

# HOW TO SUFFICIENTLY CONSIDER EFFICIENCY, COMPETITION, AND CAPITAL FORMATION IN THE WAKE OF *BUSINESS ROUNDTABLE*

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## I. INTRODUCTION

Even before the Dodd-Frank Act (“Dodd-Frank” or “Act”), rules promulgated by the Securities and Exchange Commission (“SEC”) occasionally struggled to cross the threshold of the D.C. Circuit’s arbitrary and capricious review standard. This standard is bolstered by the requirement found in various acts of Congress that, before the appropriate agency promulgates a rule, it must consider whether the rule promotes efficiency, competition, and capital formation.<sup>1</sup> Striking examples of rulemaking failures include the fixed-indexed annuity rule, the independent director rules, and most recently, the proxy access rule.<sup>2</sup> While Dodd-Frank did not create the difficulties inherent in defining and exceeding the standard, it did exacerbate the problem. The Act mandated the promulgation of more than 100 new rules, contained a slew of non-mandatory rulemaking provisions, and imposed other new responsibilities.<sup>3</sup> The SEC has proceeded with implementation of “the broadest financial reforms since the 1930s”<sup>4</sup> “almost entirely with existing staff,”<sup>5</sup> much of whose time has been taken away from “other critical responsibilities.”<sup>6</sup> Consequently, an understanding of the standard of judicial review should become increasingly important as these new rules come out.

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<sup>1</sup> See, e.g., 15 U.S.C. § 77b(b) (Supp. 2012).

<sup>2</sup> *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1154 (D.C. Cir. 2011); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 179 (D.C. Cir. 2010); *Chamber of Commerce of the U.S. v. SEC*, 443 F.3d 890, 909 (D.C. Cir. 2006); *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133, 145 (D.C. Cir. 2005).

<sup>3</sup> U.S. SEC. & EXCH. COMM’N, IN BRIEF FY 2012 CONGRESSIONAL JUSTIFICATION 2 (Feb. 2011), available at <http://www.sec.gov/about/secfy12congbudgjust.pdf>.

<sup>4</sup> Jeff Merkley & Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 515 (2011).

<sup>5</sup> U.S. SEC. & EXCH. COMM’N, *supra* note 3.”

<sup>6</sup> *Management and Structural Reforms at the SEC: A Progress Report Before the S. Comm. on Banking, Housing & Urban Affairs Subcomm. on Sec., Ins., & Inv.*, 112th Cong. (2011) (statement of Robert Khuzami), available at <http://www.sec.gov/news/testimony/2011/ts1116rk.htm>.

This article will examine parallels between the standard applied by the D.C. Circuit and well-established law and economics principles. Because of the impact of the Law and Economics movement on the legal profession, most judges should be familiar with the basic precepts.<sup>7</sup> Consequently, before promulgating a rule, agencies that are required to analyze the rule's effect on systemic efficiency and competition should perform their analysis in accordance with what are now well-established insights from the Law and Economics movement.<sup>8</sup> Doing so should ensure that the rule survives judicial scrutiny by satisfying the requirement found in many authority-granting statutes that the agency must consider the rule's effect on efficiency, competition, and capital formation. This article will use Dodd-Frank's incentive-based compensation rules and clawback provisions as illustrations. Ultimately, this article will lay out guidelines that, if followed, should increase the likelihood that a rule passes judicial review.

## II. THE IMPETUS BEHIND DODD-FRANK'S ENACTMENT

The Dodd-Frank Act was enacted in response to the financial crisis that led to what is now known as the Great Recession.<sup>9</sup> This article will summarize what happened in the crisis, briefly discuss the role that subprime loans and securitization played, and briefly discuss the aftermath of the crisis. This historic background should help provide some context for the issues that courts face in interpreting Dodd-Frank.

### A. *The Financial Crisis*

In 2008, the United States experienced a financial disaster that was “eerily similar” to the financial disaster that led to the Great Depression.<sup>10</sup> The similarities have earned the post-2008 time period the sobriquet, “The Great Recession.”<sup>11</sup> In both the Great Depression and the Great Recession, an enormous bubble in the market for real estate

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<sup>7</sup> Richard A. Epstein, *Law and Economics: Its Glorious Past and Cloudy Future*, 64 U. CHI. L. REV. 1167, 1167–72 (1997) (mentioning the “self-conscious instrumentalism that guides so many judges today” as a result, in part, of their having lived through the 1970s when “virtually everyone . . . learned to restock his tool kit with the new devices from Law and Economics.”).

<sup>8</sup> *Id.* at 1174 (The Law and Economics movement is “no longer nourished by huge advances outside its own field.” The doctrinal issues are now familiar and for decades, growth has been within established disciplinary lines.)

<sup>9</sup> BAIRD WEBEL, CONG. RESEARCH SERV., R41350, THE DODD-FRANK WALL STREET REFORM ACT: ISSUES AND SUMMARY 1–3 (2010).

<sup>10</sup> Steven Pearce, *Accounting for the Lack of Accountability: The Great Depression Meets the Great Recession*, 37 HASTINGS CONST. L.Q. 409, 409 (2010).

<sup>11</sup> *Id.* at 420.

waxed and burst.<sup>12</sup> Also, during the boom time, lenders became increasingly comfortable extending riskier loans.<sup>13</sup>

Borrowed money was increasingly easy to obtain during the boom times preceding both the Great Depression and the Great Recession. In the 1920s, investors used excessive margin to purchase stocks that they expected would always rise in value.<sup>14</sup> Similarly, in the years leading up to 2008, homebuyers took out increasingly riskier loans because they came to view their houses not as homes but as investments that would always increase in value.<sup>15</sup> In the early 2000s, for example, banks created and marketed an easy process for homeowners to take out their built-up home equity.<sup>16</sup> Loan underwriting guidelines became astoundingly lax.<sup>17</sup> Loans that defied common sense called “ninja” loans were issued.<sup>18</sup> In a “ninja” loan, the borrower has “no income, no job, no assets.”<sup>19</sup> The loosening of loan underwriting standards contributed to an explosion in homebuying and homebuilding.<sup>20</sup> From 2001 to 2005, housing prices in California as a percentage of personal income increased by thirty-five percent.<sup>21</sup> Figure 1, below, demonstrates the divergence of housing prices from household income that occurred during the first decade of the millennium.<sup>22</sup>

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<sup>12</sup> See generally JOHN KENNETH GALBRAITH, *THE GREAT CRASH OF 1929 3–7* (1997) (detailing the rise and fall of the “great Florida real estate boom” and, interestingly, discussing the role played in it by the eponymous founder of the Ponzi scheme, Mr. Charles Ponzi).

<sup>13</sup> CHARLES POOR KINDLEBERGER, *THE WORLD IN DEPRESSION, 1929–1939, REVISED & ENLARGED EDITION* 130 (1986) (This 1930 story of the demise of the Bank of the United States could just as well have been written about the big bank failures in 2008.).

<sup>14</sup> RICHARD A. POSNER, *A FAILURE OF CAPITALISM* 11–12 (2009) (Investors in the 1920s could and would put down ten percent of a stock’s purchase price and take a bank loan for the other ninety percent.).

