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You Can’t Stop What You Can’t See: Complementary Risk Mitigation Through Compensation Disclosure

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YOU CAN'T STOP WHAT YOU CAN'T SEE: COMPLEMENTARY RISK MITIGATION THROUGH COMPENSATION DISCLOSURE

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The end of man is knowledge, but there is one thing
he can't know. He can't know whether knowledge
will save him or kill him. He will be killed, all right,
but he can't know whether he is killed because of the
knowledge which he has got or because of the
knowledge which he hasn't got and which if he had
it, would save him.
—Robert Penn Warren, *All The King's Men*[1]

ABSTRACT

Section 956 of the Dodd-Frank Act requires regulators to help prevent the next financial crisis by monitoring executive compensation arrangements to prevent them from becoming excessive or leading to "material financial loss." A now-pending rule seeks to do just this. This Article argues that the rule is well-conceived inasmuch as it limits the total portion of compensation that can be based on risk-inducing incentives, ties incentive-based compensation to longer-term performance, places a ceiling on potential incentive-based earnings, provides for downward adjustment and clawbacks,

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[1] ROBERT PENN WARREN, ALL THE KING'S MEN 14 (2005).

prohibits many hedging behaviors, and institutionalizes governance mechanisms and oversight policies. But, by placing a number of scholars in conversation, the Article proposes a framework within which incentive-based compensation creates risk. Within this framework, the rule is insufficient to prevent systemic risk. Accordingly, this Article proposes that regulators add to the rule a requirement that companies disclose the full annualized value of key executives, subdivided and monetized into salary, benefits, incentive pay, and perquisites. Doing so will allow market actors to make important qualitative judgements about corporate risk taking. This disclosure requirement will complement the proposed regulatory mechanisms and allow regulators to verify compliance ex post as market actors mitigate risk ex ante.

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INTRODUCTION

United States regulatory agencies have been tasked with preventing the unknowable cause of the next financial crisis.[2] Success is immeasurable because stopping ten crises and never facing another brings the same result: business as usual. Failure, on the other hand, could upend the global economy.[3] Again.[4]

To prevent future upheaval, regulators' ex post analysis of the 2008 crisis[5] must correctly identify structural sources of risk to guide rulemaking that mitigates systemic risk ex ante.[6] This Article considers a now-pending rule that seeks to mitigate systemic risk arising from executive compensation arrangements.[7] Section 956 of the Dodd-Frank Act requires regulators to monitor executive[8] compensation arrangements to prevent them from becoming excessive or from leading to "material financial loss."[9] The pending rule will mitigate some risk by limiting incentive-based pay by subjecting deferred compensation to downward adjustments and clawback provisions, by eliminating certain hedging behaviors, and by institutionalizing certain corporate governance measures.[10] However,

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[2] *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376–2223 (2010) (codified as amended at 12 U.S.C. §§ 5301–5641 (2012)).

[3] *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, at xvii, 117, 354, 389–90, 397 (2011) [hereinafter FCIC REPORT].

[4] *See generally id.*

[5] The crisis is referred to in the Article as the "2008 crisis," not because it began in or was limited to that year, but to denote that the crisis came to a head in that year, as demonstrated by the market crash. *See, e.g.*, *id.* at 213–14, 256–353.

[6] *See* John H. Farrar & Louise Parsons, *Globalisation, the Global Financial Crisis and the Reinvention of the State*, 24 SING. ACAD. L. J. 367, 398 (2012).

[7] Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670 (proposed June 10, 2016) (to be codified at 17 C.F.R. pts. 240, 275, 303). This Article refers to this rule as the Re-Proposed Rule in the main text.

[8] This Article uses the word "executive" generically to stand in for the subset of employees in financial institutions who are entrusted with making decisions that put the firm's well-being at risk. The Re-Proposed Rule effectively defines this group with its criteria for "covered persons." *Id.* at 37,690.

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, § 956, Pub. L. No. 111-203, 124 Stat. 1376, 1905–06 (codified as amended at 12 U.S.C. § 5641 (2012)).

[10] The Re-Proposed Rule divides institutions into Level 1, Level 2, and Level 3 institutions. Incentive-Based Compensation Arrangements at 37,684. All of the

the rule could better account for certain qualitative risks inherent in the corporate structure, including the risks that executives will continue bargaining for excessive salaries, that boards may not discipline risk-taking executives, and that corporations may offset deferred compensation in a way that minimizes its effect.[11] To reduce these qualitative risks, this Article proposes mandating a robust disclosure requirement similar to some already in use by the Securities and Exchange Commission,[12] to the recommendations of the 2010 Guidance on Sound Incentive Compensation Policies,[13] and to The Basel Committee's Pillar 3 Disclosure Requirements.[14]

I. Background

Before the end of 2008, several large U.S. investment banks faltered, some failed, and the financial consequences threatened to derail the global economy.[15] These failures were the result of a series of unforeseen circumstances, and they caused considerable human suffering and outrage.[16] The crisis caused 17 trillion dollars in household wealth to disappear and raised unemployment

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rule's requirements apply to Level 1 institutions, which have over $250 billion in average total consolidated assets. *Id.* at 37,685. The least stringent requirements apply to Level 3 institutions, which have average total consolidated assets over one billion dollars but less than fifty billion dollars. *Id.* This Article considers the rule at its zenith, so focuses primarily on those requirements placed on Level 1 institutions. It is important to note, though, all of the major substantive requirements apply to all covered institutions. *See id.* Level 1 institutions are simply given more flexibility and less regulatory burden. *See id.*

[11] *See generally id.*

[12] *See, e.g.*, Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,224–25 (issued Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274); Proxy Disclosure and Solicitation Enhancements, 75 Fed. Reg. 9100 (corrected March 1, 2010) (to be codified at 17 C.F.R. pt. 249); 17 C.F.R. § 229.402 (2016) (as enacted).

[13] *See* 75 Fed. Reg. 36,395, 36,395–414 (issued June 25, 2010) (referred to as the "2010 Guidance" within this Article).

