.* at 66-9.

[28] Because of the increased use of derivatives in the 1990s, the SEC introduced regulations requiring firms to include disclosure of quantitative risk models in their financial statements; *See* 17 C.F.R *§* 210.4-08(n) (2009); *See* Emergency Economic Stabilization Act of 2008, PUB. L. NO. 110-343, *§* 101 (a) (1), 122 Stat. 3765; *See* American Recovery and Reinvestment Act of 2009, PUB. L. NO. 111-5, *§* 7001 (a) (2) (codified at 12 U.S.C. *§* 5221(a) (3) (2011).

[29] *See e.g.*, Henry Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1463 (1993); James Barth *et al.*, *Reassessing the Rationale and Practice of Bank Regulation and Supervision after Basel II*, *in* 5 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 225, 227 (2008).

[30] *See e.g.*, Lucian Bebchuk & Holger Spamann, *supra* note 2, at 281.

[31] *Id*.

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compensation with the achievement of specific long-term company goals under the strict supervision of the board to ensure that managers make more prudent, long-term decisions. This regulatory task would not be more demanding in terms of information than regulators' direct intervention in investment, lending, and capital decisions.[32]

It is highly problematic to define what amounts of compensation are excessive, because in that case regulators might usurp the shareholder's power to choose what level of risk-seeking is preferable for their firm. The shareholders enjoy insofar great discretion in the selection of the desirable level of risk-taking for their company, which induces them to offer lower or higher levels of compensation. Companies should always be free to negotiate the height and total sums of compensation with candidate managers.[33] In that respect, the Joint Proposed Rule can be helpful only in assessing the risks stemming from certain structures and designs of managerial compensation. These criteria are, however, not exclusive and it strikes one that they do not link the level of compensation with the past, actual and future performance of a manager.

Concluding, it must be stressed that the value of the Joint Proposed Rule is restricted to the establishment of the factors that decrease the likelihood that an incentive plan could lead to material financial loss. The importance of these factors will be analyzed in the third section of this article concerning the optimal design of compensation schemes in order to reduce skewed-incentives, pay without performance and ultimately company, sector or economy-wide crises.[34] As will be shown below, the key issue of the optimal design of compensation schemes lies in the fact that managers must hold a large fraction of their equity after it vests and Agencies must focus on the optimal design of limitations on unwinding. The Act fully authorizes the Agencies to develop such a regulatory framework, which will certainly be more flexible and provide financial institutions certain discretionary powers to allow the application of more than one appropriate compensation schemes. On the basis of this Act, Agencies can order the amendment or even prohibit certain incentive plans. Of course, this applies only to the financial sector. In other sectors, the Agencies are allowed to only indirectly compel the governing bodies of a company to improve or even abolish flawed incentive plans.

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[32] *Id.* at 286.

[33] Some may argue that pay regulation will drive talent away and that financial firms will lose valuable employees. This will be prevented, however, because regulation of pay in financial firms can focus on pay structures and won't limit compensation levels: *See* Lucian Bebchuk & Holger Spamann, *supra* note 2, at 287; *See Compensation Structure & Systemic Risk: Hearing Before the H. Comm. on Fin. Servs.,* 111 th Cong. 6 (2009): Professor Bebchuk testified that at least for non-financial firms, "[t]he government should not seek to limit the substantive arrangements from which private decision makers may choose.".

[34] *Cf.* JACK BUFFINGTON, THE DEATH OF MANAGEMENT: RESTORING VALUE TO THE U.S. ECONOMY 115-45 (2009).

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D. Regulation of managerial compensation in other business sectors

It has been argued that the proponents of managerial compensation regulation generally hold that there exists a causal link between excessive compensation and excessive risk-taking, which led to the systemic crisis in the financial sector.[35] However, the reason for interfering with executive payment in other business sectors was also associated with the need to prevent excessive risk-taking, which encourages short-sighted profit-maximizing strategies.[36] Indeed, business failures in other sectors – quality issues in the automotive industry, environmental issues in the Gulf of Mexico disaster, the Enron and Worldcom scandals, where boards had allegedly not fully understood the financial structures of their companies, and excessive earnings management – clearly show that similar governance problems pertain to all business sectors.

Generally speaking, all companies, whatever their specific fields of operations, face a wide variety of external or internal risks. Some companies face high risks that significantly affect society as a whole: risks related to climate change, to the environment, health, safety, human rights, etc;[37] others operate critical infrastructure, the disruption or destruction of which could have major international impacts. Irrespective of their specificities (field of activity, size, international exposure, complexity), companies of one or more business branches can after their aggregation cause systemic risks similar to those of the financial industry.

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[35] *See* Karl Okamoto, *After the Bailout: Regulating Systemic Moral Hazard Essay,* 57 UCLA L. REV. 183, 204-09 (2009-2010), analyzing the skewed incentives of an asset manager who is rewarded for profits, but terminated for either no profits or losses; *See* FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT 419 (2011), available at: http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf (last accessed: 27 June 2013), where the dissenting members of Commission highlighted ten essential causes of the meltdown, including a "common shock" that caused unrelated financial institutions to fail because of "similar failed bets on housing" and a "risk of contagion" due to particular firms' failures "triggering balance-sheet losses in its counterparties".

[36] *See* John Graham *et al.*, *Value Destruction and Financial Reporting Decisions*, 62 FIN. ANALYSTS J. 27, 27-31; Natalie Mizik, *supra* note 15, at 594, who, in their large surveys of several hundreds of executives and companies, found out that, in order to meet earnings expectations, executives and their firms were only focused on short-termism and seemed to be ready to sacrifice long-term sustainability; LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 80-95 (2004); *Cf.* Lucian Bebchuk & Jesse Fried, *Paying for Long-Term Performance Symposium: Protection of Investors in the Wake of the 2008-2009 Financial Crisis,* 158 U. PA. L. REV. 1915 (2009-2010).

[37] *See* Kristin Johnson, *supra* note 2, at 61.

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It cannot be predicted with adequate accuracy which business branch or even company will trigger the next economic crisis.[38] For example, the 2000/2001 economic crisis was triggered by the investor's disappointment at the performance of the so called New Economy, that is, the ICT business sector,[39] which caused the so called dot-com bubble.[40] Other characteristic examples include the relatively recent General Motors and Chrysler bailouts, which clearly show that it is not only the financial sector that may be of systemic importance for the national and international economies. Past economic crises were launched by incidents related to stock exchange performance but they certainly had their roots in real company underperformance, which is to a large extent attributable to the flawed decision-making of executives and other high-level officials.[41]

However, the overall rationale of regulatory interventions in the firm decision process for managerial compensation schemes is not confined to risk-taking. Rather, it can be traced back to the postulate that no manager or any other company official should be paid independently of her actual performance. It is important to keep in mind that poor long-term performance can not only be the result of excessive risk-taking. It can also be ascribed to other management-related factors, such as risk-independent decision-making failures, various kinds of skewed incentives, just plain greed or even low risk-taking.[42] Performance should on its part be measured in the long-run, since important investments such as R&D projects and strategic decisions can prove their effectiveness and eventually pay off in the middle- to long-run.[43] Moreover, it would be counterproductive to prevent

[38] *Cf.* DAVIDE GUALERZI, THE COMING OF AGE OF INFORMATION TECHNOLOGIES AND THE PATH OF TRANSFORMATIONAL GROWTH: A LONG RUN PERSPECTIVE ON THE LATE 2000S RECESSION 69-70 (2010).