<sup>15</sup> CHARLES R. MORRIS, *THE TWO TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH* 68 (2008).

<sup>16</sup> *Id.* at 67 (In the second half of the 1990s a “refi” boom occurred. “Refi” was the term used to refer to exotic new loan types that allowed easy access to cash in exchange for the encumbrance of built-up home equity. “Refis jumped from \$14 billion in 1995 to nearly a quarter-trillion in 2005, the great majority of them resulting in higher loan amounts.”).

<sup>17</sup> *Id.* at 68–69 (Automated procedures allowed more people to qualify for loans and to qualify faster than before. Also, the amount of documentation required became increasingly light, which eventually led to “ninja” loans where the borrower had “no income, no job, no assets.” These loans carried high rates and high fees.).

<sup>18</sup> *Id.* at 69.

<sup>19</sup> *Id.*

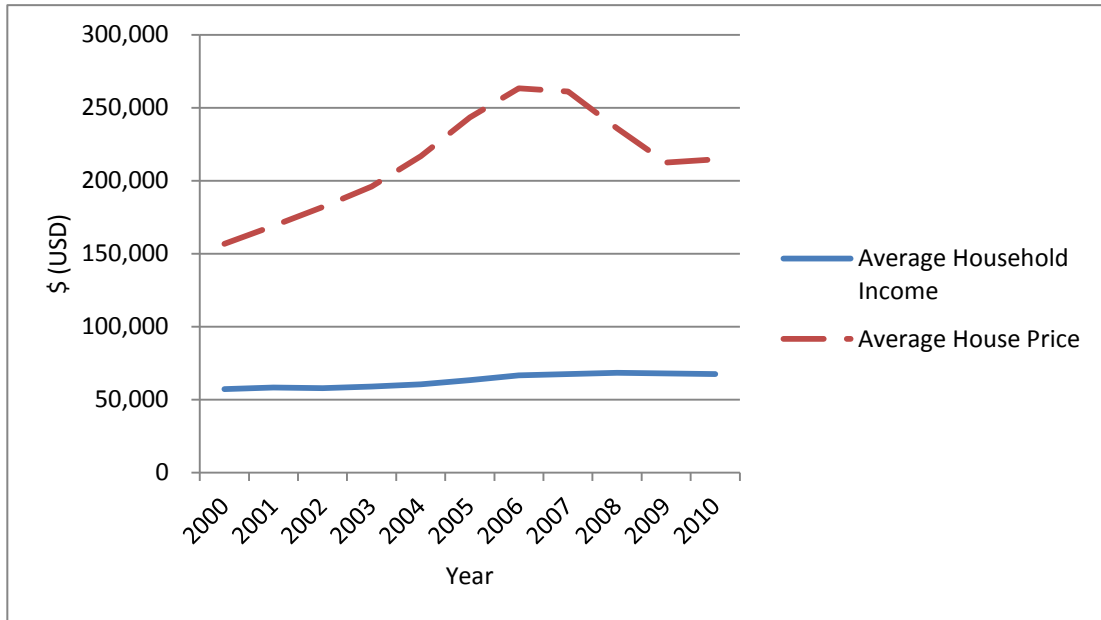
<sup>20</sup> *Id.* at 66, 68 (“By 2005, 40 percent of all home purchases were either for investment or as second homes.” Also, “[t]he market value of homes grew by more than 50 percent, and there was a frenzy of new construction. Merrill Lynch estimated that about half of all American GDP growth in the first half of 2005 was housing-related.”).

<sup>21</sup> WILLIAM BONNER & ADDISON WIGGIN, *EMPIRE OF DEBT: THE RISE OF AN EPIC FINANCIAL CRISIS* 278 (2006).

<sup>22</sup> Data taken from U.S. Census Bureau, Table H-6. Regions—All Races by Median and Mean Income, *available* at <http://www.census.gov/hhes/www/income/data/historical/household/index.html>, and from

The graph illustrates how traditional views on the appropriate percentage of mortgage payments to household income eroded as mortgages ate up increasingly larger percentages of many family budgets.

**Figure 1**



In 2004, the amount owed on home equity lines of credit increased by forty-two percent.<sup>23</sup> The median down payment on a home decreased from six percent in 2003 to a mere three percent in 2004.<sup>24</sup> The ramshackle marriage of lax loan underwriting and rampant lending ended disastrously.

#### 1. *The Role of Subprime Loans*

Banks traditionally underwrite loans based on the four Cs: (1) credit, (2) capacity, (3) capital, and (4) collateral.<sup>25</sup> A borrower who takes out a subprime loan typically fails to

Federal Housing Finance Agency, Summary Statistics for House Prices, [Ad Hoc Release] Quarterly Average and Median Prices for States and U.S.: 2000Q1-2010Q2, *available at* <http://www.fhfa.gov/Default.aspx?Page=87>, [http://www.fhfa.gov/webfiles/17330/State\\_statistics\\_for\\_download.xls](http://www.fhfa.gov/webfiles/17330/State_statistics_for_download.xls) (From the Census Bureau table, the non-inflation adjusted annual numbers are used. From the Federal Housing Finance Agency table, the second quarter figures for each respective year are used.).

<sup>23</sup> BONNER & WIGGIN, *supra* note 21, at 280.

<sup>24</sup> *Id.*

<sup>25</sup> THE 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 67 (Jan. 2011) (*available at* <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>).

demonstrate adequate strength in one or more of these categories.<sup>26</sup> In 1996, \$70 billion dollars of subprime loans were originated.<sup>27</sup> By 2006, this number had increased by 857 percent to \$600 billion.<sup>28</sup> Over a third of subprime loans were for 100 percent of the home value, which meant that the borrowers had very little “skin in the game.”<sup>29</sup> Many of these mortgages were non-recourse, meaning that when the borrowers returned the house to the bank, they never had to repay the unpaid balance of the loan.<sup>30</sup> Moreover, due to the time, expense, and risk involved in collecting on deficiency judgments, many recourse loans “consequently become de facto non-recourse loans.”<sup>31</sup> Many subprime loans were of a dangerous type called an option adjustable-rate mortgage (“option ARMs”), which allowed borrowers to pay only the interest or even less than the interest, resulting in negative amortization, i.e., the loan balance would actually grow rather than shrink over time as payments were made.<sup>32</sup> These loans often had initial “teaser” rates that were exceptionally and artificially low.<sup>33</sup> The interest rate on the loans would stay fixed for two or three years before resetting to a higher “go-to” rate.<sup>34</sup> The loan issuer would sometimes approve the loan based on the teaser rate payments knowing that the borrower’s income would not support payments at the go-to rate.<sup>35</sup> This created a situation where the borrower would almost certainly need to refinance the loan after a few years.<sup>36</sup> Due in part to securitization, lenders had very little interest in the borrower’s ability to repay and had very great interest in the borrower’s need for continual and systematic refinancing.