[14] *See* Basel Committee on Banking Supervision, Pillar 3 disclosure requirements for remuneration, July 2011, http://www.bis.org/publ/bcbs197.pdf [https://perma.cc/93ZM-M5FF] [hereinafter Basel Committee, Pillar 3]; Basel Committee on Banking Supervision, Revised Pillar 3 disclosure requirements for remuneration (2015), https://www.bis.org/bcbs/publ/d309.pdf [https://perma.cc/4YSF-RXFL] [hereinafter Basel Committee, Revised Pillar 3].

[15] *See, e.g.*, FCIC Report, *supra* note 3, at xv–xvi, 233–56.

[16] *See, e.g.*, *id.* at 3, 23, 353–402.

to over ten percent.[17] In 2008 alone, there were over three million home foreclosures, "over two million Americans lost their homes," and over 2.6 million people lost their jobs.[18] By 2010, the Fed had provided banks an aggregate of over 19 trillion dollars in emergency credit.[19] Between 2007 and 2015, 518 U.S. banks failed.[20] And yet, banking industry executives continued earning billions.[21] In the last quarter of 2008, the same banking firms that were reporting multi-billion-dollar losses and borrowing money from taxpayers were also obligated by preexisting compensation arrangements to pay employees a composite total of around $18.5 billion in bonuses.[22]

Reasonable minds pinpoint the crisis's cause differently—both during its immediate aftermath, and in the academic and policy debates that have followed.[23] However, the generally accepted narrative lays at least some of the blame at the feet of the same

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[17] *Id.* at 389 ("Seventeen trillion dollars in household wealth evaporated within 21 months, and reported unemployment hit 10.1% at its peak in October 2009.").

[18] Janice Kay McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wake-up Call for Reforming Executive Compensation*, 12 U. PA. J. BUS. L. 131, 132–33 (2009).

[19] Arthur E. Wilmarth, Jr., *A Two-Tiered System of Regulation is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks*, 2015 MICH. ST. L. REV. 249, 262 (2015).

[20] *See* Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,675 (proposed June 10, 2016) (to be codified at 17 C.F.R. pts. 240, 275, 303).

[21] McClendon, *supra* note 18, at 134.

[22] *Id.* at 134–35 ("In 2008, New York City Wall Street Investment bank employees made approximately $18.5 billion in bonuses.... These [individual] multi-million dollar bonuses were primarily related to past MBS originations or sales that produced short-term corporate gains and were paid under existing contractual agreements, even though these financial institutions were reporting then-current multi-billion dollar quarterly and annual losses.").

[23] *See, e.g.*, Jeffrey M. Lipshaw, *The Epistemology of the Financial Crisis: Complexity, Causation, Law, and Judgement*, 19 S. CAL. INTERDIS. L. J. 299, 299–351 (2010) (arguing that complexity led to the crisis, and poses an insurmountable obstacle to regulators. He is "skeptical that regulation can eliminate objectionable levels of boom-and-bust."); Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?*, 64 SMU L. REV. 1243, 1249 (2011) ("[I]t was the 'big banks'—by funding the subprime lenders, buying their mortgages and securitizing them, slicing them to form CDOs and synthetic CDOs through derivatives, and leaning on the credit rating agencies to get AAA ratings for junk—that were the primary cause of the financial crisis."); Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 375–76 (2008) (blaming "conflicts of interest, investor complacency, and overall complexity" which was exacerbated by greed).

banking executives who collected these bonuses.[24] This consensus extends to conclude "that flawed incentive-based compensation practices in the financial industry were one of many factors contributing to the financial crisis[.]"[25] Unsurprisingly, when Congress passed a financial reform bill in the wake of the crisis, it sought to curb incentive-based compensation.[26]

In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in direct response to the financial crisis.[27] In its final form, the law runs to just under 850 pages and contains hundreds of sections.[28] Section 956 of the Act required the regulators of jurisdiction[29] jointly to pass "regulations or guidelines" by March of 2011 requiring financial institutions to disclose to regulators "the structures of all incentive-based compensation arrangements offered" sufficient to determine whether compensation is (1) excessive or (2) "could lead to material financial loss[.]"[30] However, the law does not require institutions to report actual compensation of particular individuals and does not require companies with less than one billion dollars in assets to comply.[31]

Within one month of the statutory deadline, the regulatory agencies of jurisdiction issued a notice of proposed rulemaking and solicited public comment.[32] The rule had five key substantive features. First, it prohibited excessive compensation, as defined

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[24] *See, e.g.*, FCIC REPORT, *supra* note 3, at xxv–xxvi, 417–19 (dissenting statement). Other generally accepted causes included a credit bubble, a housing bubble, low interest rates, risky mortgage instruments, concentrated institutional risk, leverage and liquidity risk from reduced institutional capital, and contagion. *Id.*

[25] Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37,674 (citing FCIC REPORT, *supra* note 3, at 209, 279, 291, 343).

[26] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 956, Pub. L. No. 111-203, 124 Stat. 1376, 1905–06 (codified as amended at 12 U.S.C. § 5641 (2012)).

[27] *See generally id.*

[28] *See generally id.*

[29] *See* Incentive-Based Compensation Arrangement, 81 Fed. Reg. at 37,670–71. These agencies include the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the Securities and Exchange Commission, and the Federal Housing Finance Agency. *Id.*

[30] Dodd-Frank Wall Street Reform and Consumer Protection Act § 956.

[31] *Id.*

[32] Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (proposed April 14, 2011) (referred to in the text as the "Proposed Rule").

by the rule, through the use of incentive-based compensation that motivated excessive risk taking.[33] Second, it prohibited institutions from using incentive-based compensation arrangements that encouraged inappropriate risk of material financial loss.[34] Third, it required institutions to establish appropriate compliance policies within a flexible framework.[35] Fourth, it required annual reports to regulators on the structure of existing incentive-based compensation plans.[36] Finally, it required deferred compensation at some larger institutions.[37]

The Proposed Rule received more than 10,000 comments.[38] While most of the comments were form letters, the academic community contributed, too.[39] These academics' recommendations included:

> Adopting a corporate governance measure tied to stock ownership by board members; regulating how deferred compensation is reduced at future payment dates; requiring covered institutions' executives to have "skin in the game" for the entire deferral period; and requiring disclosure of personal hedging transactions rather than prohibiting them.[40]

The institutional stakeholders also responded. They generally sought the issuance of guidelines rather than a rule, requested clarification, and argued that the scope of the 2011 rule was too broad

[33] *Id.* at 21,178.