[39] *Cf.* CHRISTOPHER DOW, MAJOR RECESSIONS: BRITAIN AND THE WORLD 1920-1995 9 (2000), showing that recession was driven not by exogenous shocks but by a downward shift in business and consumer confidence, in reaction to the previous speculative boom.

[40] *See* e.g., David Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 633 (2011).

[41] *See* PAUL CAROLL AND CHUNKA MUI, BILLIION DOLLAR LESSONS 279-91 (2008); *See* JAMES HOOPES, CORPORATE DREAMS 35 (2011).

[42] *See* Lynne Dallas, *supra* note 5, at 321, explaining the causes of executives' "greed and ambition" syndrome; *see* David Walker, *supra* note 40, 636, stressing that risk aversion "is the most frequently modelled individual-level characteristic affecting the optimal" design of individual pay packages.

[43] *See* Lessons Learned from Enron's Collapse: Auditing the Accounting Industry: Hearing Before the Committee on Energy and Commerce, 107th Cong. 96, 104 (2002), prepared statement of Baruch Lev, available at: http://republicans.energycommerce.house.gov/107/action/107-83.pdf (last accessed: 27 June 2013), stressing

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the excessive risk-taking of financial institutions without mitigating the risks of managerial failures in other business sectors. When firms in other business sectors make wrong and risky investments with the help of bank credits, they can eventually trigger considerable market risks,[44] which on their part pose systemic threats to worldwide financial and economic systems.

The provisions of the Dodd-Frank Act are, as will be shown below, inadequate and cannot prevent future systemic crises deriving from managerial malpractices and excessive risk-taking in businesses outside the financial industry.[45]

I. Say-on-pay

The Dodd-Frank Act provisions concerning say-on-pay cannot effectively prevent managerial exaggerations and excessive risk-taking. According to the SEC rules, firms will be required, not less frequently than once every three years, to provide a separate shareholder advisory vote in proxy statements to approve the compensation of their named executive officers.[46] More specifically, firms would be required to disclose in a proxy statement for an annual meeting (or other meeting of shareholders for which SEC rules require executive compensation disclosure) that they are providing a separate shareholder vote on executive compensation and to briefly explain the general effect of the vote, such as whether the vote is non-binding.[47] Firms are also required to address in CD&A whether and, if so, how their compensation policies and decisions have taken into account the results of the most recent shareholder advisory vote on executive compensation.

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the importance of intangible assets, such as R&D. organizational designs and knowledge management systems for long-term firm success.

[44] *See* PHILIPPE JORION, VALUE AT RISK: THE NEW BENCHMARK FOR MANAGING FINANCIAL RISK 62 (2001), explaining that "risk can be defined as the volatility of unexpected outcomes, generally the value of assets or liabilities of interest".

[45] Steven Schwarcz, *supra* note 8, at 193, 205-207, arguing that regulation in this area is justified both on an efficiency basis and to meet public welfare goals.

[46] SEC Shareholder Approval of Executive Compensation, 17 C.F.R. § 229, 240, 249, 6013 (2011).

[47] *Id*. at 6014.

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Although these rules are a step forward in an effort to strengthen shareholders' rights,[48] they cannot effectively prevent flawed compensation policies for two reasons. First, shareholders can only react to flawed managerial compensation schemes *ex nunc*,[49] in many cases only after they and their firms have suffered from managerial policies leading to excessive risk-taking and financial losses. Second, their vote is essentially non-binding.[50] Congress thereby preserved the classic separation of ownership and control between shareholders and board of directors.[51] Surely, shareholders, whose vote has not been seriously taken into account, could react to the board's ignorance echoing the landmark Delaware opinion: "If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out." In reality, however, it is still extremely difficult to replace the directors of public companies by a rival slate.[52] The disincentives to challenge executives supported by the board are high, except where proposals for direct shareholder nominations of board candidates and unlimited power to amend by-laws through the corporate proxy statement

[48] *See* Lynne Dallas, *supra* note 5, at 353, rightly proposing that there should be a differentiation between transient institutional and long-term shareholders. Enhancing the voting power of long-term shareholders is the most effective way of blocking flawed incentive pay schemes. Activists and short-term institutional shareholders including banks, insurance companies, investment companies, pensions, hedge funds etc. usually treat firms as a short-term arbitrage opportunity to increase short-term gains; *Cf.* William Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 654-660 (2009-2010); Lawrence Mitchell, *The Legitimate Rights of Public Shareholders*, 66 WASH. & LEE L. REV. 1635, 1640 (2009), advocating the elimination of shareholder rights in the case of short-termism; *Cf.* Emeka Duruigbo, *Stimulating Long-Term Shareholding*, 33 CARDOZO L. REV. 1733 (2011-2012), proposing several instruments to stimulate long-term shareholding.

[49] The United Kingdom introduced a nonbinding say-on-pay rule in 2002: *See* Andrew Lund, *Say on Pay's Bundling Problems*, 99 KY. L. J. 119 (2010-2011), emphasizing that "[t]he experience in the U.K. provides little evidence that say on pay disciplines firms; Proposed regulation to give shareholders ex ante consideration of these plans seems of marginal value given that shares of a publicly-held company change hands many times over the course of a year. Given this fact, new shareholders are constantly making an ex ante binding decision about whether the disclosed compensation plan is acceptable to them"; *See* Leo Strine Jr., *One Fundamental Corporate Governance Question we Face: Can Corporations be Managed for the Long Term Unless their Powerful Electorates also Act and Think Long Term Essay,* 66 BUS. LAW. 1, 11 (2010-2011), citing data that suggest that the annual turnover across all U.S. stock exchanges in 2008 was over 300%.

[50] *See* Kristin Johnson, *supra* note 2, at 98.

[51] *See* Robert Scully Jr., *Executive Compensation, the Business Judgment Rule, and the Dodd-Frank Act: Back to the Future for Private Litigation?*, 58 FED. LAW. 38 (2011).

[52] *See* Christopher Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 332-34 (2010-2011); Stephen Bainbridge, *Is Say on Pay Justified Corporate Governance,* 32 REGULATION 42, 157 (2009-2010); David Skeel Jr., *Inside-Out Corporate Governance*, 37 J. CORP. L. 147, 156-58 (2011-2012); John Olson, *supra* note 4, at 289-99.

and by corporate funding of proxy contests is possible.[53] This remains, however, the exception to the rule.[54]

In many cases, elections are not held very often and shareholders do not have access to the corporate ballot. In many companies shareholders do not have the power to replace the whole board. With default election arrangements in place, corporate democracy cannot function properly. Boards can adopt bylaws that make director removal more difficult without shareholder approval.[55] On the other hand, shareholders have not been very successful in litigating claims that excessive pay packages to executives equals to a breach of fiduciary duties that boards owe to shareholders or constitute waste.[56]

II. Independence of Compensation Committees

The installation of an independent compensation committee cannot warrant, I argue, that its decisions will be truly unbiased. The committee/part of the board and its prospective executives are not contracting in a perfect environment. The Dodd-Frank Act does not prescribe that compensation committees must be comprised only of outside directors. The SEC recently issued more detailed rules specifying the Dodd-Frank Act, which direct the stock exchanges to include the requirement in their listing standards that a firm must establish an independent compensation committee. Current exchange listing standards generally require listed issuers either to have a compensation committee or to have independent directors determine, recommend, or oversee executive compensation matters.

