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Dodd-Frank: Frankly an Inefficient Form of Corporate Governance

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NOTE

DODD-FRANK: FRANKLY AN INEFFICIENT FORM OF CORPORATE GOVERNANCE

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I. INTRODUCTION

In 2008, both the U.S. financial markets and the global economy faced the worst crisis since the Great Depression. The events surrounding the financial crisis involved a complex array of financial transactions, "[a] failure of several Wall Street financial firms,"[1] and a collapse of the housing market.[2] Responding to that crisis, Congress

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1. Z. Jill Barclift, *Too Big to Fail, Too Big Not to Know: Financial Firms and Corporate Social Responsibility*, 25 J. CIV. RTS. & ECON. DEV. 449, 449-50 (2001).

2. Charles M. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection*

enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[3]

The principal cause of, and blame for, the financial crisis is debatable.[4] For instance, some suggest that the cause was deregulation,[5] while others suggest that greed, on the part of lenders, borrowers, and investors, caused the crisis.[6] Others, however, point the finger to the corporate governance failures of major financial corporations.[7] Congress, in an attempt to address those concerns, increased derivatives[8] regulation[9] and implemented corporate governance reform.[10] In this regard, Congress imposed significant burdens on the vehicle that revolutionized both American and global business: the corporation.

In the years following World War II, the U.S. economy soared and the use of corporations as a form of doing business grew rapidly.[11] Now, the corporate entity is perhaps the most dominant form of social organization competing only with big government.[12] The popularity of the corporate form, as compared to a partnership,[13] is partially attributable to the concept of limited liability.[14] That is, investors typically face no risk of monetary loss beyond the value of their investment.[15] In exchange for limited liability, however, investors trade in their ability to control their investment by vesting control in corporate managers.[16] As such, the corporation is an attractive vehicle for both

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Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?, 64 SMU L. REV. 1243, 1244 (2011).

3. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 11-203, 124 Stat. 1376 (2010).

4. Sharon E. Foster, *Systemic Financial-Service Institutions and Monopoly Power*, 60 CATH. U. L. REV. 357, 358 (2011) (discussing underlying policies and history leading to the financial crisis).

5. *Id.* at 358 n.2.

6. *See* Murdock, *supra* note 2, at 1255–78.

7. Brooksley Born, *Forward: Deregulation: A Major Cause of the Financial Crisis*, 5 HARV. L. & POL'Y REV. 231, 231 (2011).

8. For a discussion on derivatives, see *infra* text accompanying notes 23 & 34.

9. Murdock, *supra* note 2, at 1244.

10. *See* Dodd-Frank, § 951 (codified at 15 U.S.C. § 78n-1).

11. Brian R. Cheffins, *The History of Corporate Governance* 2 (Eur. Corp. Governance Inst., Working Paper No. 184, 2012).

12. Michael R. Seibecker, *A New Discourse Theory of the Firm After* Citizens United, 79 GEO. WASH. L. REV. 161, 170 (2010).

13. Jing Li, *Money Under Sunshine: An Empirical Study of Trust Contracts of Chinese Hedge Funds*, 17 FORDHAM J. CORP. & FIN. L. 61, 70 (2012).

14. Carol R. Goforth & Clayton N. Little, *A Review of Piercing the Veil Cases in Arkansas*, 2011 ARK. L. NOTES 17, 17 (2011).

15. *Id.*

16. *See* Kimberly D. Krawiec, *Derivatives, Corporate Hedging, and Shareholder Wealth: Modigliani-Miller Forty Years Later*, 1998 U. ILL. L. REV. 1039, 1053 (1998). This is the

raising capital and making investments.

This Note addresses Congress's regulatory response to the financial crisis and concludes that Dodd-Frank promotes an inefficient form of corporate governance. Part II of this Note provides a background on the financial crisis and on the theory underlying corporate governance. Part III of this Note then analyzes two components of Dodd-Frank: the regulations it imposes on derivative transactions and its say-on-pay provisions. Moreover, Part III addresses the impact of those regulations on corporate governance.

II. BACKGROUND

A. *Background on the Financial Crisis*

The financial crisis of 2008 nearly destroyed the global economy.[17] Many blame the financial crisis on the emergence of "too big to fail" firms.[18] Those firms engaged in a complex array of financial transactions involving the use of derivatives and sub-prime lending.[19] It is those transactions to which much blame has been attributed.

