

# CORPORATE GOVERNANCE IN THE FINANCIAL SERVICES INDUSTRY: DODD-FRANK REFORMS TO BANKER COMPENSATION ARRANGEMENTS

LISA H. NICHOLSON\*

## INTRODUCTION

Dramatic failures of corporate governance and risk management at many systemically important financial institutions were cited as among the key causes of the 2008-2009 financial and economic crisis.<sup>1</sup> What resulted is the realization that neither the financial market should be self-regulated, nor that financial institutions should be trusted to police themselves. Too many bank and nonbank financial institutions recklessly took on too much risk with too little capital reserves while heavily dependent on the short-term funding for increasingly risky trading activities.<sup>2</sup> Moreover, compensation policies at many of the large financial institutions often rewarded short-term gains in an environment of intense competition for talented professionals and eager investors instead of consideration of the long-term consequences of the entities trading activities.<sup>3</sup> In 2009, the Obama Administration publicly called for heightened oversight of executive compensation at all banks amid increased public fury over the payment of executive bonuses by some firms who were viewed by the public as the

---

\* Professor of Law, University of Louisville, Louis D. Brandeis School of Law. The Author extends thanks to Professor Jayne Barnard at the College of William & Mary for her insights and to Louis D. Brandeis School of Law students Jacob Levy (J.D. 2013) and David J. Nichols (J.D. 2014) for their research assistance.

1. There are a wealth of articles and reports on the various causes of the financial crisis by academics, Congressional committees, and various policy makers, federal regulators and financial industry professionals. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT, at xv-xxviii (2011) [hereinafter FCIC REPORT]. The Financial Crisis Inquiry Commission ("FCIC" or "Commission"), established as part of the Fraud Enforcement Recovery Act of 2009 (Pub. L. No. 111-21, 123 Stat. 1617 (codified in scattered sections of 18 U.S.C.)), was created to examine the causes of the 2008-2009 U.S. financial and economic crisis. *See id.* at xi. The FCIC was a ten-member bipartisan commission charged with determining the causes of the financial crisis and issuing a report to the President by January 2011. *Id.* Consequently, the FCIC Report does not include any recommendations with regard to regulatory or policy reform. *See also* Brooksley Born, Former Comm'r, Fin. Crisis Inquiry Comm'n, Keynote Address: 2011 American University Business Law Review Symposium: Law, Finance and Legitimacy After Financial Reform "Financial Reform and the Causes of the Financial Crisis," in 1 AM. U. BUS. L. REV. 1 (2011-2012); SENIOR SUPERVISORS GRP., RISK MANAGEMENT LESSONS FROM THE GLOBAL BANKING CRISIS OF 2008 (2009) [hereinafter SSG REPORT], available at [www.sec.gov/news/press/2009/report102109.pdf](http://www.sec.gov/news/press/2009/report102109.pdf).

2. Born, *supra* note 1, at 3.

3. *Id.*; *see also* Lynne L. Dallas, *Short-Termism, The Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265 (2012).

primary culprits of the crisis due to their unreasonably excessive risk-taking.<sup>4</sup>

Congress enacted and President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or the “Act”)<sup>5</sup> in July 2010 to set forth corrective initiatives to deal with the apparent failures that led to the financial and economic crisis. The legislation, which focused primarily on regulations for financial institutions, was developed as a means to avert systemic failures in the future and its provisions are designed to improve transparency and accountability in the capital and financial markets going forward.<sup>6</sup> To that end, the Dodd-Frank Act (which takes up approximately 2,300 pages) reaches nearly every facet of the banking and financial services industry including reform of the regulations of mortgage origination and securitizations, derivatives trading, proprietary trading, credit rating agencies, corporate governance generally, and executive compensation in particular.<sup>7</sup> Since the legislation requires significant rule-making by various federal regulatory authorities—much of which has yet to be adopted, it is still too soon to tell conclusively how effective the Dodd-Frank Act will be in deterring future failures, and the ensuing harm to the nation’s financial system.

Nevertheless, this Article attempts to prognosticate the effectiveness of the Act’s corporate governance provisions as they relate to executive compensation—a small slice of the many financial regulatory reforms contained therein. More specifically, this Article addresses two areas relating to executive compensation: (i) enhancements to corporate claw-back policies and (ii) restrictions on incentive-based compensation for financial institutions. In Part I, corporate governance principles are discussed generally. Part II examines whether Sections 954 and 956 of the Dodd-Frank Act can help the financial industry change from the pre-financial crisis environment where many directors of systemically important financial institutions allowed managers free reign to engage in risky behavior without fear of being held accountable.

In drafting Sections 954 and 956, which purportedly impose restrictions on the compensation structures at financial institutions, Congress seemingly relied to some degree on the criminal law behavioral model to induce better corporate governance—through enhanced accountability—by the corporation and its executive officers. That criminal law model is premised on the notion that people either (i) will comply with the law out of an unconscious instinct to be law-abiding, or (ii) will comply with the law after a conscious evaluation of the risks

---

4. See Stephen Labaton, *Administration Seeks Increase in Oversight of Executive Pay*, N.Y. TIMES, Mar. 22, 2009 (reporting that the Obama administration proposed greater requirements on the boards of all financial institutions “to tie executive compensation more closely to corporate performance and to take other steps to ensure that compensation was aligned with the financial interests of the company”); see also Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257 (2010).

5. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.).

6. *Id.*

7. See generally *id.*

associated with disobeying the law.<sup>8</sup> The latter notion, itself, is the theory of deterrence which presupposes that a potential wrongdoer will engage in the necessary cost-benefits analysis that should lead him to avoid misconduct.<sup>9</sup>

Designed properly, the regulation of compensation policies can be a significant mechanism for enhancing corporate accountability. The Dodd-Frank Act's mandated executive compensation reform requiring, *inter alia*, structured compensation payouts over several years, with the possibility that some remuneration can be clawed back from executives under certain circumstances could have a deterrent impact. If employees know that their pay depended on profits that were sustainable, not the kind that could blow up twelve months or more down the road, they would have greater motivation to weigh the risks along with the rewards.<sup>10</sup> The proposed changes to the structure of executive compensation will help to ensure that the funds will be available if a claw back is required.

#### I. CORPORATE GOVERNANCE PRINCIPLES GENERALLY

Corporate governance involves the relationships and roles among and between a corporation's board of directors, its managers, its shareholders, and in some cases, its other stakeholders (e.g., employees, suppliers, customers and creditors). The term *corporate governance*, which has been around for decades, refers to the system of rules—typically state-sponsored—by which the corporation is both directed and controlled, with the intention of monitoring the actions of managers and mitigating instances of conflicts of interest between the owners and the operators of the corporation.<sup>11</sup>

The board of directors is expected to play a key role in corporate governance, having statutory authority to “manage [or direct the management of] the business and affairs” of the corporation.<sup>12</sup> In other words, the Board is charged with developing directional policy and organizational strategies; appointing, supervising and compensating senior executives who generally implement said policies and strategies; provide advice and counsel to those managers and make recommendations to shareholders where appropriate.<sup>13</sup> State corporate law

---

8. See Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 956 (2003).

9. See Lisa H. Nicholson, *Sarbanes-Oxley's Purported Over-Criminalization of Corporate Offenders*, 2 J. BUS. & TECH. L. 43, 51-52 (2007) [hereinafter Nicholson, *Sarbanes-Oxley's Purported Over Criminalization*].

10. Accord Andrew Ross Sorkin, *Where's the Plan*, *Wall Street*, N.Y. TIMES, Mar. 26, 2009.

11. See Committee on the Financial Aspects of Corporate Governance, Report of the Committee on the Financial Aspects of Corporate Governance § 2.5, at 14 (1992), available at <http://www.ecgi.org/codes/documents/cadbury.pdf>.

12. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (West 2013); MODEL BUS. CORP. ACT §§ 8.01(b) & 8.30(b) (1998)

13. See generally Arthur R. Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. LAW 257 (Supp. 2010).

imposes upon the Board a fiduciary duty in carrying out these responsibilities to ensure that the corporation is run in the long-term interests of the shareholders.<sup>14</sup>

The Board's fiduciary obligation necessarily includes authority to design and implement a compensation structure (including the form and amount) for its senior executives that will ensure that they conduct themselves in the best interest of the corporation. Executive compensation is a major issue for Boards given the separation of ownership from the control of the corporation. The Board is therefore required to examine whether the amounts paid are commensurate with the benefits received by the corporation. Best practices would require that a corporation's compensation policies align managerial incentives with those of shareholders.<sup>15</sup> The "pay-for-performance" movement took hold in the 1990s in the hope of meeting this end.<sup>16</sup>

The 2008-2009 financial and economic crisis, however, highlighted an environment in which directors gave managers free rein to engage in risky behavior without sufficient regard for the resulting impact on the corporation, its shareholders, or the economy. Executive compensation policies, which seemingly emboldened risk-takers at many bank and nonbank financial institutions, found their way into the public spotlight. Disgruntled shareholders and the general public began to express concern that executive pay and corporate performance continues to be misaligned since the top executives at many of the financial institutions made money despite the fact that their companies suffered huge losses.<sup>17</sup> They expressed concern that the current corporate compensation structures incentivized corporate managers to take unnecessary risks.<sup>18</sup>

Congress, in enacting Dodd-Frank's corporate governance provisions,<sup>19</sup> aimed specifically to address this concern by giving shareholders of publicly-held corporations a greater "say on pay" as well as better proxy access to nominate directors and encouraging greater accountability through the regulation of

---

14. See generally *Dodge v Ford*, 170 N.W. 668 (1919).

15. See, e.g., Charles M. Yablon, *Bonus Questions: Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271 (1999) (noting "the theory of pay for performance is that shareholders benefit when management compensation is significantly at risk, so that a high level of compensation is dependent on a high level of corporate performance").

16. *Id.* In the 1990s, performance-based compensation gained new support after a change in the tax laws, which prohibited corporations from deducting any compensation paid to a corporate officer in excess of \$1 million unless the additional compensation was performance-based. See Section 162(m) of the Internal Revenue Code, adopted in 1993.

17. See Sorkin, *supra* note 10 (noting "Wall Street's pay structure has become the biggest occasion for national ridicule, and rage . . . In good years, tope employees share in huge riches. In truly dreadful years, like [2008] there are still bonuses across the firm—just smaller ones."); see also Ben W. Heineman, *Boards Fail—Again*, BUSINESSWEEK (Sept. 26, 2008), <http://www.businessweek.com/stories/2008-09-26/boards-fail-againbusinessweek-business-news-stock-market-and-financial-advice>.

18. See Lisa M. Fairfax, *Government Governance and the Need to Reconcile Governmental Regulation with Board Fiduciary Duties*, 95 MINN. L. REV. 1692, 1696 (May 2011).

19. See discussion *infra* Part II.

corporate compensation, including the establishment of guidelines for the composition of corporate compensation committees, and the disclosure and payout of incentive-based compensation. The legislation also provides for enhanced compensation oversight specifically for the financial industry. Fear of recoupment through claw backs or delayed payouts should force corporate executives to accept greater personal risks in the absence of better Board accountability. Opponents of the federalization of corporate compensation polices however argue that compensation is a matter that is best left to the markets—shareholders can vote with their feet and sell their shareholdings if they disagree with corporate payouts.<sup>20</sup>

This is the second time that the regulation of corporate governance practices, once the exclusive province of state corporate laws, was elevated to the federal level. The first occasion followed public revelations of the massive financial frauds at numerous public companies during 2001 and 2002.<sup>21</sup> Referencing the subsequent demise of many well-established public companies (including Enron, WorldCom and Arthur Anderson), federal legislation was adopted to ensure that more meaningful checks and balances of the chief executive and top management existed.<sup>22</sup> The Sarbanes-Oxley Act of 2002<sup>23</sup> (“S-Ox”) set forth federally mandated corporate governance rules as a means to restore public confidence in the publicly-held corporation.

S-Ox addresses, inter alia, executive-level certifications of financial reports; requires real-time public disclosures of material events; prohibits corporation-to-employee loans; increases obligations for corporate legal counsels; and provides for better whistle-blower protections.<sup>24</sup> S-Ox corporate governance provisions

---

20. See, e.g., Squam Lake Working Group on Federal Regulation, Regulation of Executive Compensation in Financial Services (Council on Foreign Relations, Feb. 2010) (arguing that “governments should generally not regulate the level of executive compensation in financial institutions . . . society is better off if compensation levels are set by market forces.”). The Squam Lake Working Group consists of academic economist, who first convened during fall 2008 as the financial and economic crisis was deepening, to “help guide reform of the capital markets.” *Id.* at 1.