[53] *See* Michael Siebecker, *New Discourse Theory of the Firm After Citizens United, A*, 79 GEO. WASH. L. REV. 161, 213 (2010-2011).

[54] *See* Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 857, 865 (2004-2005).

[55] *See* Lucian Bebchuk, *Letting Shareholders Set the Rules,* 119 HARV. L. REV. 1784, 1794, 1799, 1803 (2005-2006).

[56] *Cf.* the solution to this problem put forward by Lawrence Cunningham, *New Legal Theory to Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177 (2010-2011); Robert Scully Jr., *supra* note 51*,* at 39; *Cf.* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) a case, in which the Board of Directors had hired a certain executive and had terminated her contract without cause sixteen months after she had started working for the company. Most importantly, the contract contained a termination provision according to which the Board of Directors had to pay and indeed paid this person $130 million compensation. The Supreme Court of Delaware nevertheless didn't find that the Board of Directors had breached any fiduciary duties.

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As far as independence requirements are concerned, both NYSE and Nasdaq rules preclude a finding of independence only in cases of employment, business, or financial ties of a director and/or its relatives with a listed issuer or its auditor. As far as other, non-pecuniary relations and ties are concerned, Nasdaq relies on the judgment of an issuers' board as to whether any such relationship could impair a director's independence.[57]

The SEC has abstained from directing the exchanges to develop a definition of other relevant factors, which could influence a compensation committee's independence other than the already established ones.[58] Even if the rule was put in place that committees have to be comprised only of outside directors, these directors would regularly be selected by the CEO to be nominated to the board, so true independence might not exist in that case either.[59] In addition, other kinds of conflicts of interest regularly exist, which are not really obvious. Outside directors/members of the compensation committee may favor executive officers who happen to be fellow employees of inside directors because of the latter's social ties with outside directors. The SEC does mention that the exchanges might also conclude that other relationships or factors linked more closely to executive compensation matters such as relationships between the members of the compensation committee and the listed issuer's executive management should be addressed in the definition of independence.

However, social networking and human interrelations are extremely intricate and cannot be confined to present or past monetary and/or immaterial relationships and ties. Classical and evolutionary game theory suggests that interests might be formed in anticipation of future favorable behavior, promotion, or even informal collusive interaction. This was acknowledged by the Delaware Supreme Court in its Oracle judgment.[60] Another category

[57] *See* "Listing Standards for Compensation Committees" – Release Nos. 33-9330; 34-67220; File No .S7-13-11, available at: http://www.sec.gov/rules/final/2012/33-9330.pdf (last accessed: 5 July 2013) .

[58] According to the SEC relevant factors, include, but not limited to, the source of compensation of a director, including any consulting, advisory or other compensatory fee paid by the issuer to such director, and whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

[59] *See* Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007)*; See* Lucian Bebchuk, *Letting Shareholders Set the Rules,* 119 HARV.L. REV. 1784 (2006)*; See* Lucian Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 833 (2005); *Cf.* Kelli Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783 (2011), who supports the relatively radical view to replace the board of directors because of these and other deficiencies.

[60] *In re* Oracle Corp Derivative Litigation*,* 824 A.2d 917, 917 (Del. Ch. 2003), the Court concluded that close personal relationships were a factor in deciding that a special litigation committee was not independent. The court noted: "Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement .... We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed

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of problems was identified by commentators who suggested that there are cognitive biases and structural limitations that affect the decision-making process of a firms' governing bodies in general and do not only pertain to the design of compensation schemes. Many commentators have pointed to the fact that these flaws will inevitably continue to plague board's efforts to effectively manage risk including its ability to safeguard a compensation committee's independence and unbiased judgment.[61]

Similar thinking applies to third-party compensation consultants who provide executive compensation advice. These experts may on the one hand have social or industry ties with certain candidate managers. On the other hand, they can inject an industry bias in increasing pay packages that can over time lead to the establishment of higher average market prices for executives.[62]

The Dodd-Frank act identifies the first type of danger and instructs the SEC among other things to direct National Securities Exchanges and National Securities Associations to check if there exists any business or personal relationship of the third-party compensation counsel with a member of the compensation committee. These provisions have been put in place to ensure that the contracts that result from bounded negotiations between the compensation committee of a company and perspective executives are kept in check. However, the Dodd-Frank Act does not identify or address other types of dangers–such as social ties and the like–mentioned above. The SEC can issue rules pertaining to these risks

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or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values."

[61] *See* Lisa Fairfax, *Uneasy Case for the Inside Director,* 96 IOWA L. REV. 127 (2010-2011); *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 924-26 (1998-1999); Eliezer Fich & Lawrence White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards the Changing Role of Directors in Corporate Governance,* 38 WAKE FOREST L. REV. 935 (2003); Idalene Kesner, Bart Victor & Bruce Lamont, *Board Composition and the Commission of Illegal Acts: An Investigation of Fortune 500 Companies,* 29 ACAD. MANAGEMENT J. 789, 794-96 (1986); Marleen O'Connor, *Enron Board: The Perils of Groupthink, the Sixteenth Annual Corporate Law Symposium: Agency Law Inside the Corporation,* 71 U. CIN. L. REV. 1233 (2002-2003); Donald Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals about Self-Deception, Deceiving Others and the Design of Internal Controls Essay*, 93 GEO. L. J. 285 (2004-2005), discussing the duration of CEO power and how it is obtained; Rakesh Khurana & Katharine Pick, *Social Nature of Boards, the Corporate Misbehavior by Elite Decision-Makers Symposium - Perspectives from Law and Social Psychology*, 70 BROOK. L. REV. 1259 (2004-2005); s*ee* James Cox & Harry Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 83 (1985); Kenneth Davis Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305 (2004-2005), discussing the meaning of structural bias for special litigation committees.

[62] *See* Lucian Bebchuk & Jesse Fried, *Pay without Performance: Overview of the Issues*, 30 J. CORP. L. 647, at 657-8 (2005).

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and it hopefully will do so since Congress authorized it to consider *all relevant factors* in order to enhance the quality of its rule-making and safeguard the process of negotiating fair and performance-centered incentive plans. The SEC reserved the right to examine, prior to final approval, whether the Exchanges considered the relevant factors outlined in Section 10C(a) and whether the Exchanges' proposed rule changes are consistent with the requirements of Section 6(b) of the Exchange Act.

In summary, it can be said that the Dodd-Frank Act leaves a great deal of discretion to the SEC and the National Securities administrations, so that its direct impact on bounded negotiations and excessive pay agreements cannot yet be foreseen. The task of checking whether any business or personal relationship endangers the independence of compensation committees is a most convoluted and intricate task. This became clear in the *Beam v. Stewart* case.[63] The breadth and complexity of such interrelations may make it impossible for a public authority to identify and analyze them properly and to monitor bounded firm behavior accordingly.[64] Moreover, it is extremely difficult to assess the extent to which such relationships may possibly affect the judgment of the compensation committee of any given company. There exist obvious evidentiary problems, problems of factual assessment as well as forecasting problems pertaining to the evolution and complexity of human interactions. Most importantly, structural limitations and cognitive bias aggravate, reinforce, and conceal the phenomenon of board capture. Finally, a broader issue that cannot be easily resolved is related to the existence of an imperfect competition market for executives, where the level and scheme of compensation is

[63] In Beam v. Stewart, 845 A.2d 1040, 1040 (Del. Super. Ct. 2004), shareholders alleged that because of structural biases, which restricted the boards' independence, the board would block shareholders from moving a derivative case forward prior to the formation of a special litigation committee, which would be established to assess the merits of that claim. Structural bias was the result of members of the boards' personal and/or professional relationships with the chairman and CEO who was involved in an insider trading scandal. The court made it considerably difficult for shareholders to prove that the board was not independent and raised the requisite standard of proof. The court was unwilling to find that personal and business relationships could alone amount to such a grave structural bias, which would prevent directors from acting in an independent manner. A demonstration that the board was not independent would entail a pleading of particularized facts that create a reasonable doubt sufficient to rebut the presumption that the directors were independent of the CEO. Arguments of structural bias not based on concrete incidents have no sufficient evidentiary basis. On the contrary, when directors have the burden of demonstrating independence as was the case in *Oracle* (supra note 61) they must demonstrate impartiality and the court can freely consider the possibility of structural biases in assessing independence. This creates for shareholders and potentially also for an Agency a procedural/litigation disadvantage.