A derivative, the most basic example of which is an option contract,[20] is a bilateral contract that derives its value from some underlying source.[21] Derivative users fall into either of two categories: hedgers and speculators.[22] Hedgers use derivatives to reduce risk by offsetting a current position,[23] whereas speculators attempt to profit by embracing the risk that hedgers seek to avoid.[24] Although most

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concept of "separation of ownership and control." Nevertheless, investors do retain some control over their investment given the relative ease of transferring their interest in the corporation.

17. Murdock, *supra* note 2, at 1244.

18. Barclift, *supra* note 1, at 453. "'[T]oo big to fail' refers to a banking or financial organization so large that the federal government must support and prevent the collapse of the institution because its failure poses a significant risk to the entire financial and economic systems." *Id.*

19. Murdock, *supra* note 2, at 1244.

20. *See* David A. Skeel, Jr., *Inside-Out Corporate Governance*, 37 J. CORP. L. 147, 186 (2011). For example, the value of an option contract, which "[provides] the owner [of the contract with a] right to either buy or sell an asset at a future date for a specified premium," necessarily depends on the value of the asset at the time the option is exercised. *Id.*

21. Krawiec, *supra* note 16, at 1045. The contract might derive its value based on changes in interest rates or currency values. Skeel, *supra* note 20, at 150.

22. Krawiec, *supra* note 16, at 1045.

23. *Id.* For example, Southwest Airlines engaged in the most well-known use of risk-hedging derivatives when it negotiated a derivative contract that allowed it to buy fuel at a substantially reduced price. MARK JICKLING & KATHLEEN ANN RUANE, CONG. RESEARCH SERV., R41398, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: TITLE VII, DERIVATIVES 1 (2010).

24. Krawiec, *supra* note 16, at 1045.

derivative losses have been linked to speculative users, the existence of those users is necessary for others to hedge.[25]

Derivative transactions have typically been conducted either on exchanges or in over-the-counter (OTC) markets.[26] Exchanges, which are regulated by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), are "centralized markets where all the [transactions] come together."[27] In contrast, the historically unregulated OTC market is not centralized and typically involves only the contracting parties.[28]

Prior to Dodd-Frank, financial institutions, engaging in the highly lucrative process of securitization, used complex derivatives known as mortgage-backed securities (MBS) and collateralized debt obligations (CDO).[29] The securitization process is described as follows: a bank makes a loan to a homeowner and collateralizes the loan with a mortgage. The bank then sells that mortgage to a financial company such as Bear Sterns.[30] The financial company then combines the mortgages in a pool of other mortgages (the MBS) and sells interests in the MBS on the secondary market.[31] A CDO is similar to an MBS in that both are asset-backed securities.[32] The difference, however, is that the pool of underlying assets from which a CDO derives its value may consist of other asset-backed securities, including MBSs.[33] Further, CDOs are divided into "different 'tranches' [(or slices)] that reflect [varying] levels of risk."[34]

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25. *See* Kimberley D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 15 (1997).

26. *See* MARK JICKLING & KATHLEEN ANN RUANE, CONG. RESEARCH SERV., R41398, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: TITLE VII, DERIVATIVES 2 (2010).

27. *Id.*

28. *See id.*

29. Barclift, *supra* note 1, at 450. An MBS, a type of asset-backed security, is "a debt obligation[] that represent[s] [a] claim[] to the cash flows from pools of mortgage loans." U.S. SEC. & EXCH. COMM'N, *Mortgage-Backed Securities*, http://www.sec.gov/answers/mortgage securities.htm (last visited Feb. 17, 2012).

30. *See* Kimberly Amadeo, *Role of Derivatives in Creating Mortgage Crisis*, ABOUT.COM, http://useconomy.about.com/b/2008/10/13/role-of-derivatives-in-creating-mortgage-crisis.htm (last visited Mar. 30, 2012).