## 2. *The Role of Securitization*

By way of a process known as “securitization,” banks transfer to investors the risks and rewards of owning home loans. Securitization “refers to the aggregation and pooling of assets with similar characteristics in such a way that investors may purchase interests or

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<sup>26</sup> *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326, 359 (S.D.N.Y. 2011) (explaining that while the term “subprime” lacks a singular meaning in the industry, subprime loans typically show one or more of the characteristics that make a loan more risky than a traditional loan).

<sup>27</sup> THE FIN. CRISIS INQUIRY COMM’N., *supra* note 25, at 70.

<sup>28</sup> *Id.*

<sup>29</sup> MORRIS, *supra* note 15, at 69.

<sup>30</sup> Dov Solomon & Odelia Minnes, *Non-Recourse, No Down Payment and the Mortgage Meltdown: Lessons from Undercapitalization*, 16 FORDHAM J. CORP. & FIN. L. 529, 531 (2011).

<sup>31</sup> *Id.* at 536–37.

<sup>32</sup> Tomasz Piskorski & Alexei Tchisty, *Optimal Mortgage Design*, 23 REV. FIN. STUD. (Issue 8) 3098, 3099 (2010).

<sup>33</sup> MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* 66 (2010).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

securities backed by those assets.”<sup>37</sup> For example, in a collateralized mortgage obligation (“CMO”), the assets in the pool are home loans.<sup>38</sup>

Securitization allowed banks that originated loans to easily transfer the default risk on the loans to investors.<sup>39</sup> Traditionally, banks make money by relying on “spread income.”<sup>40</sup> Spread income is the difference between the interest rate that banks charge to the borrower and the cost to banks of acquiring money to lend out, i.e., the cost of operating a network of bank branches where people deposit money that can then be loaned out to other people.<sup>41</sup> With securitization, however, banks no longer need to worry about the vagaries of their spreads. As soon as a bank originates a loan, it can sell the loan for inclusion in a CMO and stop worrying about the spread.<sup>42</sup> Banks prefer income from loan sales to spread income because (1) it does not depend on vacillating interest rates; (2) the risk to the bank that the borrower will default, for the most part, vanishes; and (3) under Generally Accepted Accounting Principles, the bank can immediately book the compensation as income and does not have to wait for each monthly payment to arrive.<sup>43</sup> Consequently, lenders began originating loans that would almost certainly need to be refinanced within a couple years because doing so would allow them to sell loans more frequently, systematically, and continuously.<sup>44</sup> Lenders too often wanted the borrower to face default after two years because the lender was unaffected by the default risk and because the looming default would force the borrower to refinance, allowing the lender to charge refinancing fees and sell another new loan.<sup>45</sup> Mortgage bond investors probably should have taken prudent measures to oversee originations, but because the outlook was that house prices would always go up, problem loans were either ignored or unnoticed until it was too late.

### B. *The Initial Government Response*

The burst of the real estate bubble led to a series of public anathemas. These started with the largest one-time expenditure in the history of the federal government, the

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<sup>37</sup> RONALD S. BOROD, *SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES* 1-3 (2004).

<sup>38</sup> *Id.* at 1–20.

<sup>39</sup> For a more detailed empirical analysis, see Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru & Vikrant Vig, *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans* 1 (European Finance Association 2008 Athens Meetings Paper, Working Paper), available at <http://ssrn.com/abstract=1093137> (“Our findings suggest that existing securitization practices did adversely affect the screening incentives of lenders.”).

<sup>40</sup> BOROD, *supra* note 37, at 1–8.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

Troubled Asset Relief Program (“TARP”).<sup>46</sup> The program created a \$700 billion fund that Henry Paulson, then United States Secretary of the Treasury and the former CEO of Goldman Sachs,<sup>47</sup> would have absolute, non-reviewable discretion over.<sup>48</sup> Paulson procured this money from Congress with doomsday predictions about the imminent failure of the U.S. economy, proclaiming, “If we don’t do this, it’s coming down on all our heads.”<sup>49</sup> Paulson announced that fear over the insolvency of mortgage-based assets was “clogging” the financial markets and could cause the system to grind to a halt.<sup>50</sup> Paulson’s warnings seemed credible in light of the failure of the largest savings and loan institution in the country, Washington Mutual, as well as dramatic and incessant job loss reports and declines in the stock market.<sup>51</sup>

The TARP fund began bailing out firms that were considered “too big to fail.”<sup>52</sup> The doling out began with Bank of America, Citigroup, Goldman Sachs, J.P. Morgan, Morgan Stanley, State Street, and Wells Fargo.<sup>53</sup> The rapid government intervention would continue with the federal government taking an approximately eighty-percent ownership stake in American International Group (“AIG”).<sup>54</sup> When Paulson explained the extent of AIG’s entwinement in the American economy, President Bush responded, “An insurance company does all this?”<sup>55</sup> AIG absorbed the brunt of the financial debacle by insuring CMOs through a largely unregulated product called a credit-default swap.<sup>56</sup> Due to the lack of regulation, credit-default swap issuers, unlike issuers of traditional insurance, did not have to keep reserves to cover the potential obligations arising from the products.<sup>57</sup> More than a quarter of AIG’s bailout money immediately and directly went toward the satisfaction of its gargantuan obligations.<sup>58</sup> Many Americans were unhappy to discover that the government now owned large private banks.<sup>59</sup> They were often more unhappy to find out that the bank’s

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<sup>46</sup> ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES* 465 (2009).

<sup>47</sup> *See id.* at 43–45 (discussing Henry Paulson’s rise to CEO of Goldman Sachs from his days in the Nixon administration and his subsequent appointment to the Treasury).

<sup>48</sup> *Id.* at 465–66.

<sup>49</sup> *Id.* at 493.

<sup>50</sup> *See id.* at 446 (Paulson announced at a press conference, “As illiquid mortgage assets block the system, the clogging of our financial markets has the potential to have significant effects on our financial system and our economy . . . .”)

<sup>51</sup> *Id.* at 491, 504.

<sup>52</sup> *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, preamble, 124 Stat. 1376, 2011–2018 (2010) (proclaiming the end of “too big to fail”).

<sup>53</sup> SORKIN, *supra* note 46, at 524.

<sup>54</sup> *Id.* at 401.

<sup>55</sup> *Id.* at 401.

<sup>56</sup> POSNER, *supra* note 14, 56–57.

<sup>57</sup> *Id.* at 58.

<sup>58</sup> SORKIN, *supra* note 46, at 532.