[34] *Id.*

[35] *Id.* at 21,179–80, 21,183.

[36] *Id.* at 21,172, 21,184.

[37] *Id.* at 21,180–83.

[38] Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670, 37,677 (proposed June 10, 2016) (to be codified at 17 C.F.R. pts. 240, 275, 303).

[39] *Id.* The form letters fell into two categories: (1) advocating for minimizing "the incentives for short-term risk-taking by executives by requiring at least a five-year deferral period for executive bonuses at big banks, banning executives' hedging of their pay packages, and requiring specific details from banks on precisely how they ensure that executives will share in the long-term risks" or (2) claiming to be from someone affected by the financial crisis and in favor of measures such as "basing incentive-based compensation on measures of a financial institution's safety and stability, such as the institution's bond price or the spread on credit default swaps." *Id.* Other commenters encouraged measures including strengthening the rule, revising certain definitions, increasing the deferral period for incentive-based compensation, including more data in annual reports on incentive-based compensation, and "public reporting by the Agencies of information quantifying the overall sensitivity of incentive-based compensation to long-term risks at major financial institutions[.]" *Id.*

[40] *Id.*

(either in terms of which institutions would be covered or which employees within those institutions would be covered).[41] Further:

> Many of these [institutional] commenters also opposed the 2011 Proposed Rule's mandatory deferral provision, and some asserted that the provision was unsupported by empirical evidence and potentially harmful to a covered institution's ability to attract and retain key employees. In addition, many of these commenters asserted that the material risk-taker provision in the 2011 Proposed Rule was unclear or imposed on the boards of directors of covered institutions duties more appropriately undertaken by the institutions' management. Finally, these commenters expressed concerns about the burden and timing of the 2011 Proposed Rule.[42]

No final rule was issued.

On June 10, 2016, the rule was re-proposed in a 170-page entry in the Federal Register.[43] The comment period closed on July 22, 2016. While the Re-Proposed Rule largely matches—but expounds upon—the 2011 rule, it does include changes that purport to account for a number of developments in regulatory practice since 2011.[44] Notable changes include: a shorter deferral period for incentive-based

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[41] *Id.*

[42] *Id.*

[43] *Id.* at 37,670.

[44] *Id.* at 37,673, 37,679 ("Since the 2011 Proposed Rule was published, incentive-based compensation practices have evolved in the financial services industry. The Board, the OCC, and the FDIC have gained experience in applying guidance on incentive-based compensation, FHFA has gained supervisory experience in applying compensation-related rules adopted under the authority of the Safety and Soundness Act, and foreign jurisdictions have adopted incentive-based compensation remuneration codes, regulations, and guidance. In light of these developments and the comments received on the 2011 Proposed Rule, the Agencies are publishing a new proposed rule to implement section 956.... [T]he proposed rule reflects the Agencies' collective supervisory experiences since they proposed the 2011 Proposed Rule. These supervisory experiences, which are described above, have allowed the Agencies to propose a rule that incorporates practices that financial institutions and foreign regulators have adopted to address the deficiencies in incentive-based compensation practices that helped contribute to the financial crisis that began in 2007. For that reason, the proposed rule differs in some respects from the 2011 Proposed Rule.").

compensation, an added clawback provision for referred compensation, and a record-keeping requirement in place of the annual incentive-based compensation reporting requirement.[45]

The 2011 Proposed Rule sought to lower the chances of future crises by curtailing the excessive risk-taking behaviors encouraged by executive compensation arrangements.[46] The Re-Proposed Rule improves on these efforts, but it could do more with an added compensation disclosure requirement.[47] To understand why such an added requirement is needed, I turn now to the theoretical framework within which the problem of excessive executive compensation arises.

II. THE PROBLEM OF EXCESSIVE COMPENSATION

Executive compensation contributed to the financial crisis by incentivizing—but not penalizing—corporate risk taking.[48] The high demand for housing created market risk.[49] The practices of mortgage brokers were based on faulty assumptions about the

[45] *Id.* at 37,680–81 ("The 2011 Proposed Rule contained an annual reporting requirement, which has been replaced by a recordkeeping requirement.... Unlike the 2011 Proposed Rule, the proposed rule would explicitly require a shorter deferral period for incentive-based compensation awarded under a long-term incentive plan.... [T]he proposed rule would require a Level 1 or Level 2 covered institution to include clawback provisions in the incentive-based compensation arrangements.... The 2011 Proposed Rule did not include a clawback requirement.").

[46] *See* Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (proposed April 24, 2011).

[47] *See generally* Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670.

[48] *See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE, INCENTIVE COMPENSATION PRACTICES: A REPORT ON THE HORIZONTAL REVIEW OF PRACTICES AT LARGE BANKING ORGANIZATIONS 1 (2011) (concluding that "[r]isk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007.") [hereinafter FEDERAL RESERVE]; *see also* FCIC REPORT, *supra* note 3, at xvii (concluding that the crisis could have been avoided, but "[t]he captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public.").

[49] *See, e.g.*, Andrea J. Boyack, *Lessons in Price Stability from the U.S. Real Estate Market Collapse*, 2010 MICH. ST. L. REV. 925, 927 (citing Gilbert Burck, *A New Kind of Stock Market*, FORTUNE, Mar. 1959, at 120, 201 (quoting Alan Greenspan discussing how high demand leads to high prices, which could result in disaster)).

market, which created risk.[50] Many realtors and appraisers were drawn into the cycle by what they perceived as competitive business practices.[51] As homes were valued and mortgaged, and individual mortgage instruments were bundled, rated, sold, and securitized, the risk spread from individual loans to the entire system.[52] The market risk of one overvalued house, owned by an over-leveraged and undercapitalized family with a single subprime mortgage was multiplied when it was bundled with similarly risky mortgages in security instruments or collateralized debt obligations which were fully financialized in the form of credit default swaps; risk was added to risk.[53] But the managers and executives with the information and sophistication to identify and mitigate these risks did not break the cycle.[54] Instead, they seized on these risky transactions to increase their own income.[55] The structure of their compensation arrangements—which in 2008 ultimately externalized market risk to American taxpayers—incentivized their seemingly reckless behavior.[56]

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[50] *See, e.g.*, *id.* at 949–50, n.145 (discussing the recklessness in the primary mortgage market and citing to a statement from the president of the Mortgage Brokers Association for Responsible Lending in which his organization found that within a small sample of mortgage applications, 60 percent of applicants overstated household income by over 50 percent).