21. Accounting irregularities were unearthed at Enron Corporation, Kmart Corporation, Adelphia Communications Corp., WorldCom Inc., and Tyco International Ltd., to name a few. See Stephen Laboton, *Downturn and Shift in Population Feed Boom in White-Collar Crime*, N.Y. TIMES, June 2, 2002. For a more detailed discussion of the 2001-2002 corporate frauds, see Lisa H. Nicholson, *The Culture of Under-Enforcement: Buried Treasure, Sarbanes-Oxley and the Corporate Pirate*, 5 DEPAUL BUS. & COM. L.J. 321, 321-25 (2007) [hereinafter Nicholson, *The Culture of Under-Enforcement*].

22. See Elisabeth Bumiller, *Corporate Conduct: The President; Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002 (reporting on statements made by President George W. Bush during the signing of the Sarbanes-Oxley Act of 2002).

23. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

24. See *id.*; see also Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 481, 503 n.119 (2006) (“Among

also set forth specific rules rather than discretionary principles, particularly with regard to the role, structure and composition of the Board and its committees.<sup>25</sup> The goal was strengthen the hands of corporate gatekeepers.<sup>26</sup> Arguably, Dodd-Frank Act's corporate governance provisions were enacted to fill the perceived gaps remaining after the 2002 enactment of S-Ox.

## II. INCENTIVE-BASED COMPENSATION REFORMS UNDER THE DODD-FRANK ACT

Although 26.2 million Americans were out of work as of November 2010<sup>27</sup> and the U.S. unemployment rates reached a high of 10.1% in October 2009,<sup>28</sup> year-end bonuses that were paid to New York City securities professionals in 2009 totaled \$20 billion, up 17% from the previous year, with “[a]verage compensation r[ising] by 27% to more than \$340,000.<sup>29</sup> Following the ensuing government intervention to shore up the economy in 2008, commercial bank profits rose from \$7.6 billion in the first quarter of 2009 to \$18 billion by the first

---

other provisions, the legislation toughened penalties for accounting fraud, established a five-person independent board to oversee the accounting industry, prohibited non-audit services to audit clients in most cases, mandated auditor rotation, and established employment restrictions on accountants who go to work for their former audit clients. Further, the law required company officials to certify periodic reports, subject to civil and criminal penalties; made it a crime for issuers to interfere with audits; prohibited corporate loans to company executives; and required enhanced financial disclosures. It also bolstered the budget of the SEC and made it a crime to retaliate against corporate whistleblowers.”).

25. See, e.g., Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1193-95 (2004) (noting that pre-S-Ox, corporate governance under state law was not regulatory in nature but relied on director and judicial discretionary interpretations). “Sarbanes-Oxley—housed in the federal securities law—not only represents a new federal presence in corporate governance, it adopts a wholly novel, rules-based approach to corporate governance.” *Id.* at 1194-95; see also Burch, *supra* note 24, at 504-05 (“Several provisions in Sarbanes-Oxley, and the SEC and self-regulatory organization (“SRO”) rules promulgated thereunder, deal directly with or will influence the scope of directors’ fiduciary duties, including audit committee composition and board composition, nominating/ corporate governance committee composition and duties, oversight of public accountants by the audit committee of the board of directors and the functions and role of the audit committee with respect to independent audits of the corporation’s financial controls and internal controls . . .”).

26. See Beverley Earle & Gerald A. Madek, *The New World of Risk for Corporate Attorneys and Their Boards Post-Sarbanes-Oxley: An Assessment of Impact and Prescription for Action*, 2 BERKLEY BUS. L.J. 185, 189-90 (2005).

27. See FCIC REPORT, *supra* note 1, at 391.

28. See *id.* at 389.

29. Press Release, Thomas P. DiNapoli, New York State Comptroller, Wall Street Bonuses Rose Sharply in 2009 (Feb. 23, 2010), available at <http://www.osc.state.ny.us/press/releases/feb10/022310.htm>. See Susanne Craig, *Wall Street Pay Rises, for Those Who Still Have a Job*, N.Y. TIMES, Feb. 26, 2013, at B1.

quarter of 2010.<sup>30</sup> Indeed, “[f]or banks with assets greater than \$1 billion, profits more than doubled from \$6.3 billion to \$14.5 billion” during that period.<sup>31</sup> Reportedly, nearly half of the 2009 revenues of Wall Street firms were earmarked for compensation.<sup>32</sup> The public’s notice of, and outrage about, the increased compensation rates for financial-industry personnel served as a backdrop to the legislators debating what would become the Dodd-Frank Act.

The compensation policies and practices of many systemically important financial institutions were believed to have played a role in fueling the financial crisis.<sup>33</sup> Risk-takers were seemingly favored by some financial institutions, whose compensation structures provided these employees with stature and influence which enabled them to skirt their firm’s risk management and control functions.<sup>34</sup> Firm guidelines for granting incentive-based compensation awards typically did not reference the individual’s risk management performance and generally failed to take into account the true economic profits that resulted from an employee’s actions—adjusted for all costs and uncertainties.<sup>35</sup> Accordingly, some commentators noted that rule changes for incentive-based compensation in the

---

30. See FCIC REPORT, *supra* note 1, at 401 (citing FDIC, *Quarterly Banking Profile: First Quarter 2009*, Mar. 2009, available at <http://www2.fdic.gov/qbp/2009mar/qbp.pdf>; and FDIC, *Quarterly Banking Profile: First Quarter 2010*, Mar. 2010, available at <http://www2.fdic.gov/qbp/2010mar/qbp.pdf>).

31. See FCIC REPORT, *supra* note 1, at 401.

32. Susanne Craig & Ben Protess, *A Bigger Paycheck on Wall Street*, N.Y. TIMES, Oct. 9, 2012, at B1.

33. BD. OF GOVERNORS OF THE FED. RESERVE SYS., INCENTIVE COMPENSATION PRACTICES: A REPORT ON THE HORIZONTAL REVIEW OF PRACTICES AT LARGE BANKING ORGANIZATIONS 1 (2011).

34. *Id.* See Olufunmilayo B. Arewa, *Risky Business: The Credit Crisis and Failure (Part i)*, 104 NW. U.L. REV. COLLOQUY 398, 406-07 (2010) (“Internal risk management at many financial market firms was not well-positioned to cope with the market volatility that came with the credit crisis. The ability of many firms to successfully endure such volatility has been hindered by a number of factors, including inadequate risk management, high leverage, and compensation structures that may have encouraged speculation and incentivized risky trading.”); Marisa Anne Pagnattaro & Stephanie Greene, *“Say on Pay”: The Movement to Reform Executive Compensation in the United States and European Union*, 31 NW. J. INT’L L. & BUS. 593, 600-01 (2011) (“As the financial markets collapsed in 2008, shareholders were outraged by what they perceived as excessive compensation for executives who profited even as shareholders suffered tremendous losses. . . . Treasury Secretary Geithner urged corporate boards in general, to ‘pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm.’”); see also Terrance Gallogy, *Enforcing the Clawback Provision: Preventing the Evasion of Liability Under Section 954 of the Dodd-Frank Act*, 42 SETON HALL L. REV. 1229, 1233 n.23 (2012) (“the collapse of Lehman Brothers reflected larger problems in the financial system, including incentives for excess risk-taking and insufficient risk management”) (citing *Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Financial Serv. Comm.*, 111th Cong. 179 (2010) (prepared statement of Mary Shapiro, Chairman, U.S. Sec. & Exch. Comm’n)).

35. BOARD OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 33, at 13.

financial industry and enhanced risk management oversight by the Board would be crucial to reining in risky behavior at the employee level and ensuring the financial stability of the capital markets.<sup>36</sup>

The Dodd-Frank Act's corporate governance provisions, in response, seek to give shareholders of publicly-held corporations a say on executive pay and create a basis for them to hold the Board and managers accountable to ensure that executive pay is performance-related.<sup>37</sup> Enhanced transparency is expected to enable shareholders to see at a glance the performance of their company and to decide whether the compensation awarded executives is justified. The Act's compensation reforms also seek to reduce excessive risk-taking, particularly with regard to financial institutions.

Sections 951-956 of the Dodd-Frank Act require shareholder *advisory* votes on both executive compensation and golden parachutes,<sup>38</sup> require disclosure about the role of, and potential conflicts from, compensation consultants to the Board;<sup>39</sup> require additional disclosures about pay-for-performance, including the ratio

---

36. See FCIC REPORT, *supra* note 1, at 343 (noting "Lehman's failure resulted in part from significant problems in its corporate governance, including risk management, exacerbated by compensation to its executives and traders that was based predominately on short-term profits."); see also *id.* at 465 (where the Commission's majority noted other factors to explain the crisis included "Wall Street greed and compensation policies, systemic risk caused by credit default swaps, excessive liquidity and easy credit."); Eric D. Chason, *The Uneasy Case for Deferring Banker Pay*, 73 LA. L. REV. 923 (2013); Jeffrey Manns, *Insuring Against a Derivative Disaster: The Case for Decentralized Risk Management*, 98 IOWA L. REV. 1575 (2013). This Author will address the boards' risk management oversight failures in a forthcoming article.

37. The SEC had already begun taking action to enhance certain disclosure rules by providing investors with more information on the role of the board and the voting rights of brokers several years prior the enactment of the Dodd-Frank Act. For example, the SEC enhanced executive compensation disclosure rules (effective February 2010) by requiring proxy disclosures on (i) the relationship between compensation policies and practices and the associated risks (See SEC rule 14a-21(b) and Regulation S-K, item 402); (ii) the Board's role in risk oversight (See SEC rule 14a-3 and Regulation S-K, item 407(h)); and (iii) the background and qualifications of directors and nominees (See SEC rule 14a-8 and Regulation S-K, item 401(a-f)).

38. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). Publicly-held companies are required to provide shareholders with a non-binding vote to approve executive compensation once every three years, as well as a vote once every six years to determine whether this advisory vote on executive compensation should be held every one, two, or three years. Section 951 also requires institutional investment managers subject to Exchange Act Section 13(f) to report at least annually how they voted on these advisory shareholder votes.

39. See *id.* § 952. Section 952 sets forth rules intended to establish the independence of the Board's Compensation Committee, its consultants and any other advisors. To that end, Section 952 also requires the SEC to establish competitively neutral independence factors for all retained to advise the Board's compensation committee, as well as to direct the national exchanges to enact listing standards that include enhanced independence requirements for members of the Board's compensation committee.



between the CEO's total compensation and the median total compensation for all other company employees;<sup>40</sup> require additional disclosures about whether directors and employees are permitted to hedge any decrease in the market value of the company's stock;<sup>41</sup> require the SEC to direct national exchanges to prohibit securities listings by issuers who have not developed and implemented a compensation claw back policy;<sup>42</sup> and require prudential regulators to jointly promulgate rules prohibiting as an "unsafe and unsound compensation practice" any incentive-based compensation plan by covered financial institutions that provide to directors or executives excessive compensation fees and benefits or that could lead to material financial loss by the company.<sup>43</sup> As a result of these corporate governance provisions, many publicly-held corporations may have to redesign their compensation policies and alter the composition and operation of their compensation committees.

While the Dodd-Frank Act, as illustrated, contains a host of corporate governance provisions,<sup>44</sup> this Article addresses only two areas relating to executive compensation: (i) enhancements to corporate claw-back policies and (ii) restrictions on incentive-based compensation for financial institutions. To that end, I will examine whether the provisions of the Dodd-Frank Act governing compensation reform has the potential to reduce excessive risk-taking, or change compensation arrangements in the financial industry. First up: whether the enhanced claw-back policy at Section 954 is strict enough to have the desired deterrent impact. Thereafter, the Article's analysis will turn to Section 956's guidelines for the regulation of incentive-based compensation at financial

---

40. *See id.* § 953. Section 953 provides that this information regarding executive compensation actually paid and the financial performance of the company must be disclosed in the company's proxy materials under Section 402 of Regulation S-K. *Id.*

41. *See id.* § 955. Section 955 provides that the new rules must require such disclosures in the company's proxy materials.

42. *See id.* § 954. Section 954 also requires that current or former "executive officers" repay to the issuer any "incentive-based compensation (including stock options awarded as compensation)" received "during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement." *Id.* Presumably "executive officer" will have the meaning given the term by Rule 3b-7 of the Securities and Exchange Act of 1934. *See infra* note 135; *see also infra* Part II.A (discussing Dodd-Frank's claw back provision).

43. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). Covered financial institutions with less than \$1 billion in assets are excluded from Section 956. *See also* discussion *infra* Part II.B.

44. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951-56, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). The Dodd-Frank Act also addressed the composition of the Board through new proxy access rules and a mandatory disclosure requirement that companies explain why they have selected joint chairman and chief executive officer positions. *See id.* §§ 971 and 972, respectively.

institutions.