<sup>59</sup> *Id.* at 529–30.

assets too-often consisted of large numbers of poor quality loans or credit-default swaps insuring those junk loans.<sup>60</sup>

### C. *The Fallout*

The financial debacle created a wide swath of devastation. Over \$350 billion dollars of subprime mortgages were scheduled for dangerously high rate resets between 2008 and 2010.<sup>61</sup> The percentage of home loans in foreclosure nearly quadrupled from 1.2 percent in 2006 to 4.6 percent in 2010.<sup>62</sup> The percentage of underutilized workers (a term including both unemployed workers and workers involuntarily working part-time rather than full time) jumped from 8.7 percent in December 2007 to 13.5 percent a year later.<sup>63</sup>

These dreary statistics set the stage for the enactment of the broadest set of financial reforms since the 1930s.<sup>64</sup> These reforms constitute the Dodd-Frank Act.<sup>65</sup> The Dodd-Frank Act addresses a few problems head-on but mandates agency rulemaking or creates new agencies to handle most problems.<sup>66</sup>

## III. JUDICIAL REVIEW OF NEW DODD-FRANK RULES

The specter of arbitrary and capricious review by the D.C. Circuit hangs over most agency rulemaking.<sup>67</sup> In a string of cases from 2005–2011, the D.C. Circuit has demonstrated particular willingness to strike down rulemaking promulgated by the Securities and Exchange Commission (“SEC”).<sup>68</sup>

The Administrative Procedure Act requires a court reviewing agency action to “hold unlawful and set aside” action found to be “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”<sup>69</sup> The D.C. Circuit has applied this standard to SEC

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<sup>60</sup> *Id.* at 531–32.

<sup>61</sup> MORRIS, *supra* note 15, at 133.

<sup>62</sup> U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES, Table 1194 (2012), *available at*

[http://www.census.gov/compendia/statab/cats/banking\\_finance\\_insurance/payment\\_systems\\_consumer\\_credit\\_mortgage\\_debt.html](http://www.census.gov/compendia/statab/cats/banking_finance_insurance/payment_systems_consumer_credit_mortgage_debt.html).

<sup>63</sup> POSNER, *supra* note 14, at 15.

<sup>64</sup> Merkle & Levin, *supra* note 4.

<sup>65</sup> *Id.*

<sup>66</sup> Reza Dibadj, *Dodd-Frank: Toward First Principles?*, 15 CHAP. L. REV. 79, 80 (2011).

<sup>67</sup> See CHRISTOPHER P. BANKS, JUDICIAL POLITICS IN THE D.C. CIRCUIT COURT 1–2, 37 (1999) (explaining that the D.C. Circuit has exclusive jurisdiction over certain agency appeals, and, because of its location near the Capital, it gets the lion’s share of administrative agency regulatory appeals even when it lacks this exclusive jurisdiction).

<sup>68</sup> See *generally* cases cited, *supra* note 2.

<sup>69</sup> 5 U.S.C. § 706(2)(A) (2006) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).



rulemaking and has also read provisions of the Securities Act of 1933, the Exchange Act of 1934, and the Investment Company Act of 1940, as amended, into the reviewing analysis.<sup>70</sup>

Under the Exchange Act, the SEC, when “engaged in rulemaking” and when required to “determine whether an action is necessary or appropriate in the public interest,” must consider “in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”<sup>71</sup> The National Securities Markets Improvement Act of 1996 added this provision.<sup>72</sup> The other major acts enforced by the SEC—the Investment Company Act and the Securities Act—contain virtually identical provisions.<sup>73</sup> Additionally, the Exchange Act requires the SEC to consider the impact that its regulations will have on competition.<sup>74</sup> The Exchange Act also forbids regulations that “would impose a burden on competition not necessary or appropriate in furtherance of the purposes of this chapter.”<sup>75</sup> Furthermore, it requires that the “statement of basis and purpose” in the rule contain “the reasons for the [SEC’s] determination that any burden on competition imposed by [the rule] is necessary or appropriate in furtherance of the purposes of this chapter.”<sup>76</sup> Due to these statutory provisions, the D.C. Circuit has required the SEC to “apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation.”<sup>77</sup>

This is not a hollow truism or unnecessary red tape that the agency should try to skirt as it attempts to fulfill its mission. In the three rulemaking failures mentioned earlier, the D.C. Circuit vacated SEC rules for failure to adequately consider and discuss the implications of the rules.<sup>78</sup> One year after the SEC’s independent director rules were struck down in the first *Chamber of Commerce* case, the SEC attempted to use extra-record data to supplement its considerations and get the rule approved.<sup>79</sup> In the second *Chamber of*

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<sup>70</sup> See *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (“the Commission acted arbitrarily and capriciously for having failed once again . . . adequately to assess the economic effects of a new rule.”).

<sup>71</sup> Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>72</sup> National Securities Markets Improvement Act of 1996, Pub. L. No. 104–290, 110 Stat. 3416, 3425 (1996).

<sup>73</sup> Investment Company Act of 1940 § 3(c), 15 U.S.C. § 80a–2(c) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12); Securities Act of 1933 § 2(b), 15 U.S.C. § 77b(b) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>74</sup> Securities Exchange Act of 1934 § 23(a)(2), 15 U.S.C. § 78w(a)(2) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>75</sup> *Id.*

<sup>76</sup> Securities Exchange Act of 1934 § 23(a)(2), 15 U.S.C. § 78w(a)(2) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>77</sup> *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (quoting *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133 (D.C. Cir. 2005)).

<sup>78</sup> See cases cited, *supra* note 2.

<sup>79</sup> *Chamber of Commerce of the U.S. v. SEC*, 443 F.3d 890, at 901–02 (D.C. Cir. 2006).

*Commerve* case, the court found that the extra-record data supplied “basic assumptions” used to estimate costs and that “data critical to support a rule” must be offered for public comment.<sup>80</sup> Effectively, the SEC was sent back to the drawing board.

If the D.C. Circuit finds the SEC’s considerations on efficiency, competition, or capital formation to be arbitrary and capricious, the court will vacate the rule.<sup>81</sup> In performing this analysis, the D.C. Circuit has drawn numerous specific rules from the general guidance of the statutes. These specific rules include the following: (1) if the Commission believes that no “reliable basis” exists for estimating costs of a rule, then it must “hazard a guess” and, at a minimum, estimate the costs to one particular company;<sup>82</sup> (2) the SEC cannot justify the adoption of a rule based solely on the assertion that having a rule promotes clarity, because any rule is better than no rule;<sup>83</sup> (3) the SEC must consider and discuss the adequacy of “the existing state law regime” and the differences between it and the federal regime in terms of efficiency and capital formation before supplanting state law with federal rules—failure to do so is “arbitrary and capricious;”<sup>84</sup> (4) the Commission cannot rely “exclusively and heavily” on “unpersuasive” studies that offer, at best, admittedly mixed empirical evidence;<sup>85</sup> (5) the Commission acts arbitrarily when it fails to adequately address or respond to comments on “an important aspect of the problem;”<sup>86</sup> and (6) internal inconsistency is arbitrary, e.g., the Commission cannot anticipate frequent use of its rule when estimating benefits, but assume infrequent use of the rule when estimating costs.<sup>87</sup>

Additionally, split votes of the five Commissioners of the SEC may breed more stringent judicial review. In *Chamber of Commerce*, the Commission’s failure to discuss the pros and cons of an alternative suggestion of two dissenting Commissioners was found to be “arbitrary and capricious.”<sup>88</sup> Similarly, in *Business Roundtable*, the court pointed out twice that the vote on the rule was a 3–2 split and also that the two dissenting commissioners “faulted the Commission on both theoretical and empirical grounds.”<sup>89</sup>

#### A. *Developments in Business Roundtable*

The court struck down the SEC’s proxy access rule with particular vehemence in *Business Roundtable*, at one point calling the Commission’s reasoning “unutterably mindless.”<sup>90</sup>

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<sup>80</sup> *Id.* at 902–03.