[64] *Cf.* Charles Yablon, Lucian Bebchuk & Jesse Fried*, Pay without Performance: The Unfulfilled Promise of Executive Compensation*, 4 N.Y.U.J.L. & Bus. 96, 97, 107, 108 (2007-2008).

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influenced to a great extent by the moves of peer firms and by the powerful executives lobby.[65]

In any case, it is questionable that the Dodd-Frank Act provisions about compensation committees and compensation consultants can prevent risk-inducing executive pay. These provisions seem to be redundant, since the Exchanges had already adopted relevant listing requirements before 2007. These could not prevent the outbreak of the crisis that gave birth to the Great Recession.[66]

The Dodd-Frank Act contains provisions and explicitly instructs the SEC to issue rules concerning the organizational and procedural framework for defining, designing, and implementing compensation policies for company executives. I have shown, however, that these provisions cannot fight board capture and bounded negotiation problems effectively. It is therefore necessary for Congress and the SEC to take additional parameters and factors into account, to make substantive rules and to issue guidelines pertaining to the minimum requirements that pay packages should fulfill in order to minimize the risks of awarding excessive compensation benefits to executives that on their part stimulate excessive risk-taking and flawed decision-making.[67] The Dodd-Frank Act's main normative innovation is that it transposes the regulation of corporate governance, which is traditionally a province of state law, to the federal level, thus demonstrating the need to make nationwide and uniform substantive amendments to corporate governance.

III. The Necessity of Additional Rules for the Design of Incentive Plans

The balance between two public policy imperatives delineates the public interest that determines the type, extent, and degree of regulatory intervention in this case. These imperatives include the need to prevent systemic risks that cause severe economic recessions and depressions, on the one hand, and the primacy of individual autonomy and

[65] *See* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform,* 62 S. M. U. L. REV. 299 (2009), describing the optimal contracting theory and two countervailing theories: market forces theory, in which the market for CEO pay is weak/imperfect; and managerial power theory, wherein the board is captured; *Cf.* the very insightful analysis of Christine Jolls, Cass Sunstein & Richard Thaler, *Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1997-1998).

[66] *See* Kristin Johnson, *supra* note 2, at 98.

[67] For similar suggestions concerning the regulation of banker's pay, see Lucian Bebchuk & Holder Spamann, *supra* note 2, at 283.

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contractual freedom over regulation and state intervention, on the other.[68] Companies should always be free to negotiate the height and total sums of compensation with candidate managers.[69] Regulators are not allowed to replace the judgment of the board with their own judgment. The business judgment rule has wisely not been amended by Dodd-Frank.[70] It would be a big mistake to underestimate the great potential of individual firms' decentralized search for knowledge and the valuable output of their discovery processes, when it comes to the optimal level of executive pay.[71] It is precisely for this reason why the SEC should not and cannot prescribe the exact design of compensation schemes. Each organization's culture, mission, values, strategy, and the purpose and intent of its incentive programs should guide the design of the plans to drive performance in the most effective way. In any case, the design of incentive plans should not be entirely formulaic; instead it should allow the compensation committee and the board to determine achievement of results and the corresponding payouts after considering the particularities of each executive's case.[72] Discretionary decisions are inevitable in the case of the evaluation of management achievements of qualitative or strategic nature.

Nevertheless, regulatory intervention in the public interest is warranted when more or less obvious causal links between excessive risk-taking and inappropriate managerial

[68] *Cf.* Lucian Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257 (2010); Steven Schwarcz, *supra* note 8, at 205-07, arguing that regulation in this area is justified both on an efficiency basis and for public welfare reasons; *Cf.* Robert Scully Jr., *supra* note 51, at 38, 40, stating that 'this massive bill newly federalizes a great deal of corporate and securities law, but at the same time it largely preserves the century-old practice of adjudicating claims of directors' liability for approving payment of excessive executive compensation under the business judgment rule'; *Cf.* Jose Gabilondo, *Dodd-Frank, Liability Structure, and Financial Instability Cycles: Neither a (Ponzi) Borrower nor a Lender be the Sustainable Corporation*, 46 WAKE FOREST L. REV. 469 (2011), putting forward arguments that the existing legal framework and the business judgment rule suffice and that no superior public interest dictates a more intense regulatory intervention.

[69] *See* Lucian Bebchuk & Holder Spamann, supra note 2, at 287; *Compensation Structure & Systemic Risk: Hearing Before the H. Comm. on Fin. Servs.,* 111 th Cong. 6 (2009) (statement of Lucian Bebchuk).

[70] *Cf.* in this respect the concession v. nexus-of-contracts theories of the corporation: *See* Liam Seamus O'Melinn, *Neither Contract nor Concession: The Public Personality of the Corporation*, 74 GEO. WASH. L. REV. 201 (2005-2006); Stefan Padfield, *Dodd-Frank Corporation: More than a Nexus-of-Contracts*, 114 W. VA. L. REV. 209, 211 (2011-2012).

[71] *Cf.* Friedrich v. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519-30 (1945) ; FRIEDRICH V. HAYEK, DIE ANMAßUNG VON WISSEN, 3-7 (1974).

[72] *See* David Walker, *supra* note 40, stressing that "the optimal convexity of mix of stock and options in executive pay packages should be a function of market, firm and individual characteristics.".

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compensation schemes have been detected and substantiated. Additionally, the discovery of inherent and insurmountable weaknesses in the decision-making processes of compensation committees as well as the factual inability of shareholders to effectively monitor and exert control on incentive pay schemes are aggravating factors, which call for a regulatory intervention. Another equally important aspect is that eventually not only shareholders suffer from misguided managerial incentives but taxpayers and the economy as well.[73] The function and effects of skewed managerial incentives that lead firms and a whole economy to failure are best described by a theory that has been empirically verified to a great extent: the fundamental instability of a free market economy is a tendency to enter into a boom or 'euphoric' state, followed by a bust. When businesses are flourishing, firm leaders take on riskier debt to invest in speculative assets, an unsustainable strategy that would lead, in time, to an economic crisis. Government policy could contribute to the long term viability of capitalism by slowing down these boom-bust cycles.[74] One possible way of doing that would be through direct or indirect intervention in managerial compensation schemes, through lower executive pay at the beginning and higher executive pay at the end of a business cycle. This would incentivize managers to go against prevailing market sentiment and take countervailing measures against market stagnation and recession. The promotion of a leitbild and culture of sustainable corporations would aim at the prevention of decision-making, organizational and operational fallacies to prolong the business cycle of companies and reduce systemic risks as well as the number and frequency of recessions in the future.[75] This leitbild necessitates more pro-active policies on the part of the Federal Agencies.