When the issue of employee compensation was raised in 2012, James (Jamie) Dimon—chief executive officer of JPMorgan Chase & Co. (“JPMorgan”) famously argued, “We are going to pay competitively” and that the firm “need[s] top talent, you cannot run this business with second-rate talent.”<sup>45</sup> Notably, JPMorgan—the top U.S. bank holding company based on \$2.3 trillion in consolidated assets<sup>46</sup>—made Dimon the highest paid among his cohorts in 2011;<sup>47</sup> paying him \$23 million in salary and bonus compensation in 2011.<sup>48</sup> The firm reportedly also “paid the 25,999 employees in the Investment Bank unit an average of \$341,552 in 2011—about 34 percent of the unit’s revenue.”<sup>49</sup>

Ironically, JPMorgan experienced a \$6.2 billion trading loss in 2012 from a poorly monitored and ill-conceived employee-driven trading strategy in credit derivatives, at the hands of derivatives trader Bruno Iksil (the “London Whale”) and manager Javier Martin-Artajo, among others.<sup>50</sup> Iksil entered into a series of

---

45. David Benoit, *Jamie Dimon Wants to Make Sure Everyone Hears Him*, WALL ST. J. DEAL J. (Feb. 28, 2012, 4:42 PM), <http://blogs.wsj.com/deals/2012/02/28/jamie-dimon-want-to-make-sure-everyone-hears-him/> (Dimon touched on several topics while speaking at JPMorgan’s analyst day including employee compensation). See Dakin Campbell & Andrea Ludtke, *JPMorgan’s Dimon Assails Newspaper Pay Levels in the Bank’s Defense*, BLOOMBERG (Feb. 28, 2012), <http://www.bloomberg.com/news/2012-02-28/jpmorgan-chief-dimon-assails-pay-practices-at-newspapers-in-bank-s-defense.html> (JPMorgan reportedly posted \$19 billion in profit in 2011) (reporting Dimon said “Obviously our business, in investment banking in particular, . . . have high capital and high human capital.”).

46. JPMorgan is the largest bank holding company based on consolidated assets valued at \$2,439,494,000 as of September 30, 2013. Fed. Fin. Insts. Examination Council, *Top 50 Holding Companies*, NAT’L INFO. CENTER [www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx](http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx) (last visited Jan. 8, 2014). Its principal bank subsidiary is JPMorgan Chase Bank, the largest U.S. Bank. U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, *JPMORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES* 18-19 (2013) [hereinafter *SENATE REPORT*].

47. Dimon’s 2011 compensation package dwarfed that of Bank of America CEO Brian Moynihan’s \$7 million and almost doubled Citigroup CEO Vikram Pandit’s \$14.9 million—the next largest bank holding companies. Dawn Kopecki, *JPMorgan Awards CEO Jamie Dimon \$23 Million Pay Package*, BLOOMBERG (Apr. 4, 2012, 5:18 PM), <http://www.bloomberg.com/news/2012-04-04/jpmorgan-awards-ceo-jamie-dimon-23-million-pay-package.html>. Dimon’s 2011 compensation package dwarfed that of Bank of America CEO Brian Moynihan’s \$7 million and almost doubled Citigroup CEO Vikram Pandit’s \$14.9 million—the next largest bank holding companies. *Id.*; see also JPMORGAN CHASE & CO., NOTICE OF 2011 ANNUAL MEETING OF SHAREHOLDERS AND PROXY STATEMENT 13-14 (2011) [hereinafter *JPMORGAN 2011 PROXY STATEMENT*], available at [http://files.shareholder.com/downloads/ONE/2724945887x0x457330/25a50d66-47e7-442a-a74b-58fc43b40ade/Proxy2011-75BookMarked\\_for\\_web\\_post\\_April\\_7.pdf](http://files.shareholder.com/downloads/ONE/2724945887x0x457330/25a50d66-47e7-442a-a74b-58fc43b40ade/Proxy2011-75BookMarked_for_web_post_April_7.pdf).

48. Dimon’s \$23 million compensation package included \$12 million in restricted stock and options valued at \$5 million for his performance in 2011. Kopecki, *supra* note 47.

49. Campbell & Ludtke, *supra* note 45. JPMorgan reportedly posted \$19 billion in profits for that period. See *id.*

50. See Dan Fitzpatrick et al., *J.P. Morgan’s \$2 Billion Blunder*, WALL ST. J., May 11, 2012

complicated bets on credit derivatives on behalf of the firm while employed in JPMorgan's London unit of the Chief Investment Office ("CIO")<sup>51</sup> led by Ina Drew who, in 2011, received \$14 million in compensation.<sup>52</sup> Both Iksil and Martin-Artajo were among the firm's best-paid traders and managers, receiving \$7.3 million and \$12.8 million for 2010, respectively.<sup>53</sup> Iksil's prior derivatives trading activity produced a \$2.5 billion profit for JPMorgan during the five-year period that preceded the \$6.2 billion loss.<sup>54</sup> In July 2012, JPMorgan was forced to restate its first-quarter earnings because "it was no longer confident that the company's traders [in the CIO unit] had fairly valued [their trading] positions."<sup>55</sup>

By summer's end, Iksil, Drew, Macris, Martin-Artajo, chief financial officer Doug Braunstein and several other JPMorgan executives were either fired, reassigned or asked to resign.<sup>56</sup> On July 13, 2012, the firm announced that it would withhold all severance payments and 2012 incentive compensation from all relevant parties and that it would "claw back compensation from each

---

(according to Dimon, the trading strategy was "flawed, complex, poorly review, poorly executed and poorly monitored"); see also Jessica Silver-Greenberg, *JPMorgan Sues Boss of 'London Whale' in Trading Loss*, N.Y. TIMES, Oct. 31, 2012, available at [http://dealbook.nytimes.com/2012/10/31/jpmorgan-sues-boss-of-london-whale/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2012/10/31/jpmorgan-sues-boss-of-london-whale/?_php=true&_type=blogs&_r=0) (last visited May 21, 2014). Accord SENATE REPORT, *supra* note 46.

51. The CIO, which "is located within JPMorgan's Corporate/Private Equity division, has a staff of about 425, including 140 traders, and maintains offices in several locations, including New York and London." SENATE REPORT, *supra* note 46, at 21; see also JPMORGAN CHASE & CO. MANAGEMENT TASK FORCE REGARDING 2012 CIO LOSSES 21 (2013) [hereinafter JPMORGAN TASK FORCE REPORT], available at [http://files.shareholder.com/downloads/ONE/2272984969x0x628656/4cb574a0-0bf5-4728-9582-625e4519b5ab/Task\\_Force\\_Report.pdf](http://files.shareholder.com/downloads/ONE/2272984969x0x628656/4cb574a0-0bf5-4728-9582-625e4519b5ab/Task_Force_Report.pdf). Its primary purpose is to maintain an investment portfolio to manage the bank's excess deposits. JPMORGAN TASK FORCE REPORT, *supra*, at 21. By 2012, the CIO was managing a portfolio of approximately \$350 billion. SENATE REPORT, *supra* note 46, at 22.

52. See JPMORGAN 2011 PROXY STATEMENT, *supra* note 47, at 16. Achilles Macris, the International Chief Investment Officer, served as Drew's top deputy in the CIO's London office and oversaw the management of the credit derivatives trading portfolio. SENATE REPORT, *supra* note 46, at 24.

53. Dawn Kopecki et al., *London Whale Resurfaces in Potential U.S. JPMorgan Case*, BLOOMBERG (Aug. 13, 2013), available at <http://www.bloomberg.com/news/2013-08-13/london-whale-resurfaces-in-potential-u-s-jpmorgan-case.html> (last visited May 22, 2014). Reportedly, Macris was "paid \$17.3 million—more than Drew, who received \$15 million. Dimon . . . was paid \$23 million for that year." *Id.*

54. See SENATE REPORT, *supra* note 46, at 56.

55. See Jessica Silver-Greenberg, *JPMorgan Says Trading Loss Tops \$5.8 Billion; Profit for Quarter Falls 9%*, N.Y. TIMES (July 13, 2012, 10:10 AM), [http://dealbook.nytimes.com/2012/07/13/jpmorgan-reports-second-quarter-profit-of-5-billion-down-9/?\\_r=0](http://dealbook.nytimes.com/2012/07/13/jpmorgan-reports-second-quarter-profit-of-5-billion-down-9/?_r=0); see also SENATE REPORT, *supra* note 46.

56. See Floyd Norris, *Trading Loss at JPMorgan Will Result in Millions in Pay Givebacks*, N.Y. TIMES, July 13, 2012.

individual.”<sup>57</sup> Drew and Iskil reportedly surrendered two years’ and one year’s pay, respectively; with Drew forfeiting approximately \$21.5 million.<sup>58</sup> In all, using its existing internal discretionary *Bonus Recoupment Policy*,<sup>59</sup> JPMorgan clawed back more than \$100 million in employee compensation.<sup>60</sup>

---

57. SENATE REPORT, *supra* note 46, at 25. JPMorgan reportedly obtained the maximum recovery permitted under its employment policies from Drew, Marcis, Martin-Artajo, and Iskil through “a combination of canceling outstanding incentive awards and obtaining repayment of awards previously paid.” *Id.*; *see also* JPMORGAN TASK FORCE REPORT, *supra* note 51, at 14.

58. SENATE REPORT, *supra* note 46, at 25; JPMORGAN TASK FORCE REPORT, *supra* note 51, at 14; *see also* Nelson D. Schwartz & Jessica Silver-Greenberg, *JPMorgan Chase Executive Resigns in Trading Debacle*, N.Y. TIMES, May 13, 2012, [http://www.nytimes.com/2012/05/14/business/jpmorgan-chase-executive-to-resign-in-trading-debacle.html?pagewanted=&\\_r=0](http://www.nytimes.com/2012/05/14/business/jpmorgan-chase-executive-to-resign-in-trading-debacle.html?pagewanted=&_r=0); Dawn Kopecki, *JPMorgan’s Drew Forfeits 2 Year’s Pay as Managers Ousted*, BLOOMBERG (July 13, 2012, 10:50 AM), <http://www.bloomberg.com/news/2012-07-13/dimon-says-ina-drew-offered-to-return-2-years-of-compensation.html>.

59. JPMorgan’s *Bonus Recoupment Policy* is as follows:

In the event of a material restatement of the Firm’s financial results, the Board believes it would be appropriate to review the circumstances that caused the restatement and consider issues of accountability for those who bore responsibility for the events, including whether anyone responsible engaged in misconduct. As part of that review, consideration would also be given to any appropriate action regarding compensation that may have been awarded to such persons. In particular, it would be appropriate to consider whether any compensation was awarded on the basis of having achieved specified performance targets, whether an officer engaged in misconduct that contributed to the restatement and whether such compensation would have been reduced had the financial results been properly reported. *Misconduct includes violation of the Firm’s Code of Conduct or policies or any act or failure to act that could reasonably be expected to cause financial or reputational harm to the Firm.*

Depending on the outcome of that review, appropriate action could include actions such as termination, reducing compensation in the year the restatement was made, *seeking repayment of any bonus received for the period restated or any gains realized as a result of exercising an option awarded for the period restated, or canceling any unvested equity compensation awarded for the period restated.* Consideration may also be given to whether or not any one or more of such actions should be extended to employees who did not engage in misconduct that contributed to the restatement.

*Corporate Governance Principles, 5.4 Bonus Recoupment Policy*, JPMORGANCHASE, <http://www.jpmorganchase.com/corporate/About-JPMC/corporate-governance-principles.htm#recoupment> (emphasis added) (last visited Feb. 12, 2014).

60. *See* 2013 JPMorgan Chase Proxy Statement at 7, *available at* <http://investor.shareholder.com/jpmorganchase/secfiling.cfm?filingID=19617-13-305> (last visited May 22, 2014) (“The Board ensured that those directly responsible for the losses incurred over \$100 million in compensation clawbacks, and are no longer with the Company.”). For an additional discussion of JPMorgan’s application of its claw back policy to those involved in the \$6.2 billion trading debacle, *see infra* Part II.A.2.

*A. The Dodd-Frank Act Claw Back Provision*

The Dodd-Frank Act contains a significant claw back provision that removes the Board's discretion in that it *compels* publicly traded companies to recover erroneously paid executive compensation after an accounting restatement of any financial statement. Specifically, Section 954 adds Section 10D to the Securities Exchange Act of 1934 and requires the SEC to issue rules directing national exchanges to prohibit listings by any company that does not develop and implement policies to recover compensation from certain executive officers under particular circumstances.<sup>61</sup> The SEC also must adopt rules requiring every listed public company to: (1) disclose its policies on incentive-based compensation; and (2) develop and implement a policy that, in the event the company is required to restate its financials for material noncompliance with the federal securities laws, the *company will recoup* from current or former executive officers any incentive-based compensation, including stock option awards, that (i) were received within a 3-year period preceding the required restatement; (ii) are based on erroneous data; and (iii) are in excess of what otherwise would have been paid.<sup>62</sup> The SEC's current rulemaking schedule indicates that its regulations finally will be proposed by the end of October 2014.<sup>63</sup>

The genesis of Section 954 is Section 304 of S-Ox, the first initiative to codify the take back of compensation previously paid or owed to employees in certain situations. The S-Ox provision is referred to as a "claw back" because it authorizes a company to recover certain bonuses and stock profits from the company's chief executive officer and chief financial officer. Specifically, S-Ox Section 304 authorizes the forfeiture of bonuses, incentive or equity-based compensation, or trading profits from the sale of the issuers' securities during the first 12 months covered by an earnings restatement if the restatement was as a result of misconduct.<sup>64</sup> However, several issues remained more than ten years

---

61. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(a)).