<sup>81</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 177 (“We hold that the Commission’s consideration of the effect of Rule 151A on efficiency, competition, and capital formation was arbitrary and capricious.”)

<sup>82</sup> *Chamber of Commerce*, 412 F.3d at 143.

<sup>83</sup> *Am. Equity*, 613 F.3d at 177–78.

<sup>84</sup> *Id.* at 178.

<sup>85</sup> *Business Roundtable*, 647 F.3d at 1151.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 1154.

<sup>88</sup> 412 F.3d at 144.

<sup>89</sup> 647 F.3d at 1148.

<sup>90</sup> *Id.* at 1156.

Because the SEC purportedly allocated 21,000 staff hours over two years into drafting the rule and included sixty pages of cost-benefit analysis to support the rule, the Court's decision may seem surprising.<sup>91</sup> Quantity, however, does not always ensure quality.

The proxy access rule at issue in *Business Roundtable* was the product of a vigorous debate over shareholder's rights. The details of the debate are beyond the scope of this article.<sup>92</sup> The rule would have required public companies to include in their proxy materials shareholder-proposed director nominees, provided that the proponents satisfied certain thresholds.<sup>93</sup>

What the *Business Roundtable* Court pointed out so poignantly was not that there was no need for reform, but rather that reform for the sake of reform fails to meet a minimum threshold of reasonableness.<sup>94</sup> Indeed, dissenting Commissioner Troy Paredes spoke highly of the proxy access rule to the extent that it "empowers shareholders, respects the traditional role of states in regulating internal corporate affairs, and allows for efficient private ordering."<sup>95</sup>

The proxy access rule fell into the tenebrous trap of failing to consider the reciprocal nature of transactions.<sup>96</sup> This trap has been explored perspicaciously by economist Ronald Coase.<sup>97</sup> His insights are famously referred to as the Coase Theorem.<sup>98</sup> His fame stems from the fact that for a long time economists looked at the presence of externalities as an indication that governmental intervention was necessary to resolve social

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<sup>91</sup> Ben Protes, *Court Ruling Offers Path to Challenge Dodd-Frank*, N.Y. TIMES, Aug. 17, 2011, available at <http://dealbook.nytimes.com/2011/08/17/court-ruling-offers-path-to-challenge-dodd-frank/>.

<sup>92</sup> For a few arguments on each side of the debate, see for example Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. REV. 547 (2003) (arguing that centralized decision making is not only critical to the success of the modern firm, but also one of its defining characteristics); Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 412 (2012). *Contra*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 913 (2005) ("The case for management insulation from shareholder intervention does not follow from informational advantages that management has over shareholders or from the requirements of centralized management."); Leo E. Strine, Jr., *Response to Increasing Shareholder Power: Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006) (exploring the political unpalatability of Bebchuk's proposals and suggesting workable compromises).

<sup>93</sup> *Business Roundtable*, 647 F.3d at 1147.

<sup>94</sup> *Id.* at 1155–57.

<sup>95</sup> Troy A. Paredes, Commissioner, Sec. & Exchange Comm'n, Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations ("Proxy Access") (Aug. 25, 2010), available at [http://www.sec.gov/news/speech/2010/spch082510tap.htm#P56\\_13651](http://www.sec.gov/news/speech/2010/spch082510tap.htm#P56_13651).

<sup>96</sup> R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2 (1960).

<sup>97</sup> *See generally id.*

<sup>98</sup> Claude Menard, *The Inadequacy of Competition Policies: A New Institutional Approach*, in LAW AND ECONOMICS: ALTERNATIVE ECONOMIC APPROACHES TO LEGAL AND REGULATORY ISSUES 29 (Margaret Oppenheimer & Nicholas Mercurio eds., 2005).

cost problems.<sup>99</sup> Coase, however, cogently pointed out that the presence of a social cost is only the touchstone of the inquiry.<sup>100</sup> In *The Problem of Social Cost*, Coase goes on to establish an analytical framework for fleshing out the rest of the inquiry into whether or not a governmental intervention is necessary to resolve a social cost problem.<sup>101</sup>

B. *The Coase Theorem*

Coase's article initially points out that in analyzing a legal problem involving private rights,

The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is: how should we restrain A? But this is wrong. We are dealing with a problem of a reciprocal nature. To avoid the harm to B would inflict harm on A. The real question that has to be decided is: should A be allowed to harm B or should B be allowed to harm A?<sup>102</sup>

Coase goes on to examine the common law of nuisance (including smoke, vibrations, and noise), tort law regarding liability for railroad companies for fires caused by sparks from their locomotive engines, and hypothetical farmers and cattle-raisers whose land abuts and whose livelihoods conflict and cause damage to each other.<sup>103</sup> The article discusses social costs and the classic economic problem of externalities.<sup>104</sup> Social costs are, of course, costs borne not by the individual, but rather by the community.<sup>105</sup>

In the interest of brevity, this article will not walk through each step in Coase's series of inferences and analyses. The thrust of the article is the conclusion that given infinite time and resources, private parties will always bargain to the most economically efficient result from a social cost standpoint, and that this holds true whether or not the law provides the parties a remedy for an injury.<sup>106</sup> In other words, property and tort law merely allocate private rights among the parties. The parties themselves can and will alter their arrangement in such a way as creates the highest and best social use of the property by means of private negotiations. They merely need to know what their property, tort, and other rights are before they can begin negotiating.<sup>107</sup> Coase goes on to observe that (1) the time and resources involved in negotiations constitute transaction costs that impede the system; (2) more often than not, these costs are lowest in a privately administered system;

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<sup>99</sup> *Id.* at 27–29

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 27.

<sup>102</sup> Coase, *supra* note 96, at 2.

<sup>103</sup> *Id.* at 2–16, 29–34.

<sup>104</sup> *Id.* at 1.

<sup>105</sup> *Id.* at 2.

<sup>106</sup> *Id.* at 9.