[51] *See, e.g.*, Mary Szto, *Real Estate Agents as Agents of Social Change: Redlining, Reverse Redlining, and Greenlining*, 12 SEATTLE J. SOC. JUST. 1, 42 (focusing on the systemic racism in historical practices of realtors, specifically discussing "steering" during the housing bubble, which led the Realtor's association in 2006 to begin "a multi-million dollar media campaign ... to ... convince [buyers] that it was a great time to buy" and providing realtors in its magazine publication "scripts for dealing with clients worried about the advisability of buying in a down market[,]" concluding that "[m]any mortgage companies were 'captive lenders' of the real estate agents.") (internal quotations omitted); *see also* J. Kevin Murray, *Issues In Appraisal Regulation: The Cracks in the Foundation of the Mortgage Lending Process*, 43 LOY. L.A. L. REV. 1301, 1309–18 (2010) (discussing the ease with which appraisals can be inaccurate, and the negative effect that even a small number of unscrupulous appraisers can have within a local market).

[52] *See* Boyack, *supra* note 49, at 941–42, 946–47.

[53] *See* Murray, *supra* note 51, at 1312 (discussing the overpricing of homes by appraisers); Boyack, *supra* note 49, at 950 n.145 (discussing the lack of accurate reporting of income on subprime loans).

[54] *See* Boyack, *supra* note 49, at 964.

[55] *Id.*

[56] *See* FEDERAL RESERVE, *supra* note 48, at 1.

Managers' and executives' own pecuniary interests, which in some cases eclipsed their obligations to corporate shareholders and the public, left banking industry executives standing in the rubble of the U.S. financial markets in 2008 holding $18.4 billion in bonuses.[57] This scene was the natural consequence of an organizational structure that separates the functions of firm ownership and firm control.[58] Put simply, firm owners want to maximize the market value of their firms, while agents (non-owners who control firms) want to maximize present compensation and their power to leverage firms to increase future compensation.[59] Because of this conflict, a firm owner must spend money and effort to ensure that the agent is acting in the firm's best interest.[60] The costs of aligning these interests are "agency costs,"[61] and controlling these costs is a principle function of corporate law.[62] The compensation arrangements that rewarded the excessive risk taking that led to the 2008 crisis resulted directly from these agency costs.[63]

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[57] Ben White, *What Red Ink? Wall Street Paid Hefty Bonuses*, N.Y. TIMES, (Jan. 29, 2009), http://www.nytimes.com/2009/01/29/business/29bonus.html?ref=business [https://perma.cc/9QGQ-22Y7].

[58] *See* JOHN ARMOUR, HENRY HANSMANN & REINIER KRAAKMAN, HARVARD JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS, DISCUSSION PAPER NO. 644, AGENCY PROBLEMS, LEGAL STRATEGIES AND ENFORCEMENT 2 (2009).

[59] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 16 (2004).

[60] *See id.* at 17.

[61] A full exploration of agency costs would require a scope and expertise exceeding that of this Article. Agency theory combines work in economics, property rights, finance, and behavioral theory. For a helpful overview of the effects of agency costs on the corporate structure, see generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, *in* FOUNDATIONS OF CORPORATE LAW 7 (Roberta Romano ed., 1993). Jensen and Meckling define agency costs as "the sum of: 1. the monitoring expenditures by the principal [including 'efforts ... to "control" the behavior of the agent through budget restrictions, compensation policies [and] operating rules ...'] 2. the bonding expenditures by the agent, [and] 3. the residual loss." *Id.* at 7 n.1.

[62] *See* ARMOUR ET AL., *supra* note 58, at 2 (pointing out that one of the two general functions of corporate law is to attempt "to control conflicts of interest among corporate constituencies, including those between corporate 'insiders,' such as controlling shareholders and top managers, and 'outsiders,' such as minority shareholders or creditors").

[63] *See* Richard Posner, Essay, *Are American CEOs Overpaid, and, if so, What if Anything Should be Done About It?*, 58 DUKE L. J. 1013, 1029 (2009).

In a corporation, the board of directors sets and monitors executives' salaries.[64] Seeking to resolve the conflicting interests of shareholders and executives, boards tie pay to pre-determined performance measures to better align executive decision making with shareholder interests.[65] However, this introduces uncertainty in the executives' pay arrangement, which justifies a demand for higher pay as a counterbalance. Directors can rationalize this higher pay to shareholders by focusing on the cost of the salary, without considering the cost of the added risk.[66] Since the variability should, in theory, guarantee that large payouts are only in exchange for good performance, the added rents of an excessive payout are like a "success tax," the effect of which is dispersed across all shareholders. In contrast, when fixed pay makes up most of an executive's salary, shareholders pay too much for poor performance.[67] To further soften the impact of poor performance, executives engage in hedging behaviors like negotiating for large severance packages known colloquially as "golden parachutes."[68]

Shareholder monitoring, the primary check on this demand for higher wages, can be ineffective because many directors do not bargain with executives at arm's length; directors face social and psychological pressures to favor a well-liked and powerful executive.[69] Outside consultants, hoping to be rehired by an executive, give advice that pushes salaries still higher.[70] Many board members are themselves executives at other firms, so they have their own interest in keeping executive pay high.[71] The resulting compensation arrangements mean that "there is no ceiling on the potential gain, but the loss is truncated at the value of the options" for an executive, which

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[64] *See, e.g.*, BRUCE R. ELLIG, THE COMPLETE GUIDE TO EXECUTIVE COMPENSATION 592–93 (McGraw-Hill 2007).

[65] *Id.* at 41–42, 69–75.

[66] *See id.* at 542 ("Reward should be in proportion to risk. The greater the risk, the greater the possible reward. This is the underlying principle of variable pay and pay for performance.").

[67] *Id.* at 535 ("The absence of incentive pay is the most expensive to the organization for poor performers (because of fixed pay) and the least expensive for good performers (again because of fixed pay).").

[68] *Id.* at 235–42.