62. See *id.* (adding Exchange Act, Section 10D(b)).

63. The SEC has eliminated a specific rule-making schedule for Section 954 of Dodd-Frank Act, though it continues to list it as a pending matter. See *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Pending Action*, SEC.gov, last modified June 6, 2014, <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml>. Nevertheless, the SEC's rule-making agenda can be found in the Spring 2014 *Unified Agenda of Regulatory and Deregulatory Actions* which is published semi-annually by the Regulatory Information Service Center, available at <http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201404&RIN=3235-AK99>.

64. Section 304 of S-Ox provides: If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that

following enactment of S-Ox Section 304, including how this provision is to be enforced and what constituted the requisite “misconduct” trigger.<sup>65</sup> These issues may have affected use of the S-Ox claw back as a major enforcement tool to deter wrongdoing, and created a basis to retool the claw back weapon to enhance its deterrent effect.

*1. Use of S-Ox Section 304 as an Enforcement Weapon.*—“Section 304 create[d] a powerful incentive for CEOs and CFOs to take their corporate responsibilities very seriously.”<sup>66</sup> Although it does not create any private right of action, it “establishe[d] that the SEC may sue the CEO and CFO of a company when that company has been required to restate its earnings due to noncompliance with securities laws.”<sup>67</sup> Enforcement actions under S-Ox Section 304, however, have not been as plentiful—thus watering down its effectiveness as a deterrent measure. Even though the claw back remedy was enacted with an eye towards recouping both the CEO and CFO’s bonus or trading profits, history has shown that claw backs of Wall Street CEO’s compensation under Section 304 had been rare and inconsistent. Despite having authority to seek claw backs, the SEC has only pursued about a dozen of cases since 2002, and none before 2007.<sup>68</sup>

---

person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and(2) any profits realized from the sale of securities of the issuer during that 12-month period.

15 U.S.C. § 7243(a) (2002).

65. See discussion *infra* Part II.B.

66. SEC v. Baker, Case No. A-12-CA-285-SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012) (writing that Section 304 is an “enforcement mechanism that ensures the integrity of the financial markets”). “Imagine if someone told you that they would take away half of everything you earned this year if you did not catch the misconduct of one of your employees. You would most likely be highly motivated to catch the misconduct.” *Id.* (quoting Cohen v. Viray, 622 F.3d 188, 195 (2010)).

67. Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust *ex rel.* Fed. Nat’l Mortg. Ass’n v. Raines, 534 F.3d 779,793 (D.C. Cir. 2008).

68. See, e.g., SEC v. Mercury Interactive, LLC, Case No. 07-2822 (N.D. Cal. May 31, 2007) (where California-based software maker Mercury Interactive, LLC (formerly known as Mercury Interactive Corporation) and four former senior officers of Mercury—including former Chairman and CEO Amnon Landan and former CFO Sharlene Abrams were charged as wrongdoers based on allegations that the former senior officers perpetrated a fraudulent and deceptive scheme from 1997 to 2005 to award themselves and other employees undisclosed, secret compensation by backdating stock option grants and failing to record hundreds of millions of dollars of compensation expense. The SEC also alleged that during this period Mercury, through Landan and Abrams, made fraudulent disclosures concerning Mercury’s “backlog” of sales revenues to manage its reported earnings, and structured fraudulent loans for option exercises by overseas employees to avoid recording expenses.). *Accord* SEC Litigation Release No. 20136 (May 31, 2007). See also SEC v. McGuire, Civil Action No. 07-CV-4779-JMR/FLN (D.Minn. 2007) and SEC Litigation Release No. 20387 (Dec. 6, 2007) (option backdating); SEC v. Brooks, Civil Action No. 07-61526-CIV-Altonaga/Turnoff (S.D.Fl. 2007) (fraud and misappropriation of corporate funds).

Moreover, while the SEC initially focused mostly on executives involved in the misconduct that led to the restatement,<sup>69</sup> it finally decided to take a more aggressive stance beginning in 2009 when it started targeting CEOs and CFOs who were not accused of misconduct in connection with the submitted noncompliant financial reports.<sup>70</sup> The SEC even acknowledged that its case, *SEC v. Jenkins*, was the first action to seek reimbursement under Section 304 where the individual sued was not alleged to have otherwise violated the securities laws.<sup>71</sup> According to the SEC, the claw back provision “deprives corporate executives of money that they earned while their companies were misleading investors, . . . Jenkins was captain of the ship and profited during the time that CSK was misleading investors about the company’s financial health,” and “[t]he law [and fairness] requires Jenkins to return those proceeds to CSK.”<sup>72</sup>

In May 2010, the SEC’s Division of Enforcement considered “working towards a policy that would have limited claw back actions to times when the executive is implicated in the violations,” and not target those executives who were unwitting beneficiaries of the fraud.<sup>73</sup> SEC Commissioner Luis Aguilar reportedly objected at the time, however, arguing, “the plan would hinder the

---

69. See sources cited *supra* note 68.

70. See, e.g., *SEC v. Jenkins*, 718 F. Supp. 2d 1070 (D. Ariz. 2010) (where the SEC brought a claw back action under Section 304 in July 2009 against Maynard Jenkins, the former CEO of CSK Auto Corporation, seeking reimbursement of more than \$4 million in bonuses and stock sale profits while CSK—and not Jenkins—was committing accounting fraud). Jenkins was subsequently ordered by the federal district court in Arizona through a consent decree to reimburse CSK’s successor. *SEC v. Jenkins*, Final Judgment, Case No. 2:09-cv-01510-RJB (Nov. 16, 2011). See also *SEC v. Walden O’Dell*, Civil Action No. 1:10-CV-00909 (D.D.C.) (where the SEC brought a claw back action in June 2010, against Walden O’Dell, the former CEO of Diebold, Inc., seeking reimbursement of certain financial benefits while Diebold—and not O’Dell—was committing accounting fraud by engaging in fraudulent accounting transactions designed to improperly recognize revenues or otherwise inflate Diebold’s financial performance). O’Dell consented to a final judgment ordering him to reimburse \$470,016 in cash bonuses, 30,000 shares of Diebold stock, and stock options for 85,000 shares of Diebold shares. See SEC Litigation Release No. 21543 (June 2, 2010). The SEC also brought an administrative proceeding on August 5, 2010 against Navistar International over restated financial results, and announced that its CEO and former CFO would return over \$2.3 million in bonuses paid to them based on overstated earnings. See *In re Navistar Internat’l Corp.*, Administrative Proceeding File No. 3-13994, SEC Release No. 33-9132, 34-62653 (Aug. 5, 2010).

71. See SEC Litigation Release No. 21149A (July 23, 2009); see also *SEC v. Jenkins*, Case 2:09-cv-01510-JWS (D. Ariz. July 23, 2009), available at <http://sec.gov/litigation/complaints/2009/comp21149.pdf>.

72. SEC Press Release, *SEC Seeks Return of \$4 Million in Bonuses and Stock Sale Profits from Former CEO of CSK Auto Corp.* (July 22, 2009).

73. Jesse Westbrook, *SEC Rift on When to Claw Back Bonus May Leave Policy in Limbo*, BLOOMBERG NEWS (Aug. 6, 2010), available at <http://www.bloomberg.com/news/2010-08-06/u-s-regulators-said-to-debate-when-it-s-appropriate-to-claw-back-bonuses.html>.

SEC's ability to recoup pay based on inflated profits."<sup>74</sup> When the SEC used the law in the *Jenkins* case, it reportedly caused a split among the agency's commissioners along party lines; with former Commissioners Kathleen Casey and Troy Paredes opposing the case, arguing that "the SEC shouldn't go after bonuses when an executive didn't orchestrate a fraud and may not have known it was occurring."<sup>75</sup>

Despite the difference of opinions, the SEC has continued to bring enforcement actions under S-Ox Section 304 seeking reimbursement of bonuses and other compensation received during the period of the company's securities law violations against their CEO and CFO—even though these individuals are not alleged to have participated in the wrongdoing.<sup>76</sup> Where a recipient's bonus is premised on performance measures or targets that later turned out to be wrong because of fraud or other wrongdoing, such payments will result in an unjust enrichment to the recipient. Enforcement actions are necessary because the unwitting executives have no rightful claim to monies paid. A federal district court in Phoenix seemingly agreed when in June 2010 it upheld the SEC's right to seek a claw back of bonuses and other compensation in *Jenkins* absent allegations of wrongdoing by the executive.<sup>77</sup>

Rather than settle with the SEC in July 2009, Jenkins argued unsuccessfully in his motion to dismiss that the SEC is trying to force a novel vicarious strict liability interpretation of Section 304 that "departs starkly" from the regulator's own repeated application of the statute.<sup>78</sup> Judge G. Murray Snow of the U.S.

---

74. *Id.*

75. *Id.*

76. *See, e.g.*, SEC v. O'Leary, Case No. 1:11-cv-2901 (N.D. Ga.); Litigation Release No. 22074 (Aug. 30, 2011) (On August 30, 2011, the SEC announced a settlement with James O'Leary, the former CFO of Beazer Homes USA, to recover approximately \$1.4 million in cash bonuses, incentive and equity-based compensation, and profits from his sale of Beazer stock during the period of time that the SEC alleged an individual at Beazer—but not O'Leary—was committing "accounting misconduct."); SEC v. McCarthy, Case No. 1:11-CV-667-CAP (N.D. Ga.); Litigation Release No. 21873 (Mar. 4, 2011) (The SEC filed an action on March 3, 2011, against Ian J. McCarthy, the President and CEO of Beazer Homes USA, Inc., seeking to recover bonuses and other incentive-based and equity-based compensation and stock sale profits received after Beazer was required to prepare accounting restatements for the fiscal year ended September 30, 2006 and the first three quarters of fiscal 2006 due to its manipulation of Beazer's land development and house cost-to-complete accounts to increase income, and the improper recording of certain model home financing transactions as sales, again to increase Beazer's income. McCarthy was not charged with the underlying misconduct or alleged to have otherwise violated the federal securities laws.)

77. *See* SEC v. Jenkins, 718 F. Supp. 2d 1070 (D. Ariz. 2010).

78. *See id.*; *see also* Securities and Exchange Commission v. Maynard Jenkins, Notice of Motion and Motion by Defendant Maynard L. Jenkins To Dismiss the Complaint; Memorandum of Points and Authorities In Support Thereof, United States District Court for the District of Arizona, Case No. CV-09-01510-PHX-GMS, at 1 (Sept. 15, 2009), available at <https://www.complianceweek.com/s/documents/MotiontoDismiss.pdf>, last accessed May 22, 2014 (where



District Court for the District of Arizona rebuffed Jenkins' efforts in 2010 after reviewing the text of the statute and its legislative history.<sup>79</sup> The court held that while Section 304's meaning was unambiguous,<sup>80</sup> it found that the legislative history supported a congressional intent to punish even innocent executives for corporate wrongdoing;<sup>81</sup> writing that it is not irrational for Congress to require that such additional compensation amounts be repaid to the issuer, considering that "when a CEO either sells stock or receives a bonus in a period of financial noncompliance, the CEO may *unfairly benefit* from a misperception of the financial position of the issuer that results from those misstated financials, even if the CEO was unaware of the misconduct leading to misstated financials."<sup>82</sup> And further still that "Section 304 provides an incentive for CEOs and CFOs to be rigorous in their creation and certification of internal controls by requiring that they reimburse additional compensation received during periods of corporate noncompliance regardless of whether or not they were aware of the misconduct giving rise to the misstated financials."<sup>83</sup> In the end, Jenkins agreed to settle with the SEC on November 16, 2011, agreeing to pay CSK \$2,796,467 in damages.<sup>84</sup> The *Jenkins* settlement left unsolved some of the potential constitutional challenges to Section 304.<sup>85</sup>

A Texas federal court followed the *Jenkins* analysis in part, more than a year later, when it also upheld the SEC's authority to bring a stand-alone claw back action absent allegations that the defendant also engaged in wrongdoing. In the case *SEC v. Baker*, the court similarly rejects the defendants' arguments, *inter alia*, that the language of Section 304 required the misconduct of the officer from whom the reimbursement was sought, and that the statute was unconstitutional.<sup>86</sup>

---

Jenkins argued, "This truculent construction of section 304 is not only unprecedented, it departs starkly from the SEC's own repeated interpretation and application of the statute since its enactment seven years ago.")

79. *See Jenkins*, 718 F. Supp. 2d 1070.