<sup>107</sup> *Id.* at 7.

and (3) sometimes, due to the circumstances, the government is in a unique position to administer the system at a lower cost.<sup>108</sup> Government intervention becomes appropriate, then, when the government can decrease transaction costs by more than the existing system.<sup>109</sup> This theory of government intervention based on Coase's observation can be stated as follows, "In deciding whether government intervention in the economic system is appropriate, it is not enough to demonstrate that the market would operate imperfectly without intervention; government also operates imperfectly. Comparison between the actual workings of the market and of government in the particular setting is necessary."<sup>110</sup>

Weighing the pros and cons of a governmental versus a private solution involves a number of considerations including, but not limited to (1) the lack of competitive checks on the government; (2) the government's unique ability to exhibit wide-ranging influence by administrative decision; i.e., exert authoritarian methodologies; (3) the government's law enforcement capabilities; (4) the dangers and costs of uniform one-size-fits-all solutions; and (5) the risks inherent in political pressures.<sup>111</sup> Coase observes that in order to understand the consequences of a decision, legal "rights of the various parties should be well-defined and the results of legal actions easy to forecast."<sup>112</sup> Interestingly, however, what these rights are does not matter to the social cost problem so long as the rights are clear.<sup>113</sup> In other words, the costs that are internalized, i.e., the allocation of rights among the participants themselves, are irrelevant to the social cost issue. The problem of who gets what property rights "must ultimately dissolve into a study of aesthetics and morals."<sup>114</sup>

To conclude the article, Coase makes an emphatic argument that consideration of the deficiencies between private and social allocation of rights is fundamentally flawed because it "tends to nourish the belief that any measure which will remove the deficiency is necessarily desirable. It diverts attention from those other changes in the system which are inevitably associated with the corrective measure, changes which may well produce more harm than the original deficiency."<sup>115</sup> All analysis must recognize that a change to the system that leads to an improvement will likely worsen other conditions.<sup>116</sup> Both these reciprocal costs and the cost of moving to a new system must be accounted for.<sup>117</sup> Tort law has long recognized this. To paraphrase Prosser, a man "may operate a factory whose noise and smoke cause some discomfort to others . . . . It is only when his conduct is unreasonable, in

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<sup>108</sup> *Id.* at 18–19, 40–45.

<sup>109</sup> *Id.* at 17–18.

<sup>110</sup> RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 51 (2007).

<sup>111</sup> Coase, *supra* note 96, at 17–18.

<sup>112</sup> *Id.* at 19.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.* at 43.

<sup>115</sup> *Id.* at 42–43.

<sup>116</sup> *Id.* at 44.

<sup>117</sup> *Id.*

the light of its utility and the harm which results, that it becomes a nuisance.”<sup>118</sup> In other words, the problem of factory smoke cannot be solved by rules that reduce smoke unless the society’s need for factories is also accounted for in the solution. The problem is reciprocal.

In reality, just as contracts are commonly unsatisfactory merely because it would cost too much to put the matter right, governmental solutions often cost more than they are worth, despite their having some beneficial qualities.<sup>119</sup> In other words, a good regulation does not merely have good qualities of its own; it also makes the whole system function better. Regulations do not exist in a vacuum or a test tube.

C. *The Coase Theorem & Business Roundtable*

Applying these principles to the proxy access rule, one finds that the court’s position in *Business Roundtable* was not just a cruel taking of a salutary right of shareholders, but was rather a necessary check on laconic reasoning. As pointed out by Commissioner Paredes, the mandatory nature of the rule made it much more than a mere reallocation of internalized rights.<sup>120</sup> A reallocation might have been justified on moral or public policy grounds. The proxy access rule, however, was an authoritarian measure to force an inalienable right on all shareholders, even shareholders that would rationally prefer to exchange that right through private negotiations in order to achieve an optimal cost-conscious position for themselves.<sup>121</sup> It would have imposed an administrative bar to the private arrangement of affairs.<sup>122</sup>

Consequently, the rule was properly subjected to heightened scrutiny. Arguments about the rights attendant to stock ownership and the empowerment of shareholders could conceivably contain proper moral/aesthetic justifications for a rule that contains efficiency issues. Public policies could override the economic concerns. The policies should, of course, be clear. In other words, the public ought to know why certain policy considerations are more important than efficiency concerns.

The proxy access rule would have alleviated the problem of the commons that potential activist dissident shareholders face.<sup>123</sup> Specifically, dissident shareholders bear all costs of “any time, money, or initiative” expended in supporting an outside candidate, while the benefit, if any, of electing the outsider accrues to all shareholders.<sup>124</sup> As Coase said, however, identifying an economic problem and a remedy for that problem is easy in the abstract.<sup>125</sup> All remedies have costs. Proving that the costs (including direct and reciprocal

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<sup>118</sup> *Id.* at 43 (quoting W. L. PROSSER, *THE LAW OF TORTS* 389–99, 412 (2d ed. 1955)).

<sup>119</sup> Coase, *supra* note 96, at 39.

<sup>120</sup> Paredes, *supra* note 95.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> Grant M. Hayden & Matthew T. Bodie, *The Bizarre Law & Economics of Business Roundtable v. SEC*, 38 J. Corp. L. 101, 125 (2012).

<sup>124</sup> *Id.* at 126.

<sup>125</sup> Coase, *supra* note 96, at 2.

costs) of the improvement have been sufficiently confronted is a necessary precursor to the improvement's adoption. For example, shareholders have less information than management about the business.<sup>126</sup> The lack of information constitutes a transaction cost that impedes perfectly efficient negotiation. Consequently, taking decision-making authority from the more-informed party and giving it to the less-informed party increases the transaction costs inherent in the system. This makes the system less efficient. The notice and comment period during the rulemaking process produced numerous concerns regarding costs.<sup>127</sup> By ignoring these costs and focusing on the benefits, the rule fell into the classic trap of failing to recognize the reciprocal nature of transactions.<sup>128</sup>

D. *What are Efficiency Considerations?*

Commentators said that *Business Roundtable* endorses analysis that “departs dramatically from the standard law and economics of corporate law.”<sup>129</sup> Additionally, “some law and economics adherents have drifted from its own basic precepts.”<sup>130</sup> Furthermore, the *Business Roundtable* Court rejected “basic economic theory.”<sup>131</sup> Finally, “mainstream law and economics” holds that when shareholder power is insufficiently democratic that the system will be “riven with agency costs.”<sup>132</sup> These allegations are somewhat baffling, particularly in an article that does not mention, let alone address, seminal Law and Economics movement authors like Ronald Coase, Gary Becker, Guido Calabresi, Henry Manne, or Richard Posner.<sup>133</sup> Apparently the work of these authors is nothing more than a “sect” and an excuse to assert something akin to “naked political preferences.”<sup>134</sup> “Mainstream”

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<sup>126</sup> Sharfman, *supra* note 92, at 404.

<sup>127</sup> *Id.* at 412. (arguing that because shareholders have less access to information than centralized management that increased shareholder control leads to increased transaction costs).

<sup>128</sup> *Id.* at 398–402, 408 (The benefit to shareholders who would use a mandatory proxy access rule is clear, but reciprocal costs include opportunistic use that disadvantages minority shareholders, an increase in the costs of decision-making, conflicting accountability, ambiguity in authority, “megaphone externalities,” and other costs).

<sup>129</sup> Hayden & Bodie, *supra* note 123, at 133.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* at 129.

<sup>132</sup> *Id.* at 136.

<sup>133</sup> Epstein, *supra* note 7, at 1168 (listing some of the most influential authors in the Law and Economics movement); *Also see generally* Daniel B. Klein & Charlotta Stern, *Groupthink in Academia: Majoritarian Departmental Politics and the Professional Pyramid*, in *THE POLITICALLY CORRECT UNIVERSITY* 79 (Robert Maranto, Richard E. Redding & Frederick M. Hess eds., 2009) (While beyond the scope of this article, the failure to include or even address the work of key members of the Law and Economics movement might be explained as a symptom of the impact of groupthink on academia).

