Executive Compensation, Ethics, and Investor Confidence

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Following the 2008 financial collapse, American policy makers and the public scrutinized executive compensation. This article examines modern finance theory's regulation reluctance prior to the collapse and the resulting new regulations under TARP and Dodd-Frank. These changes mark a shift toward broadening theories of consumer confidence beyond mere corporate profitability.

Few issues capture the vigor of the American public's reaction to the financial crisis of 2008 more than executive compensation. America's corporate executives are paid huge sums of money. As a result, there has been debate among academics and the popular press about the impact of executive compensation on the economy leading up to the financial collapse. Discussion centers on determining how much compensation is excessive and how such excessive compensation should be managed as America attempts its recovery.

The Increasing Amount of Executive Compensation

The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 was passed, at least in part, as a response to sentiments that the old system of incentivizing executives to boost short-term profits through reckless management strategies should give way to rewarding more long term, sustainable growth. At a basic level, these new regulations were billed as a means of increasing investor confidence in the market. Modern finance theory has generally accepted a direct correlation between corporate profitability and investor confidence; however, the recent economic crisis has opened this previously accepted truism to scrutiny. An examination of the 2008 economic

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crisis, related public discourse, and recent regulation, can reveal much about what motivates investor confidence and ultimately raises questions about whether only profitability drives confidence.

The level of executive pay at large U.S. companies has increased over the past three decades. From 1970 to 2000, the average total CEO pay of S&P 500 firms increased from about $850,000 to $14 million.[3] The trend briefly reversed for the next two years, falling to $9.4 million in 2002, but again soared to approximately $13.5 million in 2007.[4] Even amid the 2008 global financial crisis, executive compensation hovered around $10.5 million.[5] Furthermore, the growth of executive compensation has significantly outpaced other employee compensation. In 1991, the average large-company CEO received approximately 140 times the pay of an average worker. In 2003, the ratio was approximately 500:1.[6]

Regulatory Reluctance under "Free Market" Principles

The debate regarding how much executives should be compensated is not a recent phenomenon. In 1933, the U.S. Supreme Court examined executive compensation concerns in *Rogers v. Hill*. Plaintiff shareholders claimed the executives of American Tobacco Co. received illegal and excessive bonuses. The Court held that overall compensation must be reasonable in proportion to the value of the services rendered. The applicable rule from *Roger's* became, "if a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority." With this language the Court effectively established the legal right to examine compensation in public companies. Despite the legal precedent set by *Rogers v. Hill,* however, compensation has grown at a remarkable rate with little oversight, at least partly because courts have been reluctant to overturn corporate board decision-making.

The courts are not alone in their reluctance to question board decisions. The U.S. government has historically involved itself in only two major aspects of executive pay, drafting regulations that require more pay disclosure and shaping the tax code to make certain forms of pay more attractive than others. It comes as little surprise that executive compensation has consequently expanded rapidly in recent decades. However, the recent Dodd-Frank Act passed in response to the

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3 Michael Faulkender et. al., *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms,*22 J. APPLIED CORP. FIN., 107, 2010.

4 *Ibid*.

5 *Ibid*.

6 Bebchuk, Lucian, and Fried, Jesse, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 30 *Journal of Corporation Law,* 749, 755, 2004.

2008 financial crisis signals a potential shift towards increased government regulation of the compensation executives may receive. Likely, the previously limited attempts to curb the growth of executive compensation are directly connected to free-market sentiment prevalent in America's investing culture. A strictly free market approach regarding executive compensation operates from two major principles inherent in the modern finance theory.

1. Market Efficiency

First, rational actors should be able to come to an agreement on terms of executive compensation. Many argue because the market is efficient, executive compensation is the product of arms' length bargaining between managers attempting to get the best possible deal for themselves and boards seeking to get the best possible deal for shareholders.

2. Utility Maximization

Second, because rational actors look to maximize utility in terms of profits, free agreements will ultimately bring about the greatest increased profits and consequently the greatest possible social welfare for all. In the words of the great American economist Milton Friedman, "The social responsibility of the firm is to increase profits."

Reassessing American Regulatory Reluctance

While use of modern finance theory has created obvious financial benefits and market growth, an examination of the recent financial crisis can shed light on the shortcomings of relying strictly on these principles.