80. *See id.* at 1074-75 (noting that "the text and structure of Section 304 require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer's CEO or CFO. According to the court, it is the issuer's misconduct that triggers the CEO and CFO's reimbursement obligation as Section 304 specifies that the reimbursement obligation is triggered if an issuer has to prepare an accounting restatement 'due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws.'). *Id.* (citing 15 U.S.C. § 7243(a)).

81. *See id.*

82. *See id.* at 1070.

83. *See id.*

84. Final Judgment as to Defendant Maynard Jenkins, CV-09-01510-PHX-RJB (Nov. 16, 2011).

85. *Id.* (The court also denied the defendant's motion to dismiss the SEC's complaint based on the argument that section 304 was unconstitutionally punitive. The court held that the nature of the relief requested was a factual issue that could not be resolved on a motion to dismiss.)

86. *SEC v. Baker*, Case No. A-12-CA-285-SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012).

Defendants Michael A. Baker and Michael T. Gluk were CEO and CFO, respectively, of Arthrocare, which previously restated its financials due to alleged fraud by two senior vice presidents.<sup>87</sup> The defendants were not alleged to have committed any conscious wrongdoing in connection with the fraud. In denying the defendants' motion to dismiss the SEC's case against them, U.S. District Judge Sam Sparks of the Western District of Texas, wrote:

Apologists for the extraordinarily high compensation given to corporate officers have long justified such pay by asserting CEOs take 'great risks,' and so deserve great rewards. For years, this has been a vacuous saw, because corporate law, and private measures such as wide-spread indemnification of officers by their employers, and the provision of Directors & Officers insurance, have ensured any 'risks' taken by these fearless captains of industry almost never impact their personal finances. In enacting Section 304 of Sarbanes-Oxley, Congress determined to put a modest measure of real risk back into the equation.<sup>88</sup>

Quickly noting that Section 304 contains no scienter or personal wrongdoing requirement,<sup>89</sup> this court then turn[ed] to a further analysis of Section 304's legislative history. Finding that a requirement of wrongdoing by executives would render Section 304 meaningless because the SEC already had the power to seek disgorgement of profits earned through wrongdoing pre-dating Sarbanes-Oxley, the court stated, "for [Section] 304 to have any meaning beyond mere exhortatory rhetoric, the Court must give effect to the statute as written, and as argued by the SEC: reimbursement is required without any showing of wrongdoing by the CEO or CFO, and the amount or reimbursement is not limited to income attributable to the wrongdoing of others."<sup>90</sup>

Further still, reading Section 304 in context with other provisions of the Act, including Section 302 (which requires CEOs and CFOs to certify issuers' financial statements), the *Baker* court stated that Congress clearly intends to increase CEOs and CFOs accountability throughout the statute.<sup>91</sup> Specifically, Section 304 "ensures corporate officers cannot simply keep their own hands clean, but must instead be vigilant in ensuring there are adequate controls to prevent misdeeds by underlings."<sup>92</sup> Declining to follow the Ninth Circuit opinion in *SEC v. Jasper*, which held that Section 304 required equitable disgorgement,<sup>93</sup> the *Baker* court also rejected the defendants' argument that Section 304 established an equitable remedy similar to disgorgement, and as such, required a finding of misconduct by the defendants.<sup>94</sup> In so doing, the *Baker* court found

---

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. 678 F.3d 1116 (9th Cir. 2012).

94. *See Baker*, 2012 WL 5499497 (citations omitted).

instead that Section 304 was a penalty that could be imposed regardless of fault.<sup>95</sup> The court in *Baker* similarly rejected the defendants' constitutional arguments that Section 304 was void for vagueness because the statutory reference to misconduct did not specify to whom the term should apply.<sup>96</sup> The *Baker* court wrote that the reference to issuer misconduct clearly referred to the issuer and its agents acting within the scope of their employment.<sup>97</sup>

Victories in the *Jenkins* and *Baker* cases, as well as the other settlements of SEC's recent enforcement actions under Section 304, may represent significant victories for the agency (issuers and derivatively, the shareholders), thereby making implementation of Dodd-Frank Section 954 unnecessary. However, the long-term significance of these decisions remains unclear. The enforcement requirements of S-Ox Section 304 are far from a settled area of law. Case law in this area remains sparse and, in some cases, conflicting.<sup>98</sup> This view is supported particularly in the Ninth Circuit,<sup>99</sup> where courts have ruled that section 304 is an equitable remedy, thus enabling defendants to argue that compensation being clawed back must be linked to the misconduct, and not to other unrelated goals. It is also too soon to determine whether the SEC will continue on this path or retreat from wielding Section 304 as aggressively. To date, the SEC has been inconsistent in its enforcement of Section 304—sparing some executives while clawing back compensation from others—all the while providing no real guidance to the public.<sup>100</sup> Only time will tell. In the meantime, given the uncertainties associated with Section 304, rulemaking under Dodd-Frank Section 954 must move forward.

2. *How Dodd-Frank Section 954 Enhances S-Ox Section 304 Claw back Weapon.*—The Act attempts to respond to those enforcement issues left unresolved by S-Ox Section 304 as Dodd-Frank Section 954 substantially broadens the S-Ox claw back rule primarily by (i) removing the “misconduct” requirement as a trigger for the claw back; (ii) increasing the recovery period; (iii) expanding the parties subject to the claw back beyond the CEO and CFO; and (vi) expanding who can enforce the claw back mandate.<sup>101</sup> However, as will be

---

95. See *id.* Accord *S.E.C. v. Microtune*, 783 F. Supp. 2d 867, 886-87 (2011); *Cohen v. Viray*, 622 F.3d 188, 195 (2010)).

96. See *Baker*, 2012 WL 5499497 (citations omitted).

97. See *id.*

98. Cf. *Sec v. Jasper*, 678 F.3d 1116 (9th Cir. 2012).

99. See *id.* at 1130 (relying on *In re Digimarc*, 549 F. 3d. 1223,1232-33 (9th Cir. 2008)).

100. For further analysis of the interpretation issues regarding Section 304 of S-Ox and the potential shortcomings of the SEC's enforcement action prior to 2009 that might bind the Agency going forward, see Allison List, *The Lax Enforcement of Section 304 of Sarbanes-Oxley: Why is the SEC Ignoring Its Greatest Asset in the Fight Against Corporate Misconduct?*, 70 OHIO ST. L.J. 195 (2009).

101. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)). Cf. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

illustrated in the next part of the Article, Section 954 also narrows the amount and nature of assets that could have been reached pursuant to the S-Ox claw back rule.

The forfeiture authority under the pre-existing S-Ox claw back rule is triggered only when the required accounting restatement results from misconduct. In contrast, the recovery right under Section 954 occurs whenever the company is required to prepare any accounting restatement due to the material noncompliance with a financial reporting requirement—without regard to whether the noncompliance was due to misconduct. Personal fault of the target of the recovery is no longer at issue; thus avoiding the litigations that plagued the S-Ox claw back remedy.

While the authorized recovery period to claw back compensation under S-Ox is limited to the 12 month period *following* the first public issuance or filing of the misstated financials where that unearned compensation was received, Section 954 expands the recovery period to a three-year timeframe *preceding* the date on which the issuer is required to prepare an accounting restatement.<sup>102</sup> Taken together with the deleted “misconduct” trigger, the expanded claw-back recovery period makes for a more impactful deterrent effect. Financial industry personnel now will have exposure to real downside risks—true compensation forfeiture; exposure for a greater period of time—if they are compensated for events that fail to occur or other instances where they receive compensation that is essentially unearned had the financial results been properly recorded.<sup>103</sup> In accord with the recent holdings in *Jenkins* and *Baker*, executive officers will be held to account under Dodd-Frank Section 954 for monies paid or due while the company was misleading shareholders through noncompliant public filings.<sup>104</sup> Such personnel implicitly will be required to ensure that their cohorts and underlings are not acting in ways that might contribute to the restatement as well as to provide oversight and vigilance for a greater period of time. The expanded recovery period to three-years also would cover those instances where the employee might consider a delayed disclosure to protect his compensation payout during the current year.<sup>105</sup> Moreover, corporate internal controls should ferret out wrongdoing or fraud during this time, and unearth any basis to cause a material restatement of a corporation’s financials. Once discovered, it is highly unlikely that a corporation would willfully refrain from restating its financials for three years to avoid the claw back mandate in order to protect an executive officer’s compensation.

Section 954 also expands the reach of the S-Ox claw back remedy beyond

---

102. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)). Cf. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

103. See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)).

104. See generally *id.* (adding Exchange Act, Section 10D(b)).

105. See generally *id.* (adding Exchange Act, Section 10D(b)).

CEOs and CFOs who are the sole targets of the S-Ox claw back rule to now reach all current and former *executive officers*.<sup>106</sup> The S-Ox claw back remedy, which sought compensation recoupment from only the CEO and CFO, left so many other employees with similar policy-making authority unjustly enriched as they were allowed to benefit despite the falsehood in the issuer's filings. Although the expansion of potential targets under Dodd-Frank Section 954 is significant, that provision continues to leave many other potential targets free from the recoupment threat. As JPMorgan recently illustrated, many financial institutions employ highly compensated, non-executive individuals who also have the capacity to harm the corporation through errant performance, excessive risk-taking or conduct that lacks integrity.<sup>107</sup> These employees also should be covered by the rules to be promulgated by the SEC.

A final distinction between the two provisions relates to the enforceability of, and penalties for, violating the claw back provision. Pursuant to Section 954, corporations must police their executives and have little discretion about whether to recover unearned compensation.<sup>108</sup> Noncompliant companies now will be required to be delisted by the national exchange or NASDAQ if they do not develop and implement policies to recover certain unearned compensation awards.<sup>109</sup> This mandate, which requires greater vigilance on the part of the company's Board in reviewing the compensation awards for *all* executive employees, differs from the approach under Section 304 of S-Ox that gave the SEC discretion to bring an enforcement action if there is a violation and the CEO or CFO did not voluntarily agree to reimburse the corporation. While some may criticize Section 954 for removing discretion from the Board since recovery must be sought if the publicly-held corporation has material financial restatements, the provision is a powerful mechanism for assisting the Board in meeting its fiduciary obligations to shareholders—Section 954 holds them accountable to shareholders who want the Board to balance proper risk management with high performance when authorizing compensation awards.

Unfortunately, the SEC has yet to propose rules to affect Dodd-Frank Section 954's mandated recovery. Indeed, the Commission has removed its rule-making timeline from its website.<sup>110</sup> Their tardy rulemaking on the claw back remedy greatly impacts the national securities exchanges' ability to move forward as well. While it is too soon to determine whether the new rules will provide a narrower interpretation of both the amount and nature of compensation that is subject to recovery, or who, and on what basis would that person be subject to the claw

---

106. *See id.* (adding Exchange Act, Section 10D(b)). *Cf.* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

107. *See infra* Part II (discussing JPMorgan's \$6.2 billion trading debacle).

108. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)).

109. *See generally id.* (adding Exchange Act, Section 10D(a)).

110. *See supra* note 64.

back remedy, there is a great danger that the SEC will do too little rather than too much.

In fact, Commissioner Troy Paredes took aim at the Dodd-Frank claw back provision when he delivered a speech on July 13, 2012.<sup>111</sup> He expressed concern that the new regulatory regime “will prove to be excessive, unduly burdening and restricting [on] our financial system . . . suppressing private sector innovation, entrepreneurship and competition at the expense of [the] country’s economic growth and global competitiveness.”<sup>112</sup> Commissioner Paredes stated that he understood why some found the “no-fault nature” of Section 954 “troubling,”<sup>113</sup> seemingly a repeat of his 2010 fairness argument. He offered the example of “an executive who has worked diligently and honestly at a company that has robust financial controls and top notched procedures and systems” but who “may nevertheless have to pay back a considerable portion of his or her compensation if the company has to restate because of an accounting error.”<sup>114</sup> Commissioner Paredes’ argument misses the point that this executive had been compensated on the basis of a mistake, albeit honest on his part, that if left uncorrected would leave that executive with a benefit that he did not earn.

Commissioner Paredes, in criticizing Dodd-Frank’s compensation rules, also raised application issues including whether: (i) companies would restructure their compensation arrangements to minimize the size of the incentive pay in favor of a larger discretionary bonus not specifically linked to a financial or performance target; (ii) executives will press for a higher base pay to compensate them upfront for the risk associated with future forfeited incentive pay; (iii) this compensation policy shift will impact an executive’s incentives; and (iv) companies will avoid or be discouraged from restating financials to avoid triggering the Section 954 claw back.<sup>115</sup> In regard to the latter argument, it is unreasonable to believe that a corporation would willfully refrain from restating its financials for up to three years simply to avoid Section 954’s claw back mandate. The Commissioner’s remaining arguments will be addressed below in the discussion of Dodd-Frank Section 956.