[69] *See* BEBCHUCK & FRIED, *supra* note 59, at 31–32.

[70] *Id.*

[71] *Id.* at 33 (citing a 2002 survey that found that 41 percent of directors on compensation committees were executives, and of the 26 percent of board members who were retirees, most were former executives).

a golden parachute further mitigates.[72] The net effect is of "[i]ncentivizing the CEO to take risk, while at the same time cushioning him from the consequences of loss[,]" which is similar to the "mistake that led to the savings and loan crisis of the 1980s."[73] Ultimately:

> The greater [an executive's] compensation is, and the closer it is tied to the price of his corporation's stock, the greater his incentive to maximize short-run profits. The compensation he can earn in the short run provides a form of insurance against the consequences of mistiming the bubble and failing to jump off it before it bursts, as does a generous severance package.[74]

Additionally, because short-run corporate profits are more easily manipulated than long-run profits, such compensation arrangements can create incentives to engage in behaviors that hide information, manipulate fluctuations in stock prices, inflate the apparent value of a corporation, and ignore generally accepted auditing standards and best practices.[75]

However, these behaviors have a limit. Bebchuck and Fried coined the term "outrage costs" to describe the negative reactions of members of the public who become aware of large executive compensation arrangements.[76] These costs are the financial consequences of the reputational damage a firm suffers when the media and the public react to the appearance of cronyism, insider dealing, and corruption.[77] The Occupy Wall Street movement is an extreme example of this phenomenon,[78] and Senator Bernie Sanders's presidential campaign represented its national and mainstream politicization.[79]

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[72] Posner, *supra* note 63, at 1026–27 (citing Wm. Gerard Sanders & Donald C. Hambrick, *Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance*, 50 ACAD. MGMT. J. 1055, 1063 (2007)).

[73] *Id.* at 1027.

[74] *Id.* at 1041.

[75] *Id.* at 1039–40.

[76] BEBCHUK & FRIED, *supra* note 59, at 64–66.

[77] *Id.* at 65–66.

[78] *See, e.g.*, Sandra D. Jordan, *Victimization on Main Street: Occupy Wall Street and the Mortgage Fraud Crisis*, 39 FORDHAM URB. L.J. 485, 486, 491, 494 (2011) (explaining the Occupy Wall Street movement as a Marxist backlash against the perception that plutocratic power structures in the U.S. allowed perpetrators of fraud to precipitate the 2008 financial crisis and get away with it).

[79] Gregory Krieg, *Occupy Wall Street Rises up for Sanders,* CNN (April 13, 2016, 1:06 PM), http://www.cnn.com/2016/04/13/politics/occupy-wall-street-bernie

Regardless of how an executive secures a compensation award, once that award crosses a certain threshold, informed shareholders and an informed public will react.[80] When the reaction is widespread and forceful, it exercises an "outrage constraint" to curb corporate compensation policies.[81] It is, therefore, in the pecuniary interest of executives to prevent this outrage.[82] To do so, some have employed creative techniques to camouflage or legitimize their compensation arrangements.[83] These techniques include deferred compensation plans, using consultants with conflicting interests to justify increased compensation, and novel retirement arrangements, such as retirement perquisites (like sports tickets, chauffeured cars, corporate aircraft, or guaranteed consulting contracts) and corporate loans with favorable interest rates, which are sometimes forgiven completely.[84] Executives' ingenuity in negotiating and crafting ways to camouflage compensation seems boundless.

As Richard Posner points out, these behaviors stemming from agency costs fall on a spectrum.[85] Excessive compensation schemes are near one end of this spectrum, and criminal and fraudulent behaviors are at the other.[86] At the criminal end of this spectrum is what Christina Paragon Skinner has called "misconduct risk," which she defines as "the intentional distortion of information

-sanders-new-york-primary/ [https://perma.cc/V2S8-HNAJ]. In December 2011, Senator Sanders introduced the OCCUPIED (Outlawing Corporate Cash Undermining the Public Interest in our Elections and Democracy) Resolution, which was directly inspired by the Occupy Wall Street movement and which would have amended the U.S. Constitution to overturn *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2008), and which would prohibit corporate campaign spending. *See* Ashley Mushnick, *Senator Sanders Files Deutch Amendment to Ban Corporate Spending in Elections in U.S. Senate* (Dec. 8, 2011), http://teddeutch.house.gov/news/documentsingle.aspx?DocumentID=271767 [https://perma.cc/6TLE-Q8V4]; *see also* S.J. Res. 33, 112th Cong. (2011).

[80] BEBCHUK & FRIED, *supra* note 59, at 5.

[81] *See* Harrell 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, 762 (2010) (explaining the sweeping effects of public backlash over excessive executive compensation in the years leading up to the Great Depression).

[82] BEBCHUK & FRIED, *supra* note 59, at 65.

[83] *Id.* at 67–68.

[84] *Id.* at 70–71, 105–10, 112–14.

[85] Posner, *supra* note 63, at 1038–40.

[86] *Id.*

that, when aggregated and synchronized across institutions, undermines market safety and soundness."[87] Her framework consists of three key features, which create systemic risk by "operat[ing] in tandem as a misconduct contagion."[88] These features are ineffective board oversight, incentive-based compensation arrangements, and the transient nature of the banking industry's workforce.[89]

While Skinner focuses on fraudulent and illegal conduct, she readily acknowledges that much of the risk-taking behavior that led to the financial crisis "may *not* have been illegal."[90] Another scholar has concluded that "financial crises result from everyday activities performed by large swathes of the financial industry in an attempt to maximize short-term profits ... [and these activities are] rarely dishonest or sensational."[91] Consequently, the term "misconduct" incorrectly implies that all of the undesirable executive and corporate behaviors Skinner describes are proscribed.[92] To the contrary, the causes and effects Skinner describes apply to information distortion more broadly: intentional and unintentional, legal and illegal.[93] When viewed this way, Skinner's framework can demonstrate that incentive-based compensation not only encourages executives to make risky business decisions but also rewards the manipulation and distortion of information about a firm's value and performance.[94] Because information distortion obstructs corporate oversight, contagion factors can cause the risk-taking behavior to spread until it becomes systemic.[95] Who is best positioned to detect and counteract information distortion before it becomes systemic?