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[73] *See* Lynne Dallas, *supra* note 5, at 293, who uses the term short-termism instead of excessive risk-taking to signify the general thinking and strategy of executives.

[74] *Cf.* HYMAN P. MINSKY, CAN "IT" HAPPEN AGAIN? ESSAYS ON INSTABILITY AND FINANCE, at 117, 118-24 (1982); See for business cycles in general: *Cf.* PAUL KRUGMAN & ROBIN WELLS, ESSENTIALS OF ECONOMICS, 301-304 (2010); For empirical confirmations of Minsky's theory, *see* Virginia Postrel, *Macroegonomics*, http://www.theatlantic.com/magazine/archive/2009/04/macroegonomics/7319/ (last accessed: 27 June 2013); Joe Weisenthal, *15 Huge Ideas That Flopped This Decade*, http://www.businessinsider.com/15-huge-ideas-that-flopped-this-decade-2009-12?op=1 (last accessed: 27 June 2013).

[75] *Cf.* Judd Sneirson*, The Sustainable Corporation and Shareholder Profits,* 46 WAKE FOREST L. REV. 541, 542 (2011), providing a broader definition of sustainability not restricted to the business context; Lynne Dallas, s*upra* note 5, at 316-23, describing how the dramatic shift in firm cultures promotes short-termism and excessive risk-taking; *Cf.* Andrew Schwartz, *The Perpetual Corporation*, 80 GEO. WASH. L. REV. 764, 777, 801, 805, 823 (2011-2012), who maintains that the corporation has to be de a viable, long-lasting institution, which follows the method of "immortal investing" to perpetuate its existence and prosper to the benefit of its stakeholders and the whole of society.

The above analysis suggests that it is in the public interest to establish general criteria and guidelines for the design of managerial compensation. These should be part of the relevant factors that the SEC has to consider when making special rules for compensation committees and executive compensation in general. Moreover, it is necessary for the SEC to complement the organizational and procedural provisions of the Dodd-Frank Act[76] with guidelines and a substantive framework for compensation committees to comply with when deciding on compensation policies and individual incentive plans. It would be possible for the SEC and/or the National Securities Exchanges/Associations to prescribe a general model for the design of manager incentive plans, from which companies would or would not be allowed to depart. However, there seems to be no sufficient legal basis in the Dodd-Frank act for such kind of intervention and substantive rule-making.

To countervail these deficiencies, the SEC can, however, on the basis of Section 953 of the Dodd-Frank Act issue very strict rules on transparency and disclosure of compensation policies along with non-binding guidelines about the minimum requirements for the design of executive pay packages. Disclosures strengthen the integrity of the marketplace and, among other benefits, foster greater stability and prevent systemic risks.[77] Firms must be obliged to disclose and explain the process of their decision-making and the subsequent design of incentive plans to the SEC, the Exchanges and their shareholders.[78] The SEC could indirectly suggest in its rules on disclosure that firms should take into account certain substantive criteria and guidelines and report in their disclosure documents if they complied with them or if and how they amended, complemented or enhanced them.[79] There is a clear evolution of the SEC's administrative practice in this direction.[80] This disclosure would be included in registration documents required by the Securities Act of

[76] *See* Robert Scully Jr., *supra* note 51, at 38.

[77] *See* Frank Easterbrook & Daniel Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); John Wilcox, *Comply-and-Explain: Should Directors have a Duty to Inform the Model Business Corporation Act at Sixty*, 74 LAW & CONTEMP. PROBS. 149, 151-52 (2011).

[78] Disclosure, transparency and accountability are the main principles that foster shareholder democracy as it is envisaged by Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2004-2005).

[79] *Cf*. GALLE, JOANNA GERDINA CAROLINA MARIA, CONSENSUS ON THE COMPLY OR EXPLAIN PRINCIPLE WITHIN THE EU CORPORATE GOVERNANCE FRAMEWORK: LEGAL AND EMPIRICAL RESEARCH (2012), explaining why and how the comply or explain principle became the main internationally sanctioned method of indirect corporate governance regulation.

[80] *See* SEC, Executive Compensation Disclosure, Securities Act Release No. 33-8765 (Dec. 22, 2006); SEC Executive Compensation Disclosure, Exchange Act Release No. 34-55009 (Dec. 29, 2006).

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1933,[81] and periodic reports required by the Securities Exchange Act of 1934.[82] The SEC mandated that companies disclose the board's role in risk oversight, and whether such policies are reasonably likely to have a material adverse effect on the company. These rules required companies to disclose and evaluate their compensation policies and practices for all employees (including non-executive officers) and assess, *inter alia*, whether there are any risks associated with those compensation policies and practices.[83] The Dodd-Frank Act provided congressional approval of the SEC's rulemaking on board leadership structure and disclosure practices.[84]

According to Section 953, the Act now directs the SEC to promulgate rules requiring publicly held corporations not only to disclose the details of compensation plans, as previously required, but also to disclose every year to shareholders how executive pay is connected to executive performance, including the preparation and disclosure of charts that compare executive compensation with stock performance of the corporation over a five-year period. This information would be in addition to other information already required to be disclosed on an annual basis on Form 10-K. This is truly useful for shareholders who want to make good use of their say-on-pay rights, as well as for the compensation committee and the board in general, because it points to a possible criterion for the assessment and design of incentive plans: the five-year stock exchange performance correlation with five-year pay packages for executives. The SEC can extract from this provision the postulate that the quality of compensation scheme design should be measured against the long-term performance of a company and suggest a general analytical framework for the design of managerial compensation schemes.

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[81] *See e.g*. Form S-1, Registration Statement Under the Securities Act of 1933, requiring under Item 11, Information with Respect to the Registrant, "(k) Information required by Item 402 of Regulation S-K, executive compensation".

[82] *See* Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (requiring under Item 11, Executive Compensation, "the information required by Item 402 of Regulation S-K"). Form 8-K, which publicly-held firms are required to file upon the happening of certain events, requires similar compensation information to be disclosed upon either the hiring of a new executive officer or an amendment to a compensation plan. *See* Form 8-K, Current Report under Securities Exchange Act of 1934, Item 5.02 Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers.

[83] *See generally* Proxy Disclosure Enhancements, Exchange Act Release Nos. 33-9089; 34-62275 (Dec. 16, 2009), available at: http://www.sec.gov/rules/final2009/33-9089.pdf (last accessed: 27 June 2013) at 5, 8, 9, 15-16.

[84] *See* Jill Barclift, *supra* note 13, at 6 (2011); Patrick Bolton, José Scheinkman & Wei Xiong, *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 743 (2005).

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IV. Disclosure of Performance Measures

The setting of the appropriate performance masures is a central element in a company's compensation policy. Furthermore, the design of compensation arrangements commensurate with the right performance is a tricky balance to achieve. The SEC should make the rule that firms have to disclose the performance measures in their long-term incentive plans and explain how these would probably affect executive behavior and cooperation inside the firm.[85] A balanced combination of multiple performance measures compounded with the appropriate balance of goals and rewards can considerably contribute to the sustainability of a firm.[86] Regulators need to encourage such arrangements, and they should always be ready to ring the alarm bell when encountering arrangements that induce excessive risks.[87]

The SEC should also instruct companies to disclose how they evaluate the risks present in the performance measures and which mitigation techniques they have employed.[88] It would be a mistake to just rely on stock performance as a measure of performance and consequently as a fundamental criterion for the assessment of an incentive plan's quality of design.[89] This is a measure pertaining to visible, outside indicators of a company's performance, which do not necessarily correspond to real performance, which is reflected

[85] It should be explained in detail how a specific incentive plan design minimizes the pressure and influence of transient institutional shareholders who focus almost exclusively on short-term results and earnings; for various corporate governance weaknesses and firm under-performance issues associated with the negative role of transient institutional shareholder: *See* Lynne Dallas, *supra* note 5, at 304-06; *Id*. at 317-8, stressing the importance of the cooperation between management, internal controls and risk management for a firms long-term success.