Most interestingly, an increasing number of companies have already begun describing their claw back policies within their proxy statements over the last two years rather than wait for the SEC’s rulemaking.<sup>116</sup> Like JPMorgan, more and

---

111. Commissioner Troy A. Paredes, Remarks at Society of Corporate Secretaries & Governance Professionals, 66th National Conference on “The Shape of Things to Come,” SEC Speech (July 13, 2012).

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. The vast majority of the “Top 25 U.S. Bank Holding Companies” have adopted some form of a claw back policy. The list of the 25 “United States’ Largest Banks” as of December 31, 2012 was sourced from the Federal Reserve System, National Information Center, and is *available at* <http://www.infoplease.com/ipa/A0763206.html>. The supporting documents and citations for all, except USAA, HSBC, TD Holdings and RBS Citizens Financials, are on file with the Author.

more financial institutions are going further with their claw back provision than was envisioned by Congress—even invoking their policies in response to adverse business results.<sup>117</sup> Several other big Wall Street banks (including Citigroup, Morgan Stanley, and Goldman Sachs) also have announced new claw back policies in recent years that target the pay of their employees who put the banks in big financial or legal trouble.<sup>118</sup> For example, according to Dimon, JPMorgan’s claw back policy targets all senior employees and also can be invoked for “bad judgment.”<sup>119</sup> A 2012 study conducted by Equilar found that 86% of Fortune 100 companies have publicly disclosed their claw back policies; 49% of their claw back triggers relate to both financial restatements and ethical misconduct; and 67% target key executives.<sup>120</sup> The SEC’s regulations should meet (if not surpass) the standards currently adopted by these companies to avoid any retrenchment on their part.

3. *What Is Lacking in Dodd-Frank’s Claw-back Reform Effort?*—While Section 954 is a very good start towards enhancing the accountability net at publicly-held corporations by removing the motivation to engage in behavior that may lead to the restatement of noncompliant financials, the provision as written unnecessarily narrows both the amount and nature of recovery by the corporation, and derivatively by the shareholders. Section 954 limits recovery to only “incentive-based compensation, including stock option awards,” and then only that amount that was paid “in excess of what would have been paid” under the restated financials.<sup>121</sup> Section 304 of S-Ox, in contrast, is more expansive; authorizing the recovery of “any bonus or other incentive-based or equity-based compensation received on the basis of the fraudulent financial statement” as well as “any profits realized from the sale of securities” during the twelve-month recovery period.<sup>122</sup>

The S-Ox claw back recovery is a penalty that, as noted by the court in *Jenkins*, punishes even innocent executives for corporate wrongdoing.<sup>123</sup> It also

---

117. See, e.g., *id.*

118. See, e.g., *id.*

119. See *supra* note 60; see also Ben Protess, *JPMorgan’s Chief Says Clawback Efforts Are ‘Likely,’* N.Y. TIMES, June 13, 2012 (according to Dimon, JPMorgan “has broad authority to recoup pay” and that the bank “can claw back compensation for ‘bad judgment’ and other missteps.”). Donal Griffin & Dawn Kopecki, *Dimon Says Clawback Likely for Executives Tied to Loss*, BLOOMBERG (June 13, 2012), available at <http://www.bloomberg.com/news/2012-06-13/dimon-says-clawbacks-likely-for-executives-tied-to-trading-loss.html>, last accessed May 22, 2014.

120. See EQUILAR, 2012 CLAWBACK POLICY REPORT (2012), available at <http://www.equilar.com/knowledge-network/research-reports/2012-research-reports/2012-Clawback-Policy-Report.php>.

121. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.) (adding Exchange Act, Section 10D(b)).

122. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

123. See SEC v. Jenkins, 718 F. Supp. 2d 1070, 1074-75 (D. Ariz. 2010). In *Jenkins*, the court

prevents unjust enrichment from those who received compensation that is essentially unearned. Like the S-Ox claw back, the Dodd-Frank claw back recovery should be deemed a penalty. To that end, Dodd-Frank's claw back provision should reach all incentive-based compensation paid *and* all ill-gotten gains realized from the sale of the securities during the relevant recovery period, not just the "erroneous" and "excess" compensation paid the executive officers. Moreover, the theory underlying deterrent-based punishment, as previously noted, is that people who comply with the law after a conscious evaluation of the risks associated with disobeying the law.<sup>124</sup> Applying this theory, potential targets of the claw back recovery purportedly will engage in the necessary cost-benefits analysis to find that the rewards gained from noncompliant financial statements may be recovered at a later date, which should lead him to be more "vigilant in ensuring that there are adequate controls to prevent misdeeds by underlings."<sup>125</sup> To be effective, the claw back penalty must remove all economic incentives that may result from either the misconduct or the failure to be vigilant. Accordingly, the SEC should promulgate rules affecting Section 954 that expansively define "incentive-based compensation"<sup>126</sup>—to go beyond annual and long-term, incentive-based compensation—to ensure that companies do not skirt the application of their recoupment mandate.

Section 954 also suffers another shortcoming. Its requirement that the company parse recovery amounts will create unnecessary confusion in fully implementing and enforcing the claw back remedy. It is not hyperbole to argue that it will be a nightmare for corporations—particularly financial institutions—to be able to easily calculate what part of the incentive-based compensation award is tied to the employee's performance related to the noncomplying financial report given the various formulas applicable to the types of compensation packages awarded.<sup>127</sup> Few financial institutions have a bright-line process by which bonuses are calculated or paid.<sup>128</sup> JPMorgan's response to the \$6.2 billion loss in 2012 is instructive.

Following the discovery of JPMorgan's massive trading debacle that resulted in losses to the firm totaling \$6.2 billion by year-end 2012 and the ensuing internal investigation into the actions of employees in the CIO unit, JPMorgan was

---

was interpreting the application of S-Ox Section 304's claw back remedy. *See id.*

124. *See* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 956 (2003); *see also* Nicholson, *Sarbanes-Oxley's Purported Over Criminalization*, *supra* note 9, at 51-53; Nicholson, *The Culture of Under-Enforcement*, *supra* note 21, at 372-78.

125. SEC v. Baker, Case No. A-12-CA-285-SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012).

126. Incentive-based compensation is not defined in Section 954 apart from the inclusion of stock options. The new rules should explicitly state that the claw back should reach both variable cash and equity earned during a particular period as well as long-term incentive and deferred compensation.

127. *See, e.g., supra* note 116.

128. *Id.*



required to restate its earnings in the first quarter 2012 filings believing employees had sought to hide the extent of trading losses.<sup>129</sup> Relying instead on the firm's compensation policy<sup>130</sup> and not on the federal claw back provision of S-Ox Section 304, JPMorgan subsequently clawed back almost \$100 million in compensation,<sup>131</sup> consisting of forfeited severance payments and salaries and bonuses undoubtedly due to the difficulty in parsing earned versus unearned compensation awards. The firm also decided to apply a blanket 50% cut to the 2012 compensation awarded Dimon; resulting in an amount of \$11.5 million notwithstanding the \$18.7 million compensation the firm disclosed for Dimon in its 2013 proxy filing with the SEC since it included a bonus awarded in 2011 but paid out in 2012.<sup>132</sup> JPMorgan reportedly "invoked comprehensive claw backs of previously granted outstanding awards and/or repayment of previously vested awards subject to claw."<sup>133</sup>

Apart from creating an issue with regard to the *amount* and nature of compensation awards subject to recovery, the language of the statute also raises numerous additional questions relating to the definition of *executive officer of the issuer*, and what constitutes *material noncompliance*. As a result, the SEC will be forced to decide whether to rely either on precedents (e.g., previous definitions of executive officer under the federal section laws or the basis for prior S-Ox Section 304 enforcement actions), or to draft new rules to interpret Section 954.

Addressing the latter concern first, it remains to be seen whether the SEC will determine that noncompliance goes beyond financial statements that do not comply with generally accepted accounting principles since misconduct in connection with the financial restatement is no longer required. Many publicly-held companies, who have existing claw back policies, also allow recovery beyond the malfeasance trigger where there has been an ethical violation or where there has been an erroneous calculation of the incentive compensation, though not

---

129. See Silver-Greenberg, *supra* note 55; see also JPMorgan Chase Form 8-K (July 13, 2012) (disclosing that "the Firm had reached a determination to restate the Firm's previously-filed interim financial statements for the first quarter of 2012," that the "restatement will have the effect of reducing the Firm's reported net income for the 2012 first quarter by \$459 million (after-tax)" and that "recently discovered information raises questions about the integrity of the trader marks [suggesting] that certain individuals may have been seeking to avoid showing the full amount of the losses being incurred in the portfolio during the first quarter.").

130. See *supra* note 60 ("JPMorgan's Bonus Recoupment Policy").

131. See Matthias Rieker, *J.P. Morgan's Dimon Total 2012 Compensation \$18.7 Million; Whale Claw backs Top \$100 Million*, WALL S. J., Mar. 22, 2013; see also JPMorgan 2013 Proxy Statement at 7.

132. See *id.*; see also JPMorgan 2013 Proxy Statement at 7; Dawn Kopecki, *JPMorgan Claws Back \$100 Million, Pays Zames More Than Dimon*, BLOOMBERG (Mar. 23, 2013) (reporting that the "board cited the debacle while cutting Dimon's 2012 compensation to \$11.5 million from \$23 million the previous year").

133. Steve Dickson, *JPMorgan Clawed Back More Than \$100 Million Tied to CIO Loss*, BLOOMBERG (Mar. 22, 2013, 3:24 PM), <http://www.bloomberg.com/news/2013-03-22/jpmorgan-clawed-back-more-than-100-million-tied-to-cio-loss.html>.

where the financials restatement is required due to a change in the applicable reporting standard.<sup>134</sup> The SEC also should follow suit, rather than take a very narrow view of what constitutes “material noncompliance.”

The SEC has more choices when it comes to defining “executive officer” as it is reasonable to presume that the SEC would look to the other definitions under federal securities laws. For example, pursuant to Rule 3b-7 of the Securities Exchange Act of 1934, the term executive officer includes: the company president, its vice presidents of business unit, division or function, and others who perform similar policy-making functions, including executives of subsidiaries who perform policy-making functions.<sup>135</sup> A narrower grouping would be captured if the SEC instead relies on the definition at Item 402 of Regulation S-K, which only includes the principal executive officer, the principal financial officer and the company’s three most highly compensated executive officers other than the aforementioned two employees.<sup>136</sup>

Nevertheless, even using the expansive definition of Rules 3b-7, many non-executive employees will be left out of the corporation’s efforts to deter risk-taking and enhance accountability by use of the claw back punishment. Trading personnel at financial institutions, for example, are just as likely as executive officers to engage in conduct that might lead to restated financials, as illustrated by JPMorgan’s derivatives trader Iksil and his fellow traders in the London office of the CIO.<sup>137</sup> Accordingly, the SEC also must develop a new definition of to capture these other employees, and to meet both the spirit of the Dodd-Frank Act’s corporate governance provisions and the public shareholders’ expectations for good corporate governance. In so doing, the new regulation reasonably could define executive officer to include both traditional executive officers, as well as key, highly compensated employees who have the capacity to harm, or have a material adverse effect on, the company through their performance or nonperformance.

Finally, when promulgating the new rules effecting Section 954, the SEC should consider another path taken by those publicly-held corporations that have already incorporated claw back policies into their compensation program. The malfeasance that triggers the claw back should go beyond a material misstatement of financials to also include reckless behavior and ethical misconduct as well as those instances where the executive terminates employment shortly after exercising their stock options to fully plug the loophole seemingly left open by Dodd-Frank Section 954.

### *B. Incentive-Based Compensation Arrangements*

The financial industry itself, which played a key role in the 2008-2009

---

134. See e.g., *supra* note 116.

135. See 17 C.F.R. § 240.3b-7 (2013) (defining “executive officer”).

136. See *id.* § 229.402(a)(3) (Item 402) (executive compensation).

137. See *supra* notes 51, 52, and 55 (discussing JPMorgan’s \$6.2 billion dollar trading loss at the hands handsomely paid traders).

financed crisis, also played a key role in weakening regulatory constraints on institutions, markets, and products, reportedly spending \$2.7 billion in lobbying expenses between 1999 and 2008.<sup>138</sup> In this environment of light regulation, compensation arrangements were designed to focus on short-term rewards rather than long-term consequences.<sup>139</sup> These arrangements also favored risk takers at the expense of independent risk managers and control personnel.<sup>140</sup>

In 2009, the Group of Twenty (the “G-20”), which serves as the economic council for wealthy nations including the United States,<sup>141</sup> noted that incentive-based compensation engendered the excessive risk-taking that fueled the global economic crisis.<sup>142</sup> The G-20 called for the reform of compensation policies as an essential part of enhancing capital market stability.<sup>143</sup> Specifically, it endorsed

---

138. FCIC REPORT, *supra* note 1, at xviii.

139. *Id.* at xix.