31. *See id.* The MBS, therefore, derived its value from the group of mortgages in the bundle. *Id.* More specifically, the mortgage payments, when made, are used to pay the MBS investors. *See id.*

32. William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 959 (2009).

33. *Id.*

34. Michael Bennett, *Complexity and Its Disconnects: Recurring Legal Concerns with Structured Products*, 7 N.Y.U. J.L. & BUS. 811, 811 n.3 (2011). For example,

> [the] senior tranche is generally the first to absorb cash flows and the last to absorb mortgage defaults or missed payments. As such, it has the most

The highly profitable nature of securitization incentivized volume[35] and, as a practical matter, required lenders to broaden their consumer base by expanding their lending practices. However, while the demand from investment banks to buy mortgages increased, the lenders' supply of available "credit-worthy" borrowers decreased.[36] The solution to this problem of economic scarcity was simple in the eyes of lenders: sub-prime lending.[37] Although such lending practices posed a greater risk than traditional lending, lenders alleviated this risk by charging higher interest rates.[38]

It is essential, at this point, to note two critical effects of this process. First, once the lender sold the mortgage, the lender became disinterested in the borrower's repayment; that is, the lender not only circumvented the risk of a default, but also, realized its profit on the mortgage by selling it for a premium.[39] This process created a "morally hazardous environment"[40] because a borrower's creditworthiness was of minimal concern to a lender who could sell the mortgage to an investment banker.[41] Second, the source from which these MBSs and CDOs derived their values encompassed these riskier sub-prime mortgages.

The lucrative nature of securitization was paramount. Everybody was making money. Investors, relying on the false assumption that housing values would always appreciate[42] and on misleading credit ratings,[43] viewed these securities as highly profitable safe bets.[44]

> predictable cash flow and is usually deemed to carry the lowest risk. On the other hand, the lowest rated tranches usually only receive principal and interest payments after all other tranches are paid. Furthermore they are also first in line to absorb defaults and late payments.

CDOs and the Mortgage Market, INVESTOPEDIA, http://www.investopedia.com/articles/07/cdo-Mortgages.asp#axzz1qe4PS xGA (Jan. 19, 2011).

35. Barclift, *supra* note 1, at 456-57.

36. *Id.* at 457.

37. *See id.* Sub-prime lending is the process of lending to borrowers with either low credit scores or limited credit history. *Id.*

38. *See id.*

39. *Id.*

40. *Id.* at 456.

41. *See* Murdock, *supra* note 2, at 1318.

42. *See* Steven L. Schwarcz, *Keynote Address: Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549, 550 (2009), *available at* http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2711&context=faculty_scholarship&sei-redir=1&referer=http%3A%2F%2Fscholar.google.com%2Fscholar%3Fhl%3Den%26q%3Dcollapse%2Bof%2Bfinancial%2Binstitutions%26as_sdt%3D2%252C10%26as_ylo%3D2008%26as_vis%3D0#search=%22collapse%20financial%20institutions%22.

43. *See* Murdock, *supra* note 2, at 1249. A credit rating represents the score a credit rating agency assigns to a particular security after undertaking an independent evaluation of the security. *Id.* at 1301-02.

44. *See id.* at 1315-16.

Further, American International Group Inc. (AIG), relying on its AAA credit rating and on the same false premises,[45] recognized an opportunity to make a handsome profit.[46] AIG thereby enhanced the attractiveness of these securities by selling credit default swaps (CDS) to the investment bankers.[47] Borrowers, lenders, investors, and insurers were in a euphoric state of financial success.

Then, as borrowers began to default and the value of homes began to drop,[48] the flaw of securitization surfaced: profitability only ensued as long as either borrowers could repay their debts or lenders could foreclose on and resell the collateralized homes.[49] The decrease in housing values created a domino effect of mortgage defaults. As such, the MBSs and CDOs were rendered seemingly worthless and CDS issuers, particularly AIG, were exposed to significant liability.[50]

B. *Background on Corporate Governance*

The overwhelming majority view in the United States is that the primary purpose of the corporation is to maximize the shareholder wealth.[51] However, a distinct characteristic of the corporate form is the separation of ownership and control model.[52] That is, shareholders do

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45. *See id.* at 1316.

46. *See id.* at 1319.

47. *See id.* at 1316. A CDS, which is very similar to insurance, "'allow[s] a purchaser of the swap to transfer loan default risk to the seller of the swap. The seller agrees to pay the purchaser if a default ever occurs.'" *Id.* at 1312 n.423 (quoting FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 444, 540 (2001) (Wallison Dissent), *available at* http://www.gpoaccess.gov/fcic/fcic.pdf).

48. Dov Solomon & Odella Minnes, *Non-Recourse, No Down Payment and the Mortgage Meltdown: Lessons from Undercapitalization*, 16 FORDHAM J. CORP. & FIN. L. 529, 546-48 (2011). In fact, the decline in housing prices left many homeowners with negative equity. *Id.* This, therefore, incentivized borrowers to default on their loans and walk away from their homes. *Id.*

49. Jordan Rand, *A Fundamental Human Right: Expanding Access to Affordable Housing for Latin America's Low – and Middle-Income Families*, 13 L. & BUS. REV. AM. 945, 965-66 (2007). However, as the supply of homes for sale increased, their values correspondingly decreased. As a result, it became difficult for lenders to foreclose on and sell the collateralized homes. *See* Solomon & Minnes, *supra* note 48, at 547-48.