<sup>134</sup> Hayden & Bodie, *supra* note 123, at 108 n.5 (quoting Brett McDonnell, *Dodd-Frank @ 1: An Overall Assessment*, *THE CONGLOMERATE BLOG*, (July 22, 2011), <http://www.theconglomerate.org/2011/07/dodd-frank-1-an-overall-assessment.html> (last visited Mar. 15, 2013)).

economists apparently know that corporate governance is more efficient when it is modeled after the democratic process present in the public voting arena.<sup>135</sup>

However, voting processes in the public arena are generally not analogous to corporate governance.<sup>136</sup> At a minimum, the bare analogy, devoid of any discussion of transaction costs and the reciprocal nature of transactions, cannot be considered “mainstream,” “standard,” or “basic” law and economics. A comprehensive criticism of “*The Bizarre Law & Economics of Business Roundtable v. SEC*” is beyond the scope of this article, though. Suffice it to say, the body of work known as Law and Economics cannot be replaced or marginalized by the aphorism that “you take preferences as they come.”<sup>137</sup>

Additionally, “the notion that the 2008 financial crisis was caused in part by short-term profit maximization has received enough academic and popular support to support policies based on this justification.”<sup>138</sup> Turning power over to institutional shareholders, however, whose “compensation turns more on short-term factors than on long-run growth” and making board positions more precarious will only increase the “laser-beam focus on quarter-to-quarter earnings” that is inimical to “sustainable, long-term wealth creation.”<sup>139</sup> In other words, individual investors’ laudable goals of sustainable, long-term wealth creation for retirement and for higher-education for their children are not necessarily or even likely to be better served by mutual and pension funds than they are by an entrenched board. Although digressive at best, if public governance must be analogized to corporate governance, then directors and management likely share more similarities with judges who should “hold their Offices during good Behavior”<sup>140</sup> than they share with Congressmen who are subject to “violent popular paroxysm[s].”<sup>141</sup>

A meaningful economic evaluation of the proxy access rule would have to consider whether the federal government is in a unique position to use authoritarian measures to lower transaction costs and what impact the federal solution would have on state law and how that would impact transaction costs. Because the proxy access rule was an across-the-board solution to a multifarious issue, it required heightened scrutiny, particularly with

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<sup>135</sup> Hayden & Bodie, *supra* note 123, at 136.

<sup>136</sup> Bainbridge, *supra* note 92, at 555–57 (“[P]ublic corporations are not participatory democracies, but hierarchies in which decisions are made on a fairly authoritarian basis.” Also, for good reasons, “large corporations tend to adopt hierarchical decisionmaking structures.” Furthermore, “[t]he necessity of a centralized decisionmaker capable of making adaptive changes by fiat thus emerges as the defining characteristic of the Coasean firm.”); Strine, *supra* note 92, at 1776 (stating that “corporate elections are not the same as elections in actual polities”).

<sup>137</sup> Hayden & Bodie, *supra* note 123, at 119–20.

<sup>138</sup> *Id.* at 124.

<sup>139</sup> Strine, *supra* note 92, at 1764–65, 1783.

<sup>140</sup> U.S. CONST. art. III, § 1.

<sup>141</sup> THE FEDERALIST NO. 16, at 87 (Alexander Hamilton) (ABA Classics, 2009); *see also*, THE FEDERALIST NO. 10, at 46 (James Madison) (ABA Classics, 2009) (Occasionally, a majority of people “who are united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interests of the community” will arise.).



regard to efficiency considerations.<sup>142</sup> While the benefits of the rule to those who wanted it may have outweighed the costs to those who did not, thus at least achieving Kaldor-Hicks efficiency,<sup>143</sup> the evidence of this efficiency was lacking.<sup>144</sup> Without the reciprocal cost analysis, the rule merely remedied a deficiency.<sup>145</sup> If every deficiency is remedied without regard for the tangential consequences, then the whole system will become increasingly complex and arbitrary until at some point, no analysis at all can be performed.<sup>146</sup>

#### IV. ANALYZING THE SUFFICIENCY OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION CONSIDERATIONS

Assumedly, if a new rule's effect on efficiency, competition, and capital formation is sufficiently considered, then the rule's enactment is not arbitrary and capricious.<sup>147</sup> A proper economic analysis of efficiency, competition, and capital formation would require analysis of transaction costs, the reciprocal effects of the rule, and wealth distribution concerns<sup>148</sup> among other things. The transaction cost analysis may also include topics like information asymmetries (e.g., which parties have the information necessary to facilitate trade?), moral hazard reduction,<sup>149</sup> risk preferences (e.g., how do asymmetric risk preferences affect the rule's impact?),<sup>150</sup> or behavioral issues.<sup>151</sup>

##### A. *Transaction Costs*

Transaction costs are probably the most difficult consideration to properly analyze. Some form of cost-benefit analysis ("CBA") will accompany nearly all rules.<sup>152</sup> The CBA should contain a discussion of transaction costs. What would make the transaction cost analysis sufficient? One commentator has recommended focusing on identification,

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<sup>142</sup> *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

<sup>143</sup> See the section of this article *infra* on "The Limitations of Efficiency Considerations" for more information on Kaldor-Hicks and Pareto efficiency.

<sup>144</sup> Paredes, *supra* note 95.

<sup>145</sup> Coase, *supra* note 96, at 2.

<sup>146</sup> Some might say that our tax code has achieved this level of arbitrariness.

<sup>147</sup> See 5 U.S.C. § 706(2)(A) (2006); 15 U.S.C. § 78c(f); *Bus. Roundtable*, 647 F.3d at 1148–49.

<sup>148</sup> Nicholas L. Georgakopoulos, *Solutions to the Intractability of Distributional Concerns*, 33 *Rutgers L.J.* 279, 279 (2002).

<sup>149</sup> RICHARD A. IPPOLITO, *ECONOMICS FOR LAWYERS* 350 (2005).

<sup>150</sup> Posner, *supra* note 110, at 11 (discussing the impact of risk-aversion, risk-neutrality, and risk preference on bargaining).

<sup>151</sup> See Christine Jolls, Cass R. Sunstein, & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 *STAN. L. REV.* 1471, 1485 (1998) (exploring deficiencies in asymmetric risk preferences as an explanation for some irrational economic conduct and exploring the frontiers of other behavioral explanations); see also Russell B. Korobkin & Thomas S. Ulen, *Law & Behavioral Science: Removing the Rationality Assumption from Law & Economics*, 88 *CALIF. L. REV.* 1051, 1075 (2000).

<sup>152</sup> See Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 *YALE L.J.* 165, 167 (1999) (exploring the pros and cons of the cost-benefit analyses typically performed by government agencies and concluding that cost-benefit analyses are usually beneficial).

quantification, and presentation of costs and benefits.<sup>153</sup> In other words, the costs must not only be identified and quantified (at least in the form of a good faith conjecture based on the best available information), but they must also be presented.<sup>154</sup> This might require the use of examples, metaphors, analogies, charts, graphics, and writing without arcane or overly specialized terminology.<sup>155</sup> Ultimately, the goal of cost-benefit analysis is to compel the decision maker to confront the costs of a proposed course of action.<sup>156</sup> A showing that costs and other negative data were given a good faith confrontation should help.<sup>157</sup> The judge is not evaluating the solution itself but is rather evaluating whether or not the solution is the product of a good faith confrontation.