140. SSG REPORT, *supra* note 1, at 4. The Senior Supervisors Group (“SSG”) is a group of senior financial supervisors from the United States, Canada, France, Germany, Japan, Switzerland, and United Kingdom, who reviewed funding and liquidity risks at a sample of global financial institutions during the 2008-2009 crisis and found extensive deficiencies in the financial institutions’ corporate governance and risk management practices that may have contributed to the industry’s distress. The United States sent representatives from the SEC, Office of the Comptroller of Currency, Federal Reserve Bank of New York and Board of Governors of the Federal Reserve System. *See id.* at Transmittal Letter.

141. *About G20*, G20, [https://www.g20.org/about\\_G20](https://www.g20.org/about_G20) (last visited Feb. 12, 2014). The G20 brings together finance ministers and central bank governors from 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States of America plus the European Union, which is represented by the President of the European Council and by Head of the European Central Bank. The objectives of the G20 include: “[1] policy coordination between its members in order to achieve global economic stability, sustainable growth; [2] promoting financial regulations that reduces risks and prevent future financial crises; and [3] modernizing international financial architecture.” *What Is the G20*, G20, [http://en.g20russia.ru/docs/about/about\\_G20-print.html](http://en.g20russia.ru/docs/about/about_G20-print.html).

142. *See* U.S. Department of State, *The Pittsburgh Summit: Key Accomplishments* (Sept. 25, 2009), available at <http://www.state.gov/e/eb/ecosum/pittsburgh2009/resources/165061.htm> (“the G-20 agreed to strong international standards for bank capital ... and also agreed to strong international standards for compensation aimed at ending practices that lead to excessive risk-taking. . . . These rules will result in a financial system that looks far different from the one that led to this financial crisis, with more capacity to absorb losses and new incentives to avoid a return to past excesses.”); *see also* Christine Harper, *G-20 Leaders Vow to ‘Raise Standards’ on Financial Regulation*, BLOOMBERG (Sept. 26, 2009), [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aF5cR\\_E70CtU](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aF5cR_E70CtU).

143. *See* G-20, *G-20 Leaders Statement after Talks in Pittsburgh (Full Text)* ¶ 13, BLOOMBERG (Sept. 25, 2009), available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=auIe3UTJncpY> (last visited May 22, 2014) (noting “Excessive compensation in the financial sector has both reflected and encouraged excessive risk taking. Reforming compensation policies and practices is an essential part of our effort to increase financial stability. We fully endorse the

aligning banker compensation with long-term value creation and provided that a significant portion of incentive-based compensation be structured as variable, deferred and tied to long-term performance subject to appropriate claw backs.<sup>144</sup> The new structure would ensure that trading risks be personally borne by the bankers whose compensation would be subject to claw backs when their trades did not work out. The G-20 also recommended more transparency and disclosures of compensation calculations.<sup>145</sup>

The G-20 proposals were supported by a 2009 study of 20 global financial institutions by a group of senior financial supervisors from seven countries including the United States (the “SSG”), which found that “historical compensation arrangements evidenced both an insensitivity to risk and the skewed incentives to maximize revenues.”<sup>146</sup> The SSG also found that these compensation “schemes for measuring individual performance also often failed to take into account [either the units’ or the firms’] true economic profits, adjusted for all costs and uncertainty.”<sup>147</sup> If the JPMorgan trading debacle is indicative, compensation arrangements following the financial crisis continue to be misaligned with the firm’s risk appetite. JPMorgan’s 2012 compensation policy, for example, was found by the Senate Sub-committee investigating the London Whale trades to be premised on rewarding employees for financial gains and risk-taking more than effective risk management.<sup>148</sup> Indeed, CIO unit managers Macris and Martin-Artajo reportedly received incentive pay worth millions of dollars each year; rates which moved in tandem with the CIO’s credit derivatives’ trading profits.<sup>149</sup>

---

implementation standards of the FSB aimed at aligning compensation with long-term value creation, not excessive risk-taking, including by (i) avoiding multi-year guaranteed bonuses; (ii) requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk; (iii) ensuring that compensation for senior executives and other employees having a material impact on the firm’s risk exposure align with performance and risk; (iv) making firms’ compensation policies and structures transparent through disclosure requirements; (v) limiting variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base; and (vi) ensuring that compensation committees overseeing compensation policies are able to act independently.”).

144. *Id.*

145. *See* G-20, *supra* note 143, ¶ 13 (“If we all act together, financial institutions will have stricter rules for risk-taking, governance that aligns compensation with long-term performance, and greater transparency in their operations. All firms whose failure could pose a risk to financial stability must be subject to consistent, consolidated supervision and regulation with high standards. Our reform is multi-faceted but at its core must be stronger capital standards, complemented by clear incentives to mitigate excessive risk-taking practices.”).

146. SSG REPORT, *supra* note 1, at 4.

147. *Id.*

148. SENATE REPORT, *supra* note 46, at 57-60.

149. *Id.* at 59.

Many firms will likely respond to criticism of their compensation arrangements by arguing, as did JPMorgan in Dimon's February 2012 remark, that "We are going to pay competitively,"<sup>150</sup> that their compensation arrangements were and continue to be driven by competition and the need to attract and retain talented staff, and that this race to retain people led to some inconsistencies in their incentive-based compensation arrangements. Some of these firms also may believe that they are protected from undesirable financial or business results that may result from their employees' acts because the firms have adopted claw back policies.<sup>151</sup> However, such policies are only as good as the firm's ability to recover the unearned funds. Once compensation awards have been made to errant personnel, the difficulty of recovery of unearned amounts is greatly amplified. The funds simply may be unavailable.

Of course, best practices would be to structure incentive-based compensation arrangements in a manner to prevent excessive risk-taking in the first place; but where that does not occur, consideration also must be given to the firm's ability to recover the unearned awards. As a result, incentive-based compensation arrangements that are structured in a manner that would allow the firms to offer deferred payments that have both longer vesting periods as well as longer distribution periods would also serve the firm's latter concern. Such a structure would enable the firm (and its shareholders) to be self-protected from any resulting tail risks.

Section 956 of the Dodd-Frank Act, which requires joint action by the appropriate federal regulators, mandates disclosure obligations and guidelines for structuring all incentive-based compensation arrangements offered by covered financial institutions in order to limit excessive risk-taking by industry personnel.<sup>152</sup> Congress further requires both the new disclosure standards and the new incentive-based compensation rules be modeled against the FDIC safety and soundness standards for insured depository institutions.<sup>153</sup> Some may question the paternalistic nature of Section 956(a)'s reporting obligation, but enhanced prudential regulation is one of the hallmarks of the Dodd-Frank legislation.<sup>154</sup>

*1. The Dodd-Frank Act Reform of Incentive-based Compensation Arrangements.*—The required disclosures under Dodd-Frank Section 956(a) must allow for a determination by the appropriate federal regulator that the firm's compensation structure does not either: (i) provide an executive officer,

---

150. See discussion *infra* Part II.A.

151. See discussion *infra* Part II.A.

152. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956, 124 Stat. 1376, 1905 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.)

153. *Id.* § 956(c).

154. See G-20, *supra* note 143 (noting "Reforming compensation policies and practices is an essential part of our effort to increase financial stability. We fully endorse the implementation standards . . . aimed at aligning compensation with long-term value creation, not excessive risk-taking, including by . . . (iv) making firms' compensation policies and structures transparent through disclosure requirements; . . .").

employee, director or principal shareholder with excessive compensation, fees, or benefits; or (ii) lead to a material financial loss to that firm.<sup>155</sup> Section 956(b) further directs federal regulators to adopt joint regulations that will prohibit incentive-based compensation arrangements that these regulators deem will encourage inappropriate risks by covered financial institutions.<sup>156</sup> The ensuing joint regulations, therefore, must restrict those incentive-based compensation plans that either: (i) provide an executive officer, employee, director or principal shareholder with excessive compensation, fees, or benefits; or (ii) could lead to a material financial loss to that firm.<sup>157</sup>

On February 7, 2011, the seven federal regulatory authorities (including the SEC)<sup>158</sup> issued the proposed rules to implement Section 956.<sup>159</sup> Though it has been more than three years since these agencies first published their proposed rule in the Federal Register,<sup>160</sup> the public is still awaiting final rules.<sup>161</sup> Nevertheless, the regulators have provided the public with an insight into their views on the best manner to meet the challenges of excessive risk-taking by financial institutions. The proposed rules are broad in scope, and lack specificity in how certain terms should be applied. Yet, they show that the federal regulators are finally moving in the right direction to reform executive compensation arrangements.

In general, the proposed rules prohibits regulated entities with consolidated assets of \$1 billion or more (“covered financial institutions”)<sup>162</sup> from maintaining incentive-based compensation arrangements for covered persons<sup>163</sup> that encourage “inappropriate risks” that could lead to “material financial loss” at such institutions, or encourage “inappropriate risks” by providing “excessive

---

155. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 956(a), 124 Stat. 1376, 1905 (2010).

156. *Id.*

157. *Id.* § 956(b).

158. Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170-01 (proposed Apr. 14, 2011). The other federal agencies include the Federal Deposit Insurance Corporation, Office of the Comptroller of Currency, Board of Governors of the Federal Reserve System, Office of Thrift Supervision, National Credit Union Administration, and Federal Housing Finance Agency. *Id.*

159. *Id.* at 21,170.

160. *Id.*

161. The proposed rule was posted in the Federal Register in April 2011. The original comment period ended May 31, 2011, and the terms of the final rules were expected to become effective six months from the publication of the final rule in the Federal Register. *See id.* at 21,170-01.

162. *Id.* at 21,174. The “covered financial institutions” include banking organizations (e.g., national or state-chartered depository institutions, bank holding companies), registered brokers or dealers, investment advisors, Fannie Mae and Freddie Mac, and any other financial institution that the appropriate federal regulators jointly by rule determine should be treated as such. *Id.*

163. *Id.* at 21,175. The term “covered persons” includes any of the institution’s “executive officers,” non-executive officers, “directors,” and “principal shareholders.” *Id.*

compensation.”<sup>164</sup> The proposed rules also require “large covered financial institutions”—those with assets of \$50 billion or more—to defer at least 50% of the incentive-based compensation paid to executive officers for a period of at least three years.<sup>165</sup> The firms are also required to ensure that those deferred compensation amounts are subject to adjustments for the actual losses of the covered financial institution, or based on other measures of performance.<sup>166</sup> Incentive-based compensation is broadly defined to include any variable compensation that serves as an incentive for performance.<sup>167</sup>

The proposed rules also direct the actions of Boards of the larger covered financial institutions; requiring directors to review and approve all incentive-based arrangements for certain designated employees (“non-executive officers”) who the boards determine have “the ability to expose the institution to possible losses that are substantial in relation to the institution’s size, capital or overall risk tolerance.”<sup>168</sup> The boards, in awarding approval, must determine that the compensation arrangements effectively balances the financial rewards to the individual with the range and time horizons of risks associated with the individual’s activities.<sup>169</sup> The boards, however, may use various methods in reaching this determination, including deferrals, risk-weighting and longer performance periods.<sup>170</sup>

Finally, all covered financial institutions are required to provide an annual report within 90 days of the end of the fiscal year to the appropriate federal regulator for its determination of the firms’ compliance with the rules’ requirements.<sup>171</sup> This annual report must detail the key components of the respective firm’s incentive-based compensation arrangements, set forth the firm’s policies and procedures governing its plans, along with any changes in policies or procedures since its latest filing; and provide the specific rationale for the firm’s determination that its compensation arrangements neither are excessive, nor provide incentive to engage in actions that would lead to a material financial loss.<sup>172</sup> The required institutional report need not, however include the actual compensation received by the individuals within those plans.<sup>173</sup>

*2. The Proposed Rules Implementing Section 956 Should Withstand the Criticisms Raised.*—In order to effectively rein in the size of executive compensation and its role in incentivizing short-term risk-taking at financial

---

164. *Id.* at 21,172.

165. *Id.* at 21,194.

166. *Id.* at 21,180.

167. *Id.* at 21,175. Incentive-based compensation is any variable compensation whether cash, equity award or other property. The broad definition is intended to provide some flexibility as forms of compensation evolve.

168. *Id.* at 21,177.

169. *Id.* at 21,181.

170. *Id.* at 21,173.

171. *Id.* at 21,174.

172. *Id.* at 21,176-77.

173. *Id.* at 21,213, 21,218.

institutions, the compensation structure must be designed to (i) tie both the bonus accrual and unit performance measurements to the firm's economic profits<sup>174</sup>—adjusted for costs and uncertainty; (ii) integrate firm risk controls into individual performance evaluations through a “bottom-line return on risk” at the unit level, rather than “top-line return on investment at the firm-wide level;<sup>175</sup> (iii) extend vesting and distribution periods for deferred compensation plans to allow for negative tail risk events; and (iv) involve the unit chief risk officer directly in business-line compensation decisions. The proposed rules, though stuck in limbo, will allow the Board leeway to so structure the firm's incentive-based compensation plans to take into account each of these points.