50. Bryan G. Faubus, *Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk*, 59 DUKE L.J. 801, 803-04 (2010).

51. Robert Sprague & Aaron J. Lyttle, *Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy*, 16 STAN. J.L. BUS. & FIN. 1, 3 (2010); *see also* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (holding that "it is not within the lawful powers of the board of directors to . . . conduct the affairs of the corporation for the . . . incidental benefit of shareholders.").

52. *See* Krawiec, *supra* note 16, at 1053.

not partake in the process of maximizing their own wealth.[53] Instead, the operation of the corporation is solely within the purview of agents, namely the board of directors and the officers, employed to act on behalf of shareholders.[54]

A fundamental tension sits at the core of the separation of ownership and control model. The model, which empowers individuals other than a corporation's owners to manage corporate affairs, increases agency costs.[55] Namely, it increases the risk that managers will spend a corporation's earnings in a way that advances their personal interests rather than those of the shareholders.[56] This agency problem has promulgated the debate that centers on two distinct models of corporate governance: the shareholder primacy model and the director primacy model.[57] Further, it has resulted in debates as to the best method for reducing agency costs.

1. Shareholder Primacy, Director Primacy, and the Business Judgment Rule

The shareholder primacy model suggests that "corporate managers should only make decisions for the benefit of [shareholders]."[58] In contrast, the director primacy model "defends managerial discretion in order to maximize shareholder wealth."[59] Despite the shareholder primacy model's predominance in the United States, shareholders often have little recourse against a board of directors for decisions that fail to maximize shareholder wealth or for decisions that result in corporate losses. Such lack of recourse is due to the business judgment rule, corporate law's central doctrine, which offers great deference to a board's decisions.[60] For example, and as it pertains to the financial crisis in particular, the shareholders of the financial institution, Citigroup, sued the board of directors for allowing the corporation to engage in

53. *Id.* In fact, before the rise of institutional investors such as pension funds and mutual funds, shareholders played an extremely passive role in conducting corporate affairs. *See* Seibecker, *supra* note 12, at 181.

54. *See* Krawiec, *supra* note 16, at 1053.

55. *See* Andrew L. Bethune, *An Efficient "Say" on Executive Pay: Shareholder Opt-in as a Solution to the Managerial Power Problem*, 48 HOUS. L. REV. 585, 590 (2011).

56. STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 6 (2008).

57. *See* Seibecker, *supra* note 12, at 183.

58. Sprague & Lyttle, *supra* note 51, at 4.

59. Seibecker, *supra* note 12, at 184.

60. Sprague & Lyttle, *supra* note 51, at 16-17; *see also, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 781 (Ill. App. Ct. 1968) (refusing to second-guess Wrigley's business decision not to host home baseball games at night).

sub-prime lending.[61] Nevertheless, the court upheld the board's decision by affording it the protection of the business judgment rule.[62] As such, the business judgment rule insulates a board of directors from liability to the extent the board's decision is in the best interest of the corporation.[63]

On its face, the business judgment rule appears to undercut the goal it purports to serve. However, the ability of directors to make "swift decisions" was a contributing factor to the rise and success of large corporations in the twentieth century.[64] Thus, the rule advances shareholder interests because it "allows [directors and officers] to maximize shareholder value in the long-term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses."[65]

2. Mitigating Agency Costs: Interest Alignment or Shareholder Empowerment

The agency problem permeates throughout corporate law because of the conflicting interests inherent in the separation of ownership and control model. In an effort to mitigate agency costs, some suggest that the solution is aligning the interests of executives with those of shareholders.[66] Proponents of interest alignment insist that it reduces agency costs and promotes economic efficiency by making it more beneficial for executives to advance shareholder interests than to advance their own self-interest.[67]

Interest alignment is generally accomplished through performance-based compensation such as bonuses and equity-based compensation.[68] In theory, these compensation packages reduce agency costs by incentivizing management to advance shareholder interests.[69] However, critics of this solution to the agency problem suggest that performance-based compensation is exactly what encouraged the directors and officers of financial institutions to adopt a risky "maximize profit in all circumstances" philosophy.[70] Further, the solution fails to account for

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61. *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 113 (Del. Ch. 2009).