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[87] Christina Paragon Skinner, *Misconduct Risk*, 84 FORDHAM L. REV. 1559, 1562 (2016).

[88] *Id.* at 1563.

[89] *Id.* at 1563, 1577, 1580–84.

[90] *Id.* at 1570.

[91] Hilary J. Allen, *The Pathologies of Banking Business as Usual*, 17 U. PA. J. BUS. L. 861, 863 (2015).

[92] Skinner, *supra* note 87, at 1570–72.

[93] *Id.* at 1580–81.

[94] *See, e.g.*, Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 108 (1997) (arguing that optimistic cognitive biases and executives' cognitive "perceptual filters" lead to distortion in information flow and disclosure).

[95] *Id.* at 101–04.

Lawmakers, regulators, and litigants cannot predict and prevent all information distortion.[96] The best solution would leverage the knowledge and skill of market participants.[97] The sophisticated market participants who have the skill and knowledge to interpret data that might indicate a risk of information distortion or that would incentivize excessive risk taking, are called information traders.[98]

Information traders are one of five groups that form the capital market.[99] Sophisticated "institutional investors, money managers, and other market professional players ... [who rely] on some sort of financial or business analytical products" as well as "[s]ell-side analysts, buy-side analysts, and independent analysts" are all considered information traders.[100] Information traders are so named because they use information to assess the value of a market instrument, and they then trade when the market value doesn't match—selling overvalued stocks and buying undervalued stocks.[101] Information traders help ensure market liquidity and accurate pricing because they affect supply and demand with their trades.[102] When information traders buy, prices rise.[103] When they sell, prices

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[96] *See id.* at 134 n.238.

[97] Skinner, *supra* note 87, at 1587 ("[R]egulators frequently lack the real-time information to anticipate the types of activity that may lead to misconduct until significant damage is done[,]" and regulators lack executives' "expertise with new or emerging financial products and strategies," and regulators cannot identify where information distortion may appear); *see also* Allen, *supra* note 91, at 921 (concluding that neither regulatory nor legal solutions are effective, and "the maintenance of financial stability sometimes rests on financial industry participants *choosing* to care about the externalities of their actions").

[98] Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L. J. 711, 714 (2006). While Goshen and Parchomovsky's article focuses squarely on securities regulation alone, they recognize the close interplay between corporate law and securities regulation: "[T]he distinction between corporate law, whose goal is to reduce corporate agency costs, and securities regulation, the goal of which is to facilitate a competitive market for analysts, is not so clear. Although the essential role of securities regulation is to facilitate a market for information traders, it also contains provisions that aim partially or wholly at improving corporate governance structure." *Id.* at 751.

[99] *Id.* at 722 (defining the five groups as "insiders, information traders, liquidity traders, noise traders, and market makers").

[100] *Id.* at 723.

[101] *Id.* at 726–27.

[102] *Id.* at 715.

[103] *Id.* at 726–27.

drop.[104] In this manner, information traders exchange information for profit.[105] By trading on their information advantage, information traders transmit their information to the market, which responds by accurately adjusting the stock's price.[106] Misleading information reduces information traders' ability to assess price-value deviations, and when they "take precautions to lower the risk of capturing price-value deviations ... their costs increase and market efficiency declines."[107] Therefore, the easier it is for information traders to find accurate information, the greater their ability "to counter price deviations."[108] Accordingly, regulators "should strive to reduce the cost of gathering, verifying, and pricing information" through mandatory disclosure, prohibitions on fraud and misrepresentation, and prohibitions on insider trading.[109]

From an enforcement perspective, criminal statutes prohibiting insider trading, fraud, and misrepresentation address the criminal end of Posner's spectrum of undesirable executive behavior while disclosure requirements, enabling information traders to quickly and accurately transmit to the market their qualitative judgments about allowable but risky behaviors, address the other end.[110] This distinction—between legal and illegal forms of risk-inducing behavior—maps onto Goshen and Parchomovsky's distinction between breaches of the duty of loyalty and breaches of the duty of care.[111] Because courts and regulators are best equipped to assess

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[104] *Id.*

[105] *Id.*

[106] *Id.* at 770–71.

[107] *Id.* at 732.

[108] *Id.* (citing Merritt B. Fox et al., *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 372–73, n.11 (2003)).

[109] *Id.* at 737.

[110] *Id.* at 741–42 ("[D]ue to the probabilistic nature of detecting fraud (i.e., the probability of detection is lower than one), criminal liability may constitute a better deterrent than civil liability that is based on actual damages.") (citing Daniel R. Fischer & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?*, 105 HARV. L. REV. 503, 519–21 (1992)); *see also id.* at 750 ("[C]ourts are ill-suited to handle breaches of the duty of care as identifying mismanagement requires second-guessing management's business decisions .... [L]egislators have permitted corporations to exempt directors from monetary damages arising from a breach of their duty of care. Hence, responsibility for handling breaches of the duty of care has moved away from courts to the market.").

[111] *See id.* at 741–42.

and remedy quantifiable breaches of the duty of loyalty—manifested as fraud, misrepresentation, and theft—at least one scholar believes that disclosure requirements should be limited to readily verifiable data. In his view, "[m]andating the disclosure of soft, forward-looking information ... is wasteful because, instead of reducing management agency costs, these requirements aim at the elusive goal of achieving efficient markets through mandatory disclosure."[112] While regulators are indeed ineffective at analyzing this forward-looking information, "information traders can detect and curtail mismanagement" and provide oversight that reduces agency costs.[113]

Taken together, Posner's theory of executive compensation, Skinner's framework of information distortion, and Goshen and Parchomovsky's efficiency-based regulatory structure create a coherent model within which to conceptualize the regulatory features needed to address the problems of executive compensation.[114] The model illuminates the interplay between agency costs and information distortion, and suggests a role for information traders: specifically, by actualizing outrage constraints to prevent excessive executive compensation from re-emerging at the seams of the regulatory schema.[115]

III. IMPROVING THE RULE

The rule should curb the quantifiable behaviors that contributed to the 2008 financial crisis and should include qualitative standards against which regulators can judge corporate oversight ex post in the event of market turbulence or material financial loss.[116] The rule should make it more difficult for executives to conceal fraud, theft, and misrepresentation of market information.[117]

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[112] *Id.* at 754.