Perhaps the delay in adopting final rules is due to the alarmingly high number of comments on, and criticisms of, the proposed rules directed to the federal regulators. The criticisms generally target (i) the lack of definiteness of the proposed rules; (ii) the unintended consequences that may arise from the implementation of the proposed rules—including the increased use, and over-inflation, of the fixed compensation component; and (iii) the adverse impact on covered financial institutions in the global competition for talented employees and clients.<sup>176</sup>

A key criticism appears to be that the proposed rules do not provide tangible benchmarks to determine when compensation is in fact *excessive*. However, it would be impossible for the regulators to create a one-size-fits-all, bright-line benchmark of what definitively is “excessive compensation” given the various types of financial institutions at issue as well as the various positions held by their personnel. Moreover, a bright-line rule would be too easy to avoid if the financial institutions wanted to continue along their historic compensation paths. In any event, the proposed rules do provide factors to be considered by the Boards of the covered financial institutions that should enable them to make the determination of what is “excessive” compensation, including: (i) the combined value of all cash and non-cash benefits provided the covered person; (ii) historical compensation of the covered person in comparison to other individuals with comparable expertise at the covered financial institution; (iii) the institution's financial condition; (iv) comparable compensation practices at comparable institutions;<sup>177</sup> (v) projected total cost and benefit of post-employment benefits; (vi) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse; and (vii) any other

---

174. See SSG REPORT, *supra* note 1, at 4-5.

175. See *id.* at 5.

176. See Public Comments on the Agencies' respective websites to their Joint Proposed Rules on Incentive-Based Compensation, which were published in the Federal Register on April 14, 2011, available at <http://www.gpo.gov/fdsys/pkg/FR-2011-04-14/pdf/2011-7937.pdf>. These concerns will be addressed in this Section.

177. When comparing financial institutions, the covered financial institution should take into consider factors such as asset size, geographic location, complexity of operations and assets. See Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,218 (proposed Apr. 14, 2011)



factors the federal agencies determine relevant.<sup>178</sup>

Arguably any limitation on incentive-based compensation awards can be avoided by any financial institution's decision to increase the base salaries of certain employees in order to retain top talent. However, that strategy will eventually undermine the purpose of providing the bonus in the first place. Incentive-based compensation is supposed to motivate employees to go beyond what is expected of them throughout the performance-review period. If financial services personnel are paid most of their compensation as salary, the motivation to exceed expectations sharply declines. Indeed, a guaranteed upfront payment, which delinks compensation from the employee-driven transactions' risk profile, also will make it harder for the financial institution to renege on the paycheck as punishment for the employee's gross negligence or other misconduct as set forth in the company's internal claw back policy. The up-front payments also do little to curtail excessive employee risk-taking—an unspoken interest of most corporations.

Opponents of executive compensation reform also continually argue that any limitation on banker compensation will force many talented and highly skilled individuals and financial institutions to move jobs overseas where the compensation rules are less restrictive.<sup>179</sup> A multinational approach to executive compensation reform would narrow the places where financial institutions could relocate to avoid new rules as governments worldwide understand (as evidenced by the statements from the G-20 leaders during the 2009 Pittsburgh Summit) the unwanted repercussions if financial instability returns to their capital markets simply because they were bullied away from meaningful reform. There remains some reputational and tax benefits to doing business in a well-regulated market.

Moreover, as the recent crisis illustrated, the global nature of risk contagion has caused other nations to re-consider a “hands-off” approach to executive compensation reform. Indeed, European lawmakers already have moved ahead on proposed rules that would limit bonuses of European bankers in hopes of curtailing the type of risky behavior that played a role in the global economic crisis.<sup>180</sup> In early March 2013, for example, the citizens of Switzerland voted to impose the strictest restriction on executive compensation—the Swiss voted

---

178. *See id*

179. *See, e.g.*, Squam Lake Working Group on Federal Regulation, *Regulation of Executive Compensation in Financial Services* (Council on Foreign Relations, Feb. 2010) (arguing that “Broader limits on the compensation of financial executives may even drive parts of this highly mobile industry to more receptive countries.”).

180. The European Parliament approved restrictions on bonus payments by financial institutions on April 16, 2013 as part of the Capital Requirements Directive (“CRD”) IV in order to amend the rules on capital requirements for credit institutions (i.e., banks) and investment firms. *See* Capital Requirements Directive IV. *See also* *Capital Requirements—CRD IV/CRR—Frequently Asked Questions*, European Commission—MEMO /13/690 (16/07/2013) ¶ 12 (“Remuneration”), available at [http://europa.eu/rapid/press-release\\_MEMO-13-690\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-13-690_en.htm?locale=en). The bonus restriction applies to both employees of EU-based financial institutions and foreign employees of financial institutions of EU-based financial institutions. *See id*.

overwhelmingly to give shareholders of companies listed in Switzerland “a binding say on the overall compensation package of their executives and directors.”<sup>181</sup> Pension fund shareholder voting also is mandatory.<sup>182</sup> Due to the firestorm of criticism that resulted from Novartis’ payment of \$78 million severance payout to its departing chairman, the new law also restricts Swiss companies from offering bonuses to either incoming or outgoing executives, or to executives in corporate acquisitions.<sup>183</sup> There are mandatory fines (up to six year’s salary) and prison time (up to three years) for violation of any of these provisions.<sup>184</sup>

Similarly, in February 2013 the European Parliament and European Commission struck a provisional agreement to limit bonuses to 100 percent of bankers’ salaries and require a majority-shareholders’ vote to allow affected banks to increase the bonuses to twice the bankers’ salaries in an effort to curb risky behavior that poses a systemic risk.<sup>185</sup> Still further, where the bonus exceeds the bankers’ annual salaries, a quarter of the additional compensation must be deferred for at least five years under the initial proposal.<sup>186</sup> By mid-April 2013, the European Parliament had finalized the plan to cap bankers’ compensation arrangements and defer part of the variable payments largely as proposed.<sup>187</sup> The Capital Requirements Directive (CRD IV), which entered into force on July 17, 2013, is applicable to employee performance from January 1, 2014 onward.<sup>188</sup> Surpassing the United States, the European Commission already has adopted the standards or technical rules for the implementation of the

---

181. Raphael Minder, *Swiss Voters Approve a Plan to Severely Limit Executive Compensation*, N.Y. TIMES, Mar. 3, 2013, [http://www.nytimes.com/2013/03/04/business/global/swiss-voters-tighten-countrys-limits-on-executive-pay.html?\\_r=0](http://www.nytimes.com/2013/03/04/business/global/swiss-voters-tighten-countrys-limits-on-executive-pay.html?_r=0) (“Almost 68 percent of Swiss voters backed” the proposals to limit executive compensation).

182. *Id.*

183. *Id.*

184. *Id.*

185. See Michael J. De La Merced & Peter Eavis, *Bonus Rules May Just Reinforce, Not Overhaul, Pay Practices*, N.Y. TIMES, Feb. 28, 2013, available at [http://dealbook.nytimes.com/2013/02/28/bonus-rules-may-just-reinforce-existing-pay-practices-rather-than-overhaul/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2013/02/28/bonus-rules-may-just-reinforce-existing-pay-practices-rather-than-overhaul/?_php=true&_type=blogs&_r=0).

186. *Id.*; see also James Kanter & David Jolly, *European Union Agrees on Plan to Limit Bankers’ Bonuses*, N.Y. TIMES, Feb. 28, 2013, available at <http://www.nytimes.com/2013/03/01/business/global/european-union-agrees-on-plan-to-cap-banker-bonuses.html?pagewanted=all> (last visited May 22, 2014.)

187. See Aaron Lucchetti & Julie Steinberg, *Regulators Get Banks to Rein in Bonus Pay*, WALL ST. J., Apr. 23, 2013, available at <http://online.wsj.com/news/articles/SB10001424127887323551004578439242195663044>; Juergen Baetz, *EU Lawmakers Vote for Banker Bonus*, ASSOCIATED PRESS (Apr. 16, 2013), available at <http://bigstory.ap.org/article/eu-lawmakers-vote-banker-bonus-cap>.

188. See *Capital Requirements—CRD IV/CRR—Frequently Asked Questions*, European Commission—MEMO/13/690 (16/07/2013) ¶ 12 (“Remuneration”), available at [http://europa.eu/rapid/press-release\\_MEMO-13-690\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-13-690_en.htm?locale=en).

restrictions on compensation arrangements in March 2014.<sup>189</sup> From the beginning, Britain has voiced opposition to the EU's restrictions on executive compensation arrangements for the financial industry, raising the same "competition" arguments as have many in the United States—that their industry would be disadvantaged because such rules would drive up fixed salaries; others would find a way to evade the restrictions; and both individual talent and businesses would be driven away to less restrictive regions like New York and Hong Kong.<sup>190</sup> Nevertheless, both caps on compensation levels and structural changes are now the law of the European Union. Given that the United States is also dealing with these issues, the competition-relocation argument must be viewed as a bit of a red herring—there are not as many viable jurisdictions for relocating a global financial capital like New York and London.<sup>191</sup> The time has come for the United States to hold fast to the statements made at the 2009 G-20 Pittsburgh Summit.

#### CONCLUSION

Risk-taking is an essential part of the financial services industry, and as such must be managed. Where the consequences of excessive risk taking affect the stability of the financial markets, governments must act to deter behavior that self-regulation cannot contain. Though it does little to enhance directors risk management oversight, Sections 954 and 956 of the Dodd-Frank Act will have a deterrent effect on certain employees in certain financial institutions if the rules promulgated thereunder hold fast to the spirit of the legislation. Restricting incentive-based compensation arrangements and recovering unjustly earned payouts serves to hold certain financial industry personnel accountable for the consequences that arise from taking outsized risks—accountability that shareholders deserve.

Unfortunately, we are more than three years out from the enactment of the

---

189. See *Commission Adopts New Standards to Increase Transparency Over Bankers' Pay and Risk Profiles*, European Commission—IP/14/210 (04/03/2014), available at [http://europa.eu/rapid/press-release\\_IP-14-210\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-14-210_en.htm?locale=en).

190. De La Merced & Eavis, *supra* note 185 (also arguing that any bonus cap would drive up fixed salaries to compensate for the shortcoming).

191. "A strong institutional framework that protects investors' and creditors' rights includes adequate mechanisms to enforce contracts and the rule of law. . . . this requires: (i) a capable and independent judicial system, free of political pressures; (ii) legal process that support the prompt implementation of regulations; (iii) transparency in government policies; and (iv) an adequate bankruptcy law." Liliana Rojas-Suarez, Center for Global Development, *Towards Strong and Stable Capital Markets in emerging Market Economies*, BIS Papers No. 75, available at [www.bis.org/publ/bppdf/bispap75c.pdf](http://www.bis.org/publ/bppdf/bispap75c.pdf). Very few jurisdictions will meet the criteria for having in place such an institutional framework. See Liliana Rojas-Suarez, Global Development: Views from the Center, *Strengthening Capital Markets in Emerging Economies: Two Key Issues that the G20 Should Not Miss* (Feb. 21, 2014), available at <http://www.cgdev.org/blog/strengthening-capital-markets-emerging-economies-two-key-issues-g20-should-not-miss>.

Dodd-Frank Act, and we are still without final compensation policy rules. Without the need of a crystal ball, we can see the concerted effort now in effect to prevent the full implementation and enforcement of the financial regulatory reforms contained in the Dodd-Frank Act.<sup>192</sup> Large financial institutions, trade associations and their lobbyists have already begun to wage a full out assault to have Congress repeal or weaken the Act. Much money and effort already has been spent to persuade the regulatory authorities to water down any regulation authorized pursuant to the Dodd-Frank Act. If there is no political will to resist the political power of the financial industry, the financial crisis of 2008-2009 that gripped the nation and the world will happen again.

---

192. See, e.g., Ben Protess, *A Year Later, Dodd-Frank Delays Are Piling Up*, N.Y. TIMES, July 22, 2011, available at <http://dealbook.nytimes.com/2011/07/22/a-year-later-dodd-frank-delays-pile-up/> (last visited May 22, 2014) (“‘They are trying to stall,’ Representative Barney Frank, the Massachusetts Democrat who was a co-author the Dodd-Frank law, said of the Republicans. ‘Their plan,’ he said in a recent interview, is to ‘hope that they will win the 2012 election with the support of the financial people.’ Once in control of Washington, he said, Republicans would ‘then undo what we were able to do, and then, yes, the system would be at risk.’”); Ben Protess, *Regulator Approves New Exchange Rules, but Delays Others*, N.Y. TIMES, May 10, 2012, available at <http://dealbook.nytimes.com/2012/05/10/c-f-t-c-approves-new-exchange-rules-but-delays-others/> (last visited May 22, 2014) (“The agency also clarified on Thursday that it would further delay a flood of other new Dodd-Frank regulations, indicating it would not wrap up rule-writing until the end of 2012. The announcement codified the latest setback for Dodd-Frank, which initially set a deadline of July 2011.”).