[86] *Cf.* IRA KAY & STEVE VAN PUTTEN, MYTHS AND REALITIES OF EXECUTIVE PAY 96-98 (2007); *Cf.* Elias George, *Using Game Theory and Contractarianism to Reform Corporate Governance: Why Shareholders Should Seek Disincentive Schemes in Executive Compensation Plans*, 42 GOLDEN GATE U. L. REV. 349, 384-85 (2011-2012).

[87] *See* Lucian Bebchuk & Holger Spamann, *supra* note 2, at 282.

[88] *Cf* Kristin Johnson, *supra* note 2, at 55, 57*; for such techniques see* MICHEL CROUHY, DAN GALAI & ROBERT MARK, RISK MANAGEMENT, 543 (2001), analyzing how these techniques function; *see* Rene Stulz, *Risk Management Failures: What Are They and When Do They Happen?*, HARV. BUS. REV. 59 (2009), exposing the limitations of such techniques.

[89] *See* Natalie Mizik, *supra* note 15, at 594, 599 (2010), who in her 6642 companies' study discovered that stock markets did not value firms with excessive focus on short-term performance less than firms that e.g. increased support for R&D while yielding equally good financial results with their short-term fixed rivals.

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in fundamental analysis data[90] ideally drawing and based on corporate performance statements. Such statements were proposed by commentators as replacement of quarterly earnings statements and would provide realized cash flow data and information on the operational model as well as key financial and nonfinancial indicators that drive a firm's value.[91] The adoption of stock performance as the sole measure may ultimately induce management to surpass the imperatives of sustainable long-termism and divulge short-term gains.[92] The SEC and the Exchanges should encourage the use of multiple metrics, and particularly more than one financial and operating metric to enable a balanced view of how a firm is performing. These metrics should consist of combinations of profitability, growth, and sustained return measures.[93] Additionally, it is important to consider qualitative measures that emphasize strategic priorities.

1. Disclosure of Individual Pay Elements and of their Mix

It is of utmost importance for the SEC to instruct companies to disclose and justify how the pay elements and their mix in the variable part of compensation lowers the risks of flawed decision-taking, thus helping to maximize long-term company performance. Two questions are crucial and have to be answered properly: How much compensation should be fixed and how much variable? Second, what should be the ratio of short-term compensation versus long-term compensation?

It is essential to determine a balanced mix of fixed and variable compensation.[94] Fixed compensation does not depend on the correlation of an executive's performance with

[90] *Cf.* Steven Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation,* 7 DEPAUL BUS. L. J. 301, 309-11 (1995), examining traditional critiques of stock-based compensation, including the assumption that stock price is an adequate proxy for executive performance; Lynne Dallas, *supra* note 5, at 271, 298, attributing short-termism to the phenomenon of herding behavior; TONI TURNER, SHORT-TERM TRADING IN THE NEW STOCK MARKET, 99 (2005), explaining the differences between fundamental analysis and technical analysis, which is suitable for short-term earning strategies.

[91] *See* Lynne Dallas, *supra* note 5, at 328.

[92] *See* Bebchuk & Fried, *supra* note 63, at 665, reporting that empirical studies suggest that executives are able to use inside information to make decisions on when and whether to hedge stock-based compensation.

[93] *Cf.* Ira Kay & Steve van Putten, *supra* note 87, at 62.

[94] *See e.g.*, David Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 621 (2011), stressing that the optimal pay arrangement would balance incentive generation with risk-bearing costs.

future profitability, earnings and her firm's stock performance. On the contrary, it results from the compensation committees' yearly review of the executives' performance and therefore incentivizes executives not to expose a company to excessive risks, which could endanger their current position. It moreover helps prevent the risk of overinvestment in companies with high levels of leverage. On the other hand, variable compensation allows for the design of sustainable growth-oriented incentive plans with a focus on future performance, which usually entails the award of equity compensation. Variable compensation induces managers to take on risk and invest more to increase the profitability of their companies.[95] However, the recommendation that in firms with high leverage fixed compensation should be the main form of compensation to discourage excessive risk-taking, while equity compensation should be preferred over fixed compensation in firms with low leverage to encourage investment and growth strategies, is very generic and oversimplifying. It is rather the risk management's advice to not undertake certain investments that can deter a manager from risk-excessive behavior. Moreover, in the structure of incentive pay that is advocated in this article, the fixed-part compensation is intended to encourage managers to perform better even in low-leverage firms, since the fixed-part is the only form of compensation they can expect to receive with some certainty. They can lose it only if they over- or under-invest in the short-term, whereas the height of the variable part of compensation cannot be predicted accurately even if a certain investment is likely to be profitable. It is due to the blending of fixed and variable parts of compensation that they undertake appropriate risk-level projects.

But even if equity compensation were the sole compensation form, a multi-year and performance-dependent compensation framework would allow for the internalization of externalities and the avoidance of risk-excessiveness. Furthermore, the problem of risk-excessiveness can be avoided with an equity compensation design that allows equity to be unwound only gradually and be cashed out several years after the award of each year's total sums of compensation. The management will have to make careful investments in order to cash out a significant portion of their equity compensation five years after the yearly compensation is awarded. Fixed compensation can incentivize executives to make risk-balanced decisions in order to cash out each year's fixed part of the total compensation plus the variable parts, awarded in previous years, which can be unwound in that year.

[95] *See* Simone Sepe, *Making Sense of Executive Compensation*, 36 DEL. J. CORP. L. 189, 195 (2011), suggesting that in firms with high levels of leverage "[t]he fixed-equity ratio of executive pay should be tied to the debt-equity ratio of the firm's capital structure, in order to exploit the property of fixed-compensation of countering manager's excessive risk incentives. In contrast, equity-based compensation should be preferred in low-leveraged firms, where overinvestment concerns are less severe given the smaller debt cushion. Accordingly, in these corporations the equity-based portion of executive pay should exceed the fixed-pay portion."

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The guiding principle behind incentive plan design should be long-termism. Long-term payments can be split and delivered in a bipartite form of fixed compensation and equity, which should take the form of performance-based awards, mainly restricted stock options.[96]

Among S&P 500 CEOs in 2009**,** on average more than 60% of compensation came in the form of equity (restricted stock options and stock option grants).[97] In the discussion that follows, stock option grants will denote conventional time-vested stock options and stock appreciation rights, and "performance-vested stock options" will denote options whose vesting depends on predetermined performance targets.[98] However, stock options and stock appreciation rights can provide inappropriate incentives for short-term strategic thinking and risk-taking linked to the performance of a company's stocks at stock exchanges, where speculative investment can drive stock values up, create bubbles and disassociate stock exchange valuation from real actual performance and earnings of the firm.[99] Stock options and stock appreciation rights should therefore not exceed a certain low threshold/percentage of the overall compensation arrangement, since they can induce short-term decision-taking and excessive risk-taking.[100] A much greater portion of annual incentive earnings should be honored by offering deferred compensation in form of restricted stock options, which should function similar to banking bonuses and provide for payout at some point in the future on the basis of future performance.[101] Deferred

[96] *See e.g.*, Richard Posner, *Are American CEOs Overpaid, and, if so, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1045-46 (2009), suggesting that restricted stock should constitute a minimum fraction of CEO pay.