[113] *Id.* at 753–55 (discussing Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1111 (1995)).

[114] *See generally* Posner, *supra* note 63; Skinner, *supra* note 87; Goshen & Parchomovsky, *supra* note 98 (outlining each framework generally).

[115] *See* Goshen & Parchomovsky, *supra* note 98, at 723–24 (describing capabilities of information traders).

[116] *See* Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670, 37,712 (proposed June 10, 2016) (to be codified at 17 C.F.R. pts. 240, 275, 303) ("[N]on-financial performance measures play an important role in reinforcing expectations on appropriate risk, control, and compliance standards and should form a significant part of the performance assessment process.").

[117] *See* Goshen & Parchomovsky, *supra* note 98, at 741–42.

The Re-Proposed Rule, by and large, does this.[118] The Re-Proposed Rule limits the total portion of compensation that can be based on risk-inducing incentives; it ties incentive-based compensation to longer-term performance; it places a ceiling on potential incentive-based earnings; it provides for downward adjustment and clawbacks; it prohibits many hedging behaviors; and it institutionalizes governance mechanisms and oversight policies.[119] Many of these requirements can be measured quantitatively for compliance, and—if excessive risk causes future loss—the qualitative aspects of the rule can be judged and analyzed ex post.[120] The rule also grants considerable discretion to corporate boards in implementing a number of the rule's key provisions.[121]

However, even accepting the framework outlined above, rational executives will continue to seek to maximize their own income, and some directors, even some who are members of an independent compensation committee, will remain conflicted due a number of social and psychosocial factors.[122] In a worst-case scenario, the rule will do little to help.

In this worst-case scenario, institutional actors will engage in any of a number of behaviors to maximize executive compensation. Executives will rely on the excessive salaries paid by comparable institutions to bargain successfully for their own excessive salaries.[123] Boards may use their discretion to choose not to make downward adjustments in the face of excessive risk taking, forgoing an opportunity to deter others considering similarly risky behavior.[124] Boards may define "excessive" in a way that does not best represent shareholders' interests.[125] Institutions may camouflage a greater

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[118] *See generally* Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670.

[119] *See id.* at 37,730 (risk-taking), 37,734 (maximum incentive-based compensation), 37,719 (long-term performance), 37,716 (clawback requirements), 37,733 (hedging), 37,738 (governance requirements).

[120] *See id.* at 37,677.

[121] *Id.* at 37,712.

[122] BEBCHUK & FRIED, *supra* note 59, at 31–34.

[123] Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37,709 (noting that institutions may consider—among other factors—"compensation practices at comparable covered institutions" in deciding what constitutes "excessive" pay).

[124] *Id.* at 37,728.

[125] *Id.* at 37,781 ("Given the flexibility inherent under a principles-based approach, it is also possible that in fact some compensation contracts to covered

percentage of the fixed portion of an executive's compensation; institutions may also increase the total amount of incentive-based compensation to offset the percentage that must be deferred.[126] Executives who engage in risky behavior to remain competitive within an industry may negotiate for relative performance measures as a hedge against the risks from these industry-wide practices.[127] If these same practices create a bubble that bursts, relative performance measures will mitigate a decrease in incentive-based compensation (and in any potential downward adjustment) since performance will remain comparable with similarly situated institutions.[128]

If all of these behaviors combine, the rule will stretch at its seams. Excessive compensation will continue, just in a slightly mitigated form: executives will continue to manipulate short-run profits, albeit on a slightly longer timeline, and the risk of information distortion will remain.[129] Exacerbating these problems is the chance that these regulations will increase the confidence of information traders, who will reduce their efforts to verify some of the information on which they trade.[130] If the information distortion risks remain, then this will reduce the efficiency with which price adjustments are quickly and accurately made.[131] So, what can regulators do to improve the rule in a way that mitigates these problems?

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persons constitute excessive compensation that could lead to inappropriate risk-taking, particularly if the compensation setting process is not efficient or unbiased.").

[126] *Id.* at 37,680 (requiring 60 percent of senior executive officers' incentive-based compensation must be deferred at Level 1 institutions, 50 percent for significant risk-takers, and 40 percent for individuals at Level 2 institutions).

[127] Gerald Garvey & Todd Milbourn, *Incentive Compensation When Executives Can Hedge the Market: Evidence of Relative Performance Evaluation in the Cross Section*, 58 J. FIN. 1557, 1558 (2003).

[128] *Id.*

[129] *See* Goshen & Parchomovsky, *supra* note 98, at 735–36; *see also* Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 324 (2012) (disclosing more long-term market information would mitigate effects of short-term focus).

[130] *See* Goshen & Parchomovsky, *supra* note 98, at 741 (describing the effects of fraud and distortion on verification costs for information traders).

[131] *Id.*

In 2010, three of the agencies responsible for the Re-Proposed Rule jointly adopted the "Guidance on Sound Incentive Compensation Policies."[132] The Guidance encouraged disclosure to shareholders:

> To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements for executive and non-executive employees and related risk-management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take imprudent risks. Such disclosures should include information relevant to employees other than senior executives. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.[133]

When the proposed rule was issued in 2011, this disclosure recommendation was softened to require only an annual report to regulators "disclosing the structure of its incentive-based compensation arrangements that is sufficient to determine whether ... [it] provides covered persons with excessive compensation ... or could lead to material financial loss...."[134] Just two months after the publication of the 2011 proposed rule, the Basel Committee on Banking Supervision published its "Pillar 3 Disclosure Requirements for Remuneration," which required institutions publicly to disclose substantial information about their compensation practices.[135] The requirements were designed to implement the principle that "[f]irms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders, including in particular

[132] *See generally* Guidance on Sound Incentive Compensation Policies, 75 Red. Reg. 36,395 (issued June 25, 2016) (clarifying that the three agencies are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision).

[133] *Id.* at 36,413.

[134] Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170, 21,176–77 (proposed April 14, 2011).