62. *Id.* at 139.

63. *Id.*

64. Bethune, *supra* note 55, at 590.

65. *In re Citigroup,* 964 A.2d at 139.

66. *See* Bethune, *supra* note 55, at 591.

67. *See id.* at 591.

68. *Id.* Equity-based compensation, such as stock options and stock appreciation rights, is the concept of compensating executives with equity interests in the company. *Id.*

69. *Id.*

70. *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder*

the divergent risk profiles of shareholders and executives.[71] For instance, shareholders have a conservative risk profile because their profit depends solely on the price of the stock.[72] In contrast, directors and officers, whose stock options are coupled with handsome salaries, can embrace risk because they have no sunk economic investment to lose.[73] In fact, performance-based compensation is widely regarded as one of the biggest contributions to the financial crisis.[74]

Another potential solution to the agency problem is shareholder empowerment.[75] Advocates of this solution suggest that "enhanced shareholder rights provide accountability and that accountability [reduces] agency costs."[76] Proponents of shareholder empowerment further insist on enhanced shareholder rights, such as shareholder choice regarding business decisions.[77] In contrast, opponents of this solution argue that enhanced shareholder rights would decrease business productivity because shareholders possess neither adequate knowledge nor the expertise to effectively conduct corporate affairs.[78] In adopting Dodd-Frank, Congress took the view that shareholder empowerment was the preferable mechanism for reducing agency costs.

III. THE DODD-FRANK ACT

Dodd-Frank, Congress's regulatory response to the financial crisis, is inadequate in two respects. First, with respect to its regulation of derivatives, Dodd-Frank fails to account for moral and economic policy considerations. In effect, the Act promotes morally hazardous trading and impedes risk management. Additionally, although President Obama commented that Dodd-Frank empowers shareholders with respect to executive compensation,[79] in substance, it purports to empower shareholders with respect to a subset of corporate law in which no

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Empowerment, 158 U. PA. L. REV. 653, 658-59 (2010).

71. Murdock, *supra* note 2, at 1264.

72. *See id.*

73. *Id.*

74. *See* Danielle Angott Higgins, *Regulation S-K Item 402(S): Regulating Compensation Incentive-Based Risk through Mandatory Disclosure*, 61 CASE W. RES. L. REV. 1049, 1051 (2011).

75. *See* Bratton & Wachter, *supra* note 70, at 655.

76. *Id.*

77. *Id.* at 662.

78. *See* Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light*, 7 N.Y.U. J.L. & BUS. 641, 661 (2011).

79. President Barack Obama, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010) (transcript available at http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act).

empowerment is warranted.

A. *Dodd-Frank's Regulation of Derivatives: Competition Between Moral and Economic Policy*

In an effort to improve transparency, Dodd-Frank extensively regulates the previously unregulated OTC derivatives market.[80] Title VII of Dodd-Frank seeks to standardize OTC derivative transactions.[81] For instance, Dodd-Frank requires public reporting of transaction data[82] and creates clearing and margin requirements.[83] In effect, Dodd-Frank makes it illegal for parties to enter into certain OTC derivative transactions unless the transaction has been submitted for clearing.[84] Further, with respect to trades involving certain derivatives, Dodd-Frank prohibits the use of OTC markets and requires the use of regulated exchanges in which multiple market participants can trade.[85] This Part first assesses the concerns surrounding the use of derivatives, specifically CDSs, and then analyzes both the efficacy of the foregoing regulatory reform in addressing those concerns and the consequences of those reforms on corporate governance.

From a policy standpoint, CDSs create a morally hazardous environment. A comparison of CDSs to insurance contracts is illustrative because CDSs serve a similar function to insurance contracts.[86] Despite their functional similarities, the two products do not share an important requirement: the requirement of an insurable interest.[87] As it pertains to life insurance contracts, the insurable interest requirement seeks to reduce the moral hazard inherent in those contracts by requiring that insurance policy beneficiaries have some interest in an insured's life[88] beyond the mere pecuniary interest resulting from the

80. Murdock, *supra* note 2, at 1322.

81. *See id.* at 1322-23.