[97] *See* Jesse Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEX. L. REV. 1113, 1114 (2010-2011).

[98] *See* David Walker, *supra* note 40, at 648- 660, providing statistical data and analysis for hundreds of public companies.

[99] *Cf.* ROY ALLEN, FINANCIAL CRISES AND RECESSION IN THE GLOBAL ECONOMY, 80 (2009); Lynne Dallas, *supra* note 5, at 270 and 306-07.

[100] *See* Lucian Bebchuk & Jesse Fried, *supra* note 36, ch. 14; *Cf*. Brian Hall, *The Pay to Performance Incentives of Executives Stock Options* (NBER Working Paper Series, Cambridge, MA 1998) 1, noting that in 1980 the average stock option grant represented less than 20 percent of direct pay and the median stock option grant was zero.

[101] Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, at 363, 465-66 (2009), stating that "[m]anagers with longer horizons will, we think, be less likely to engage in imprudent business or financial strategies or short-term earnings manipulation when the ability to exit before the problem comes to light is greatly diminished"; Lucian Bebchuk & Jesse Fried, *Paying For Long-Term Performance*, 158 U. PA. L. REV. 1915, 1919 (2009-2010); Ira Kay & Steven van Putten, *supra* note 87, at 5, 169, 174, 175.

compensation will thus separate the time that most of the restricted stock or options can be cashed out from the time that the equity vests. Furthermore, equity should vest on certain anniversaries only after the compensation committee has reviewed the achievements of the executive and approved of the vesting. Thus, equity compensation should ideally always constitute performance-based awards, and the compensation committee should exert its control function both with respect to annual fixed compensation and parts of previous years' equity compensation that are due to vest that same year.

Performance-based awards must align with critical strategic performance, but it can be difficult to set challenging yet realistic long-term goals, especially in light of market uncertainties. This obstacle should, however, not be of great concern, if the effect of market uncertainties, unpredictable events and shocks is neglected and considered to neutrally influence executive performance. This presupposes that the risks of fluctuating markets, shocks and uncertainties are born by both the executives and their firms. This is just and fair when we take into account that the higher the amount of awards one can receive the greater the risks one has to bear to maximize her earnings.

The Dodd-Frank Act does not preclude a firms' freedom to determine its own pay elements and mix of payment methods. However, if firms decide to provide more stock options than other forms of payment or if the mix of payment methods is unbalanced, the SEC should require them to explain in their disclosure of compensation policy how these awards will not induce excessive risk-taking and poor performance. The SEC should also instruct companies to disclose in every detail how each element of the long-term payment program will help reduce risky behavior and enhance cooperation among executives and other officials of the firm,[102] especially between higher management and risk management. This is essential, because the close cooperation between higher and risk management is the only way to identify, predict, control, reduce and counterbalance possible risks at an early stage of a company's operation and planning.[103]

[102] *Cf.* Lucian Bebchuk & Jesse Fried*, id.*, at 1921; Lucian Bebchuk & Holger Spamann, *supra* note 2, at 254.

[103] *Cf.* Kristin Johnson, *supra* note 2, at 55, 66; COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, ENTERPRISE RISK MANAGEMENT-INTEGRATED FRAMEWORK: EXECUTIVE SUMMARY (2004), available at: http://www.coso.org/Publications/ERM/COSOERMExecutiveSummary.pdf (last accessed: 27 June 2013).

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2. Disclosure of the Understanding of Long-Term Performance

The European Commission has suggested that a five year period in a company's life provides a good proxy for its long-term performance.[104] The Dodd-Frank Act itself seems to suggest that five years are a good time frame for assessing the effects of managerial compensation schemes. It goes without saying that the definition of long-term performance measures presupposes that the total sum of a manager's annual fixed and variable compensation scheme can be established annually, but variable compensation in form of equity would be allowed to vest periodically, on certain anniversaries over a longer time period, during which performance is measured with the help of the abovementioned metrics.

The five year period does not seem to be a reliable macro- or a reliable microeconomic indicator either. In some cases, shorter or longer periods would be appropriate. There seems to be an interconnection between the design of a compensation scheme and the inherent risks of each business sector. In pharmaceutical or life science companies, which have long business cycles, the incentive plans should be focused on longer term results than, *e.g.*, in accounting companies. It is crucial to tie the compensation schemes to the time horizon of the business cycle. Taking into account the diversity of situations, with which companies of different branches are confronted, it does not seem possible to propose a common definition of long-term performance for all business sectors.

It would be helpful if the SEC suggested a general method for defining the overall time period, over which the variable part of the annual compensation should vest periodically in order to enable the company to control and verify the achievement of long-term goals by its executives. There are two options for the SEC: to use statistical and historical data and, after consulting all affected industries, to define the approximate length of each industry's business cycle. On the basis of this information it could eventually determine the appropriate timeframe for evaluating long-term performance and subsequently the time period over which equity can periodically vest and be cashed out.

A less interventionist option, which is more compatible with the Dodd-Frank Act's legislative goals, would be for the SEC to require firms to explain how they estimate the length of their business cycle, how they define and measure their long-term performance and how they intend to adapt their compensation policy to achieve good long-term performance. This all should be part of a company's extended disclosure duties toward its shareholders and the Agency.

[104] European Commission Recommendation 2009/385/EC of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies O.J. (L 120).

3. Disclosure of Incentive Plans' Design

In accordance with the principles for the determination of the optimal pay mix set above, the SEC should recommend in its revised disclosure rules that companies should negotiate a bipartite executive pay package, which would include a fixed and a variable part. The fixed part could be payable to executives irrespective of the company's performance in the year of payment. Compensation in form of bonuses could also be included to provide a motivation for good short-term performance. Nevertheless, such bonuses should be held relatively low compared to the equity grants of the actual variable part of the compensation scheme.

Optimal variable compensation design should combine a performance with a fixed-date element. Equity grants of the variable part of the compensation scheme could vest in year X after certain performance targets have been reached and its unwinding should then be allowed. The reaching of these goals should be examined from the perspective of actual performance in the market after share value and other metrics have been taken into account by the board and/or its compensation committee, as mentioned above.[105] The fixed part should ideally not exceed the variable part. This means that if a firm decides to pay a total amount of X Dollars to its CEO and determines that this sum shall be payable under the condition that certain revenue growth targets will have been reached within a five-year period, the fixed part, which constitutes part of the total compensation, should be paid in the first year of that reference period.[106]

It would certainly be not as effective to pay the whole compensation in the first year and apply a clawback clause to recover previously awarded compensation *ex post*, if the goals agreed with the manager have not been reached in the underlying performance period of the company. There are litigation and collection risks associated with the enforcement of a clawback clause, which make it not the instrument of first choice for retrieving such high amounts.[107]

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[105] *See* David Walker, *supra* note 40, at 653, noting that such compensation schemes as "stock" "compensation which takes the form of conventional time-vested restricted stock, performance-vested restricted stock, which is actually time and performance vested, and performance shares, which are contractual arrangements that are equivalent economically to performance-vested restricted stock" are available to every public company and have been employed to various degrees by the boards of public companies.