1. Market Failures

Executives are self-interested individuals. Because executives have effective control over their company, they can engage in actions that might serve their own interests to the detriment of corporate profits, shareholders, the corporation, and ultimately society in general. For example, outlandish compensation, particularly when performance is poor, frequently harms shareholders and destroys investor confidence. The vast sums of money used to fund excessive compensation can constitute a considerable economic loss to shareholders. Extreme executive pay directly reduces a corporation's net income which, both lowers the resources available to pay shareholder dividends and decreases the value of a corporation's stock.[7]

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[7] In 1993, the aggregate compensation paid to the top five executives of U.S. public corporations constituted 5 percent of company profits; by 2003 the ratio had doubled to

Additionally, runaway compensation can also produce a corrupting incentive. Stock options, create incentives—often times illegal, self-indulgent, or dishonest— for executives to engage in actions that enhance short-term stock prices at the expense of long-term corporate growth and value. Such action not only undermines shareholder value but decreases investor confidence in the market. In the words of former Securities and Exchange Commission (SEC) Chair Arthur Levitt, Jr. "these compensation packages set up a system in which executives have…the wrong incentives. Too often executives are managing numbers for short-term gain and personal payout."[8] Importantly, the dangerous lure of compensating for short-term stock price increases, obtained at the expense of long-term stability, has complicated any clear notion of profitability under modern finance theory.

2. Empirical Evidence

These examples of market failures are not purely qualitative, as demonstrated by the alarming figures regarding executive compensation and firm performance leading up to the 2008 financial crisis. The previously five largest brokerage companies: Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers and Bear Stearns paid a record $39 billion in bonuses for 2007, a year when three of the five suffered the worst quarterly losses in their respective histories and shareholders lost more than $80 billion.[9] Merrill Lynch, the largest U.S. brokerage, paid $15.9 billion in compensation and benefits for 2007, exceeding the company's $11.3 billion of revenue, while the company posted a record fourth quarter loss of $9.83 billion.[10] At the time that the combined revenue for the five firms declined 13 percent to $110 billion, compensation and benefits grew 8.7 percent.[11]

With such staggering statistics, it comes as no surprise that investors lost confidence in the market. In light of the 2008 crisis and considering the ever increasing pay disparity between executives and their employees, policy makers are now searching for ways to make executive compensation reflect schemes in which market investors can be more confident.

10%. *See* Lucian Bebchuk & Yaniv Grinstein, "The Growth of Executive Pay", 21 *Oxford Rev. of Econ. Pol'y* 285, 2005.

8 Symposium on Bebchuk and Fried's "Pay without Performance," 30 *Journal of Corporation Law,* 749, 755 2005.

9 Christine Harder, "Wall Street Bonuses Hit Record $39 Billion for 2007," BLOOMBERG, (Jan. 17 2008, 17:02 EST), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHPBhz66H9eo.

10 *Ibid*.

11 *Ibid*.

New Attitudes Regarding Managing Excessive Compensation

After the economic collapse of 2008, legislators were faced with the tough task of not only attempting to recover, but also reforming America's financial institutions to remedy the failures the economic crisis exposed. Executive compensation was an immediate focus. Under the Economic Recovery Acts, billed as an absolute necessity for economic recovery, institutions receiving federal financial assistance through the Treasury Department's Troubled Assets Relief Program (TARP) were heavily scrutinized regarding compensation packages awarded leading up to the crisis. Early on it was clear that Congress and the nation viewed exorbitant executive compensation as both a source and symptom of the disease that had plagued the financial system. As one legislator explained, "[America] had an executive compensation system that created an incentive for imagining derivative securities that exploited regulatory and accounting loopholes."[12] One legislator reprimanded the Lehman Brothers CEO directly stating, "it seems that the system worked for you, but it didn't seem to work for the rest of the country. . ."[13]

As a testament of the resolve to reform executive compensation, President Obama appointed Kenneth R. Feinberg Special Master for TARP Executive Compensation. Feinberg, under authority delegated by the United States Secretary of the Treasury, was charged with issuing compensation determinations for the seven companies that received the most financial assistance from TARP.[14] In an address to Vanderbilt Law School regarding his position as "pay czar", Feinberg outlined his three statutory obligations.[15]