82. Dodd-Frank Wall Street Reform and Consumer Protection Act, §§ 723, 763 (codified at 7 U.S.C. § 2(a)(13)(C)(i)–(iv)).

83. *See id.* (codified at 7 U.S.C. § 2(h)). Clearing and margins requirements are central features of exchange markets, but were long absent in the unregulated OTC markets. JICKLING & RUANE, *supra* note 23, at 3-5. Clearing and margin requirements are generally described as follows: "[b]efore the trade, both [parties] . . . deposit an initial margin payment with the clearinghouse to cover potential losses. At the end of each trading day, all . . . those who have lost money . . . must post additional margin . . . to cover those losses before the next trade . . . ." *Id.* at 3. This process alleviates the concern of a counterparty default because the clearinghouse holds sufficient funds to make payments. *Id.*

84. JICKLING & RUANE, *supra* note 23, at 5-6 (citing 7 U.S.C. § 2(h)(1)).

85. *Id.* at 7.

86. Skeel, *supra* note 20, at 193.

87. *Id.* at 193-94.

88. Franklin G. Monsour, Jr., *STOLI and Intent: The Feeling's Mutual, But It's Starting Not to Matter Anyway*, 19 CARDOZO J. INT'L & COMP. L. 679, 686 (2011) (citing Grigsby v.

insurance contract.[89]

In contrast, an insurable interest requirement has been, and after Dodd-Frank, still is absent from the regulatory framework of derivatives.[90] As such, there is no mechanism in place to mitigate the moral hazard inherent in the ability for one party to benefit from another party's default. Therefore, Dodd-Frank, which fails to address this concern, should have imposed a similar requirement on derivative contracts.[91]

Yet another concern of derivatives relates to their two distinct, yet mutually dependent, functions: hedging and speculating.[92] On the one hand, corporations may use derivatives to hedge their exposure to risk.[93] A board's decision to use derivatives for such a purpose falls squarely within the protection of the business judgment rule.[94] On the other hand, a long-standing concern relating to the speculative function of derivatives is that such use is a form of gambling.[95] Despite this concern, the speculative function of derivatives is essential to the viability of the hedging function because derivative transactions are zero-sum games.[96]

Dodd-Frank attempts to distinguish the two mutually dependent functions by regulating speculative transactions and generally exempting hedging transactions from its purview.[97] For instance, Dodd-Frank's mandatory clearing requirements do not apply to certain hedging transactions.[98] On its face, such a provision appears to preserve the ability of corporations to hedge risk by protecting them against the costly undertaking of complying with Dodd-Frank. In substance, however, Dodd-Frank creates an economically inefficient result because regulating speculative transactions makes it more costly for

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Russell, 222 U.S. 149-55 (1911)).

89. *See generally* Kimball-Stanley, *Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?*, 15 CONN. INS. L.J. 241, 241 (2008).

90. *See* Skeel, *supra* note 20, at 193-94 (discussing the potential moral hazards created by CDSs and regulation of CDSs in a similar manner to other insurance regimes).

91. *See id.* (suggesting an economic purpose requirement in derivatives transactions).

92. Krawiec, *supra* note 16, at 1045.

93. *See* Skeel, *supra* note 20, at 153.

94. *See id.* at 189.

95. *See id.* at 187.

96. Timothy E. Lynch, *Derivatives: A Twenty-First Century Understanding*, 43 LOY. U. CHI. L.J. 1, 18 (2011) (citing Thomas Lee Hazen, *Rational Investments, Speculation or Gambling?—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 1006-07 (1992) & Lynn A Stout, *Insurance or Gambling? Derivations Trading in a World of Risk and Uncertainty*, 14 BROOKINGS REV. 38, 40 (1996) (stating that one party's gains are exactly equal to another party's losses)).

97. Skeel, *supra* note 20, at 153.

98. Dodd-Frank Wall Street Reform & Consumer Protection Act, § 723, 763 (codified at 7 U.S.C. § 2(h)(7)).

corporations to use derivatives for hedging risk.[99]

For example, if institutions determine that the cost of complying with Dodd-Frank exceeds the benefit of engaging in speculative derivative transactions, those firms should, from an economic standpoint, not engage in those transactions. As a result, the cost of hedging risk increases because of the decreased supply of parties willing to embrace the risk that hedgers seek to avoid. In fact, some suggest that an efficient result is best obtained by reducing the regulation of exchange-traded derivatives rather than increasing the regulation of OTC derivatives.[100]