[106] *Cf.* David Walker, *supra* note 40, at 631, who refers to Moody's Corp. compensation practices as a characteristic example of performance-vested restricted stock scheme "[t]hat vests relatively slowly, or relatively quickly, depending on growth in the company's annual operating income".

[107] *See* Lucian Bebchuk & Jesse Fried, *supra* note 102, at 1920, noting that it is essential for avoiding both spring-loading and stock-price manipulation around equity grants that at the time of vesting "the timing of equity grants should not be discretionary, and equity awards should be made only on certain prespecified dates. In addition,

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The fixed-date element should essentially function as described by Professors Bebchuk and Fried: an executive would be obliged to hold an equity grant for a fixed period of time after it vests, even if that fixed period may extend into the retirement of an executive. After this pre-specified period of time,[108] the executive would be free to unwind a certain percentage of the equity grant.[109] On each of the following anniversary dates, the executive would be free to unwind another part of the grant. So, for example, the executive would be permitted to sell the first part of equity grants two years after vesting, another part three years after vesting, and the remaining part X, X+1, X+2, X+n years after vesting.[110] The gradual unwinding feature prevents an executive from cashing out almost all of her unliquidated equity at once.Thus, even in the year preceding her retirement the executive will still be inclined to consider the implications of her current managerial actions on long-term firm value as expressed in share value.[111]

Furthermore, it is essential that in any given year, managers would not be allowed to unload more than a specified percentage of the total vested equity they hold at the beginning of the year. It must be stressed that the total vested equity a manager holds at the beginning of a given year will be representing a certain percentage of the variable part of compensation of more than one year's total compensation sum. This rule will prevent managers from attempting to manipulate stock prices in any given year to earn more at the expense of the stock price of her company's equities in the more distant future. A

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the terms and value of equity grants should not be linked to the grant-date stock price, which can easily be manipulated".

[108] *See* Robert Scully Jr., *supra* note 51, at 40; Alfred Rappaport, *Economics of Short-Term Performance Obsession*, 61 FIN. ANALYST J. 65, 73 (2005), discussing how "[r]elatively short vesting periods coupled with the belief that earnings fuel stock prices encourage executives to manage earnings, exercise their options early, and cash out shares opportunistically".

[109] *See* Lucian Bebchuk & Jesse Fried, *supra* note 102, at 1923, noting that usually, once options vest, they typically remain exercisable for ten years from the grant date. "[H]owever, standard arrangements allow executives to exercise the options and sell the underlying shares immediately upon the vesting of their options".

[110] *See* Lucian Bebchuk & Jesse Fried, *supra* note 102, at 1920, noting that at the time of unwinding it is essential "to reduce the executives' ability and incentive to time dispositions based on inside information, as well as reduce executives' ability and incentive to manipulate the stock price around the time of disposition. Executives could be required to announce their intentions to unwind equity in advance. Firms could also use 'hands-off' arrangements under which an executive's vested equity incentives are automatically cashed out according to a schedule specified when the equity incentives are initially granted".

[111] *See* Lucian Bebchuk & Jesse Freed, *supra* note 102, at 1928-29.

manager should only be allowed to unload a small percentage, e.g., ten percent of his total vested equity in that year, which will make stock price manipulation costly given the danger of a decline in the value of the ninety percent of his remaining vested equity that she can only sell in subsequent years.[112]

It is also important to provide incentives that go against rather than with the prevailing direction of the business cycle. This has to be reflected in the mechanism of unloading equities, which constitute the variable part of compensation. At the beginning of business cycles, especially when the market and the firm is growing, the unwinding of equities should be countercyclical. The amount of equities that may be unloaded on the anniversary dates after one, two and three years of operation should be much lower than the amount of equities that can be unloaded in the fourth and fifth years. The percentage of equities that can be unloaded at the beginning or in the middle of a business cycle must be much lower than the amounts that can be unloaded at the end of the business cycle. This way, managers will have more incentives to try their best and extend the business cycle, to prevent underperformance and stagnation through innovation, synergies and more sophisticated strategies of recovery and cooperation to save not only their company but, eventually, also their sector from falling into a bust.[113] This cannot stop the cycle, but it will slow it down and it will produce a softer landing, prepare a faster recovery process or even prevent the bust altogether.[114]

E. Conclusion

After the 2008 financial crisis lawmakers and regulators were ultimately convinced that they should act on the basis of the theory that flaws in compensation schemes created incentives for executives and other financial industry employees to take on excessive risk,

[112] *Id.* at 1933.

[113] *Cf.* Mason Carpenter, *The Price of Change: The Role of CEO Compensation in Strategic Variation and Deviation from Industry Strategy Norms*, 26 J. O. M. 1179, 1184, 1185, 1194, 1195 (2000), arguing that increases in long-term pay and long-term pay structure promotes strategic change, which fosters competitive advantage and secures the viability of a company.

[114] *Cf.* Michael Kowalik, *Countercyclical Capital Regulation,* 2 FED. RES. KAN. CITY ECON. REV. 63-64 (2011).

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which in the aggregate led to the creation of systemic risk that posed an immeasurable threat to the US and world economies.

Congress attempted to resolve these problems through the enactment of the Dodd-Frank Act. However, the provisions for executive pay packages in the financial industry have not yet been adequately implemented to achieve the legislative goal of preventing excessive risk-taking and systemic risks that can induce financial crises in the future. Furthermore, there is need for corporate governance regulation of the same quality both in the financial and other business sectors, since – as economic history has clearly shown – economic crises can equally originate in failures of non-financial businesses. Moreover, by pursuing regulatory intervention in the compensation policies of all type of publicly held corporations, two major drawbacks can simultaneously be remedied: major economic recessions and the pay without performance fallacy.

Because say-on-pay rights and compensation committee independence do not enable the shareholders and the board of directors to exercise their shareholding or monitoring rights and control functions effectively, they cannot offer a real solution to the principal-agent problem and align the interests of executives with those of shareholders. It is necessary for Congress and the SEC to complement the organizational and procedural provisions of the Dodd-Frank Act with some guidelines and extensive disclosure obligations for compensation committees to comply with when deciding on compensation policies and individual incentive plans.

There should be minimum standards for the design of compensation schemes in non-financial sectors, which would prescribe a bipartite pay package consisting of a fixed and a variable part. The variable part should be larger than the fixed part and mainly consist of performance-vested restricted stock to ensure that the board and the compensation committee only pay for performance. Furthermore, an executive should be obliged to hold an equity grant for a fixed period of time after it vests. After this pre-specified period the executive would be free to unwind a certain percentage of equity. On each of the following anniversary dates, the executive would be free to unwind another part of the grant. This rule will prevent a manager from attempting to manipulate stock prices to earn more in any given year at the expense of the stock price of her company's equities in the more distant future.

It is also of cardinal importance that the minimum standards for the optimal design of compensation schemes provide incentives that go against rather than with the prevailing direction of the business cycle and that this will be reflected in the mechanism of unloading equities. At the beginning of business cycles, especially when the market and/or the firm is growing, the unwinding of equities should be countercyclical. The amount of equities that may be unloaded on the anniversary dates after one, two, and three years of operation should be much lower than the amount of equities that can be unloaded in later

years. This mechanism fosters strategic thinking, prevents excessive risk-taking, enhances a company's competitiveness and ensures its viability.

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