The first was to consider compensation that would promote the competitiveness of the companies so that the businesses would thrive and repay taxpayers. The second involved encouraging those being compensated to avoid excessive risk. The final requirement was to ensure the compensation reflected long term goals. In July, Feinberg stated that his office estimated around $1.6 billion in executive compensation given by 17 bailed out companies was "ill-advised".[16] Even more startling is the fact that this accounted for nearly 80% of the compensation given to the executives of the nation's 28 largest financial

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12 *The Causes and Effects of the Lehman Brothers Bankruptcy: Hearing Before the Committee on Oversight and Government Reform*, 110th Cong. 110-207 (2008) *available* at https://house.resource.org/110/org.c-span.281618-1.raw.txt.

13 *Ibid*.

14 Those seven include Bank of America, Citigroup, AIG, GM, GMAC, Chrysler, and Chrysler Financial.

15 Feinberg, Kenneth R., *Symposium on Executive Compensation*, 64 Vanderbilt L. Rev. 349 (2011).

16 Eric Dash, *Federal Report Faults Banks on Huge Bonuses,* NEW YORK TIMES, (July 22, 2010), http://www.nytimes.com/2010/07/23/business/23pay.html?dbk.

firms.[17] While Feinberg cut the pay of the 7 companies receiving the largest amount of bailout funds in half from 2008 levels, the Treasury Department has refrained from utilizing claw back provisions to seize exorbitant executive earnings by the other companies.

Managing Compensation and Dodd-Frank

Feinberg's position only regulated the smallest fraction of Wall Street executives, but the basic principles inherent in his decision making were reflected in Congress's subsequent reform efforts. On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was enacted by congress.[18] The Act contained numerous new regulations on corporate governance affecting executive compensation. The Act's overarching purpose aims at increasing transparency and shareholder power in order to avoid future instability in the marketplace. Guidelines for new regulations regarding proxy access, disclosures and reporting, and share-holder votes are included in the hopes of curbing the excessive executive compensation which had drawn the public and Congress's ire.

The SEC has adopted rules allowing shareholders to nominate candidates for directors through annual proxy statements. Shareholders with at least a 3 percent ownership level held for at least three years can nominate a specified number of directors. Under the Act, shareholders are also granted three new non-binding votes:

- The **"Say-on-Pay"** vote regarding the compensation of named executive officers;
- The **"Say-on-Frequency"** vote to decide how often voting on compensation; occurs
- The **"Say-on-Golden Parachutes"** vote regarding compensation connected with mergers, acquisitions, or dispositions.

The Act also directs the SEC to issue rules regarding executive pay disclosures to keep shareholders informed of board structure, executive compensation in relation to performance, equity of compensation across employees, hedging against company securities granted as compensation, and incentive based compensation. Finally, the Act requires a covered company to have a compensation committee with members independent of the board of directors, as defined by the SEC.

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17 Story, Louise, "Executive Pay," New York Times, March 3, 2011. http://topics.nytimes.com/top/reference/timestopics/subjects/e/executive_pay/index.html

18 The Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).

Ethical Analysis of Dodd-Frank's Management of Compensation

According to traditional modern finance theory, new regulatory schemes are meant to instill confidence among investors when market failures cause concern. Increased confidence in turn leads to greater capital investments allowing corporations to use the increased capital to maximize profits. Without these regulatory corrections, capital is more difficult to raise because confidence falls if investors believe their capital goes toward increasing executive compensation as opposed to profits.

While confidence in the market is important, the recent economic crisis demonstrates shortcomings in purely relying on this view. Consider how high investor confidence was prior to the collapse of the market. Between 2003 and the second quarter of 2007, the ten largest global banks had more than doubled their net wealth.[19] While investments were readily occurring, what became clear was that few investors actually knew the "real risk" associated with those investments. Another example of pure market confidence failing to produce profits occurred in the housing market. The belief that home prices would continue to rise caused institutions to begin subprime lending and dramatically increased risk taking on the parts of investors.[20] Accordingly, market confidence in the realization of profits cannot be the only aim of regulation.