This Note does not suggest resorting to such an extreme because the lack of derivatives regulation was a contributing factor to the financial crisis.[101] Instead, recognizing the inefficiencies that Dodd-Frank creates, this Note suggests that a more efficient result would ensue if firms with significant derivative positions were required to disclose those positions to their shareholders.[102] This suggestion of enhanced disclosure would not erode the business judgment rule because corporate hedging would still fall within the scope of the rule's protection. Instead, this proposal merely permits shareholders to "get out" if they disagree with a firm's direction and, as a result, allows the market to dictate the corporate use of derivatives. As it stands now, if Dodd-Frank drives speculators out of the market, corporate managers will have to create a new mechanism for managing risk.[103]

B. *Say-on-Pay: Congressional Intrusion into Corporate Governance*

Corporations employ performance-based compensation as a mechanism for reducing agency costs.[104] However, the prevalent view in the United States, as demonstrated by public outrage,[105] is that executive compensation was a major cause of the financial crisis.[106] In response to this view, Congress enacted say-on-pay provisions as part of the Dodd-Frank Act,[107] which require public companies to obtain a

99. Skeel, *supra* note 20, at 153.

100. *Id.* at 191-92.

101. *See* Foster, *supra* note 4 (discussing underlying policies and history leading to the financial crisis).

102. *See generally* Jeffery S. Puretz with Assistance from Hogan Pham & Stephen Ferrara, *New Developments for Investment Advisors and New Developments in Derivatives Disclosure for Investment Companies*, 16 A.L.I.-A.B.A. 893 (2010) (discussing the SEC's rule requiring mutual funds to disclose derivatives positions in their annual reports to shareholders).

103. *Id.*

104. *See supra* text accompanying notes 66-74.

105. *See* Bethune, *supra* note 55, at 588.

106. *See id.*

107. *See id.*

nonbinding vote from their shareholders on executive compensation plan once every three years.[108]

Executive compensation is only unreasonable "if it fails to generate a corresponding increase in the value of the company beyond the cost of the compensation. . . ."[109] During the financial crisis, however, increases in executive compensation did not correlate with increases in firm value.[110] Further, the business judgment rule traditionally protected a board's decisions with respect to executive compensation.[111] Therefore, prior to Dodd-Frank, shareholders had little voice on the matter of executive compensation.

Say-on-pay advocates mistakenly suggest that the provisions empower shareholders and advance shareholder primacy.[112] In fact, President Obama has suggested that the say-on-pay provisions empower shareholders with respect to executive compensation.[113] In substance, however, these provisions do not empower shareholders to any meaningful extent because their vote is nonbinding. This Note does not suggest adopting a binding vote; rather, it posits that neither a binding vote nor a nonbinding vote is warranted.

Although say-on-pay advocates suggest that the provisions restore trust,[114] this Note concludes otherwise. Imagine a scenario in which shareholders vote against a proposed executive compensation package, and the board, in good faith, rejects that vote. In that situation, even though the board acted properly, shareholders, operating under the mistaken belief that the board acted imprudently, may lose confidence in the board and either sell their shares or vote against board members in future elections. As such, say-on-pay provisions promote inefficiency by encouraging boards to yield to shareholder demands even if those

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108. Dodd-Frank Wall Street Reform & Consumer Protection Act, § 951 (codified at 15 U.S.C. § 78n-1) (2012). Further, the say-on-pay provisions require companies to disclose certain executive compensation information such as: (1) the ratio of executive compensation to the median compensation level of company employees; and (2) the relationship between executive compensation and the company's financial performance. *Id.*

109. *See* Bethune, *supra* note 55, at 592.

110. *See id.* at 592-93.

111. Jeff Dodd & Wiley George, *Recent Ruling Allows Shareholder Lawsuit to Proceed After Negative Say-on-Pay Vote: Quirk or Harbinger* (Oct. 6, 2011), http://www.andrewskurth.com/pressroom-publications-842.html#_ftnref1.

112. Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1811 (2011).

113. President Barack Obama, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010) (transcript available at http://www.whitehouse. gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act).

114. Janice Kay McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wake-Up Call for Reforming Executive Compensation*, 12 U. PA. J. BUS. L. 131, 165 n.237 (2009).

demands are not in the best interest of the corporation. Although a binding vote would resolve the trust problem, doing so would create the same inefficiencies and would erode the business judgment rule.