[135] *See* BASEL COMMITTEE, PILLAR 3, *supra* note 14, at 1.

shareholders."[136] In January of 2015, the Committee clarified and expounded upon the disclosure requirements.[137] When the 2016 Re-Proposed Rule was issued, it purported to have considered the Basel Committee's disclosure requirements.[138]

Nonetheless, the now-pending rule takes the 2011 reporting requirement—a weakened version of the 2010 Guidance's disclosure recommendation—and replaces it with a still weaker recordkeeping requirement.[139] The proposal justifies this change by explaining that despite the value of a reporting requirement, "the burden of producing [reports] would potentially be great on smaller covered institutions. Accordingly, the agencies determined not to include a requirement for covered institutions to submit annual narrative reports."[140] There is no explanation as to why a great burden on smaller institutions justifies excusing the largest institutions from such a beneficial requirement.[141] The SEC already requires many institutions to disclose compensation and governance information to shareholders, including the monetized total compensation paid to certain executives.[142] When strengthening these very requirements in 2006, the SEC observed that the costs of the additional disclosures "will be borne by the companies' shareholders. Based on the extensive comments we received from investors supporting our proposals, strong evidence suggests that shareholders

[136] BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCEMENTS TO THE BASEL II FRAMEWORK 27 (July 2009), http://www.bis.org/publ/bcbs157.pdf [http://perma.cc/8NAP-D9KR].

[137] BASEL COMMITTEE, REVISED PILLAR 3, *supra* note 14.

[138] Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670, 37,675 n.21 (proposed June 10, 2016) (to be codified at 17 C.F.R. pts. 240, 275, 303).

[139] *See id.* at 37,680, 37,713. For other changes, see *id.* at 37,679 (new definitions), 37,680 (more detailed recordkeeping requirements for larger institutions, and different and more detailed deferred compensation requirements), 37,681 (more detailed requirements for large institutions to reduce yet-to-be-paid or vested incentive-based compensation, a clawback provision, and a mandate to create a compensation committee at large institutions). In fairness to the agencies who crafted the rule, it does require disclosure of these records to regulators, but only upon request.

[140] *Id.* at 37,713.

[141] *See id.*

[142] The SEC has many disclosure requirements. Some form of disclosure of executive pay has been in effect since 1933. *See, e.g.*, Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (issued Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 240, 275, 303).

are willing to bear these costs."[143] In effect, these comments demonstrate a consensus between the Agencies and the public regarding a disclosure requirement.[144]

Later, in 2009, the SEC said:

> [I]nvestors would benefit from an expanded discussion and analysis about how the company rewards and incentivizes its employees to the extent it creates risk to the company .... We believe that disclosure of a company's overall compensation policies in certain circumstances can help investors identify whether the company has established a system of incentives that can lead to excessive or inappropriate risk taking by employees.[145]

In proposing reforms to counteract excessive executive compensation, Richard Posner said the "most obvious [reform] is requiring publicly held corporations to disclose the full compensation of all senior executives, including" all perquisites "monetized where possible and subject to public audit."[146] He urges that his proposals not "be brushed aside on the ground that the costs may exceed the benefits when all direct and indirect consequences are considered."[147] This entreaty now seems prescient.[148] The consensus regarding compensation disclosure has formed and dissolved since he published his suggestion.[149] Nonetheless, the rule's cursory dismissal of a reporting requirement is unconvincing in the face of the previous support it had, even within the agencies of jurisdiction.[150]

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143 *Id.* at 53,224–25.

144 *See, e.g.*, *Knowledge@Wharton*, WHARTON SCH. OF THE UNIV. OF PA. (Aug. 22, 2007) (quoting positive reactions to increased disclosure by corporate governance and accounting professors).

145 Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,078 (July 17, 2009) (notice of proposed rulemaking); 75 Fed. Reg. 9100 (issued Mar. 1, 2010) (codified at 17 C.F.R. 229.402 (2010)).

146 Posner, *supra* note 63, at 1045.

147 *Id.* at 1047.

148 *See, e.g.*, *Securities Regulation,* 129 HARV. L. REV. 1144, 1150 (2016) (claiming inability to compute costs and benefits from lack of empirical data could completely invalidate rule for disclosure).

149 *Compare* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010) (supporting disclosure), *with* Ing-Haw Cheng et al., *Yesterday's Heroes: Compensation and Creative Risk-Taking, Nat'l Bureau of Econ. Research* (Nat'l Bureau of Econ. Research, Working Paper No. 16176, 2010), http://www.nber.org/papers/w16176.pdf [http://perma.cc/DH5G-B83D] (claiming disclosure is unnecessary or harmful).

150 *See* Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670 (proposed June 10, 2016) (to be codified at 17 C.F.R. pts. 240, 275, 303).

Conclusion

When regulators finalize the Re-Proposed Rule, they should require Level 1 and Level 2 institutions to disclose the full annualized value of key executives,[151] monetized and subdivided into salary, benefits, incentive pay, and perquisites. In addition, executives should be required to disclose to their firm any personal hedging transactions, which should be included in this report. Doing so will pull back the curtain on executive pay and allow the market—through the work of information traders—to make important qualitative judgements about corporate risk taking and to verify the effect of internal controls and governance measures.[152] Shareholders will be able to track the correlation between executive pay and firm performance over time to determine whether pay arrangements correctly have aligned executive incentives to benefit shareholders. It also will function as an internal control by strengthening the outrage constraint. Forcing institutions to monetize and disclose all forms of compensation eliminates many of the camouflaging behaviors typically used to avoid this constraint.

When these complementary forces are working, executive compensation will be highest when risk-taking behaviors are optimal for shareholders: the market will penalize pay that incentivizes excessive risk taking, while best practices paired with good oversight will create market confidence. In turn, boards will promote growth by increasing market confidence when they exercise the type of oversight that reduces information distortion risks. This complementary effect creates a virtuous cycle in which regulators verify compliance ex post while market actors help to mitigate risk ex ante.[153]

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[151] The disclosure requirement would not have to include all "covered persons" under the Re-Proposed Rule to be effective. It could, for example, require the disclosure of the income of senior executive officers and significant risk-takers who meet the relative compensation test. *See id.* at 37,692.

[152] *See* Goshen & Parchomovsky, *supra* note 98, at 738.

[153] *See, e.g.*, Skinner, *supra* note 87, at 1587 ("One can readily see how defining the problem as structural is conducive to complementarity-style regulatory tools. Indeed, as in these other contexts, if not more so, complementarity is ideally suited to the problems presented by misconduct in complex financial institutions.").