Alternative factors affecting market confidence

What has become clear after 2008 is that investors must understand the basis for their confidence beyond mere profitability. Policy makers and public investors are concerned with just deserts regarding compensation outcomes. Investors now realize the pitfalls of incentivizing corporate actors to increase profitability without clearly defining the parameters through which corporate business decisions can occur. If consumer confidence does not have a direct correlation to realized stock improvements, due to a fear of corporate actors gaming returns in the short-term to maximize their own compensation, another motive must be balanced against simply "maximizing profits". Companies operating under traditional modern finance theory promote the idea that competition for profits should trump concerns about just deserts. As Feinberg explains, companies always argue a CEO is irreplaceable, and their high compensation rates ensure the company will thrive because of the competitive nature of such a position. Feinberg, like so many Americans, is skeptical of this argument considering the soaring compensation levels prior to the 2008 collapse.

[19] Acharya, Viral V., et. al., "The Dodd-Frank Wall Street Reform and Consumer Protection Act: Accomplishments and Limitations," 23 J. *Applied Corp. Fin*., 43, 2011.

[20] Faulkender, Michael et. al., *Supra* Note 1.

The empty promise of high-performance as a result of high-incentives is no longer a viable model. At a very basic level, the Dodd-Frank executive compensation reforms demonstrate a willingness to ensure shareholders have a say in the correlation between realized long-term profits and compensation.

The second lesson learned from the crisis is that Americans generally value stability over profit volatility and financial bubbles. The 2008 crisis created a disconnect between those living on Main Street and those living on Wall Street, ultimately leading to diminished investor confidence in "profit maximizing" executives. For instance, while increased confidence led to increased bank lending, the lending of money and subsequent selling of mortgage-backed securities was driven by the belief that bankers were acting in a profit maximizing way generally. The bankers' actions are better described as self-serving, as they boosted short-term profits to ensure higher compensation and dismissed the long term risks of system failure. The effects were devastating to those who purchased the mortgages, those consumers who lost their homes in foreclosure, and ultimately the entire market. While high confidence resulted in profit realization for a few, most were hurt by the transactions. Investors were confident due to the willingness of banks to loan and subsequently sell risky loans resulting in diminished long-term stability. Therefore, profit-maximizing actions by individuals must be tempered by a motivation to ensure stability for the greater population subject to market forces. The brash way in which some investors were allowed to trade in the success or failure of American purchasing power is a strong example of the shortsighted nature of modern finance theory. Clearly a financial system which, ignores the dire consequences to non-transacting parties in the face of increased individual profit is undesirable.

Consequently, consumer confidence can be increased by actions ensuring stakeholder stability and well-being. Stakeholders include all individuals or groups who can substantially affect or be affected by the welfare of a corporation. The category includes not just those who are affected by a direct financial stake, but also employees, customers, communities, government officials, and society generally. Modern finance theory considers only shareholders as having a moral claim on the corporation. A severe financial crisis is a wake-up call for the need to strengthen the rights of stakeholders outside of parties directly involved in a corporation's transactions for profit.

The Dodd-Frank Act's non-binding votes, increased proxy access, and insistence on compensation increases overall accountability. These regulations increase the decision making power of shareholders in the hopes of adding an investor safeguard to corporate governance decisions. Proxy access is said to promote a more democratized corporate governance structure, and while traditional modern finance theorist may argue that this only shifts the ability to cater to a minority interest, at the very least, the shift gives responsibility to a larger representation of stakeholders. Furthermore, democratizing corporate governance opens the door to increased access. While the risk of shareholders making the same profit-maximizing mistakes of executives exists, it seems more likely that placing corporate strategy on a greater number of shoulders increases the likelihood that just deserts, stability, and the general welfare of all stakeholders will motivate decisions.

Increased attention on fairness and the common good are welcome motivational factors to be included with profits. The regulations imposed by the Dodd-Frank Act are a step in the right direction to an improved ethical financial institution. However, more important than the Act’s effectiveness as a regulatory regime, should be the acknowledgment that discourse cannot be stagnant when it comes to financial theory. A robust economy is driven by the individuals who participate in it. The economic collapse of 2008 has brought into focus the complexity of motivational variables affecting market confidence. Moving forward, institutional actors should strive to balance motivations, realizing that in a complex financial system no single motivation directly correlates to consumer confidence. Therefore, it should be a top priority of all corporate actors to determine how best to balance the variety of motivations which are held by all stakeholders, because only then can consumer confidence and general welfare be maximized.