In addition to creating trust and efficiency problems, the say-on-pay provisions also promote frivolous litigation[115] and, in doing so, undermine traditional corporate governance theory. Traditionally, under the business judgment rule, executive compensation decisions are left to the business judgment of boards of directors and their committees.[116] Further, Dodd-Frank, by its terms, neither usurps that power nor changes a board's fiduciary duties.[117] That notion, however, was jeopardized following the first proxy season of the say-on-pay era.

In 2011, the shareholders of several companies, grounding their complaints on breaches of fiduciary duties, filed derivative suits challenging their respective board's decisions to reject negative say-on-pay votes.[118] Although those challenges were generally unsuccessful,[119] one federal district court judge, Judge Timothy Black, refused to dismiss the shareholders' complaint.[120] That refusal is troublesome given the long-standing precedent of deferring to a board's decisions regarding executive compensation.[121] Therefore, Dodd-Frank both undercuts this theory of corporate governance and intrudes into state law even though its express terms indicate a contrary intent.[122]

Even if Judge Black's decision is an outlier and judges continue to dismiss such shareholder complaints, the say-on-pay provisions create another problem for corporations. That is, the nonbinding vote may encourage shareholders to challenge a board's decision to reject a negative vote in hopes of obtaining a settlement. In fact, one company paid almost two million dollars to settle this type of shareholder derivative suit.[123] Therefore, Dodd-Frank's say-on-pay provisions not only undercut the traditional theory of corporate governance, but also,

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115. *Id.*

116. Bethune, *supra* note 55, at 604.

117. Dodd-Frank Wall Street Reform & Consumer Protection Act, § 951(c)(2) (codified at 15 U.S.C. § 78n-1(c)(1)–(4) (2012)).

118. *See* Dodd & George, *supra* note 111.

119. *See* David A. Katz, *Some Thoughts for Boards of Directors in 2012*, 1931 P.L.I. CORP. 125, 135 (2012); *see also Plumbers Local No. 137 Pension Fund v. Davis*, Civ. No. 03:11-633-AC (D. Or. Jan. 11, 2012) (dismissing plaintiffs' complaint because the plaintiffs made no pre-suit demand).

120. NECA-IBEW Pension Fund v. Cox, Case No. 1:11-cv-451, 2011 WL4383368, at *5 (S.D. Ohio Sept. 20, 2011).

121. Bethune, *supra* note 55, at 604.

122. *See* Dodd-Frank, § 951(c)(2) (codified at 15 U.S.C. § 78n-1(c)(1)–(4)).

123. Peter M. Saparoff et al., *Lessons Learned from Initial "Say-on-Pay" Litigation*, MINTZ LEVIN (July 18, 2011), http://www.mintz.com/newsletter/2011/ Advisories/1251-0711-NAT-LIT/web.htm (citing Amended Stipulation and Notice of Settlement, *In R*e KeyCorp Derivative Litig., No. 1:10-cv-01786 (N.D. Ohio Apr. 26, 2011).

impose significant costs on corporations.

IV. CONCLUSION

The financial crisis of 2008 devastated the global economy. The crisis resulted from an array of factors such as derivative transactions, sub-prime lending, deregulation, corporate governance failures, and greed. The public was outraged, and a congressional response was necessary. As such, Congress responded to the crisis by enacting Dodd-Frank.

In passing Dodd-Frank, Congress sought to bring transparency to the complex derivatives that nearly destroyed the American and global financial systems. It also sought to reform corporate governance by providing shareholders with a say on executive compensation. Collectively, these two components of Dodd-Frank promote an inefficient form of corporate governance.

Dodd-Frank's derivative regulations are morally inadequate and economically inefficient. From a moral standpoint, the Act fails to alleviate the moral hazard inherent in the ability for one party to benefit from another party's default. Moreover, Dodd-Frank promotes an inefficient form of corporate governance by making it more costly for corporations to manage risk. This Note concludes that Dodd-Frank should have required corporations to disclose their derivative positions to shareholders. Doing so would have created an efficient form of corporate governance in which the market would dictate the corporate use of derivatives.

Dodd-Frank's say-on-pay provisions are a regulatory intrusion into corporate governance and state law. Dodd-Frank, by its terms, is not intended to alter state corporate law. Nevertheless, the Act does alter state corporate law to the extent that shareholders can challenge board decisions and either survive motions to dismiss or collect settlement proceeds. Further, the provisions promote an inefficient form of corporate governance by encouraging boards to yield to shareholder demands regarding executive compensation, even if those demands are not in the best interest of the corporation. This Note suggests that shareholder empowerment in the area of executive compensation is not warranted.