1. *Comparison of the New Model to the Existing Model is Essential to a Proper CBA*

Most transaction cost analyses should compare proposed preventative models against existing liability models.<sup>158</sup> For example, the law provides numerous remedies for injuries.<sup>159</sup> The threat of paying a judgment inspires people to avoid causing injury.<sup>160</sup> Because the person performing an action is often in the best position to evaluate the risks, the law generally allows him or her to make the choice and live with the consequences.<sup>161</sup> More information reduces transaction costs because increased information allows bargaining parties to bargain more efficiently.<sup>162</sup> Conversely, less information means higher transaction costs.<sup>163</sup> As a rule of thumb, vesting decision-making authority and accountability in the party with the most information tends to facilitate low-transaction-cost Coasean trade.<sup>164</sup>

In some circumstances, a prophylactic rule that attempts to prevent the harm from occurring in the first place is better than the liability model.<sup>165</sup> This is the exception rather than the general rule because the public official making the call is wholly unaware of the individual circumstances surrounding the decision.<sup>166</sup> Preventative rules are likely to sweep up perfectly non-injurious activity in their blanket prohibitions, thus, creating waste and a

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<sup>153</sup> Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort*, 12 STAN. J.L. BUS. & FIN. 1, 57–58 (2006).

<sup>154</sup> *See id.*

<sup>155</sup> *See id.* at 52–53.

<sup>156</sup> Posner, *supra* note 110, at 403.

<sup>157</sup> *Cf.* Sherwin, *supra* note 153, at 57–58 (“A good faith review of the effectiveness of existing regulations can loosen up . . . bureaucratic inertia . . .”).

<sup>158</sup> Posner, *supra* note 110, at 389.

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

<sup>161</sup> *Id.* at 555.

<sup>162</sup> Sharfman, *supra* note 92, at 400.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* at 399, 401, 412 (arguing that because shareholders have less access to information than centralized management that increased shareholder control leads to increased transaction costs).

<sup>165</sup> Posner, *supra* note 110, at 389.

<sup>166</sup> Sharfman, *supra* note 92, at 401–02.

loss of freedom.<sup>167</sup> When, however, an injury is small individually, but large in the aggregate, the costs of individual enforcement might be inefficiently high, and direct regulation might be appropriate. Further, when injury to the public is large, but liability to the injurer is limited, direct regulation might be appropriate. Richard Posner illustrates this with a drunk driving example.<sup>168</sup> The judgment-proof drunk driver may believe that the benefits of driving while intoxicated exceed his costs since he cannot be compelled to pay more than he has.<sup>169</sup> The benefit to him, however, almost certainly does not exceed the risk of injury to the general public. Consequently, a preventative regulatory rule is preferable to a liability model.<sup>170</sup> It forces the driver to internalize externalities (the risk of injury in excess of what he can compensate). Also, the reciprocal costs (the costs of forgoing the benefits of each instance of drunk driving where the driver arrives home safely not having injured anyone) of the preventative model do not outweigh the benefits of internalization, in part, because drunk driving is socially opprobrious in addition to being economically risky.<sup>171</sup>

Consequently, most agency rules should compare their preventative approach to the existing liability model in order to avoid arbitrary and capricious review. The rule should either fit one of the traditional paradigms for when direct regulation is preferable to a liability model or should contain a compelling justification for the inefficiencies that the rule will likely create. With regard to efficiency, it is also important to keep in mind that the cost of moving to a new system is a cost of the new system.<sup>172</sup> For example, rights are worth less if continually redefined.<sup>173</sup> What good is it to purchase a right that could simply be abrogated by the government? The value of rights must be discounted to reflect the risk that they will be taken away.<sup>174</sup> When allocating rights among parties, this value-depressing effect often means that keeping a less beneficial status quo is better than moving to a new system if the new system's benefits do not outweigh the costs of the change.<sup>175</sup>

To put this discussion in context, CBA of a rule like the proxy access rule should identify the problem—inadequate shareholder power.<sup>176</sup> Then, the CBA should explain why a preventative solution like a non-negotiable federal mandate is superior to a change to the existing liability model. Assumedly, if directors are not acting in the shareholders' interests,

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<sup>167</sup> Posner, *supra* note 110, at 390.

<sup>168</sup> *Id.* at 390–91.

<sup>169</sup> *Id.* at 389–90.

<sup>170</sup> *Id.* at 390.

<sup>171</sup> Posner, *supra* note 110, at 390–91; Coase, *supra* note 96, at 2.

<sup>172</sup> Posner, *supra* note 110, at 52–53.

<sup>173</sup> *Id.* at 52–53.

<sup>174</sup> *Id.* at 55.

<sup>175</sup> *Id.* at 50–55.

<sup>176</sup> *Cf.* Sharfman, *supra* note 92, at 387–89 (agreeing that shareholder power is an issue, but disagreeing that shareholders need more power).

then shareholders can hold the directors accountable.<sup>177</sup> If shareholders are given the ability to stymie decisive action or controversial ideas with the threat of heated election contests, then the reason for the change should be explored in the CBA.<sup>178</sup> Is there a reason why shareholders cannot be compensated after the fact? Under the current system, corporate managers and directors have a “great deal of authority to pursue business strategies through diverse means.”<sup>179</sup> Managers and directors enjoy considerable flexibility to “make and pursue risky business decisions.”<sup>180</sup> Often, they must make decisions that are unpopular in the short run but utterly prescient in the long run. Why does the new preventative threat model protect shareholders better than the old liability model? The Commission should at least “hazard a guess”<sup>181</sup> at how much the decrease in managerial flexibility will ultimately cost the enterprises.

## 2. *The Limitations of Efficiency Considerations*

Efficiency is a consideration that must be confronted. Efficiency concerns alone, however, are often not enough either to justify a rule or to strike a rule down.<sup>182</sup> For example, if a rule passes the Pareto optimality test, then it means that the rule makes someone better off without making anyone worse off.<sup>183</sup> Because lack of knowledge is a transaction cost, society may always be operating at peak Pareto efficiency since, assumedly, if we knew that we could make someone better off without harming anyone then we would do so.<sup>184</sup> Kaldor-Hicks optimal efficiency occurs when “winners win more than losers lose,” and losers are compensated accordingly so that the winners only accrue the net win.<sup>185</sup>

Kaldor-Hicks optimality has been referred to as “Potential Pareto Superiority” because a rule is Kaldor-Hicks efficient as long as the winners win more than the losers lose.<sup>186</sup> The winners might potentially compensate the losers and take only the net gain, but the winners might also keep the gain because transaction costs impede the efficient operation of the system.<sup>187</sup> In Pareto optimality, no one is injured.<sup>188</sup> In Kaldor-Hicks optimality, no-injury is possible, but may not actually happen due to practical

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<sup>177</sup> Strine, *supra* note 92, at 1765 (2006) (“Unlike corporate managers, neither institutional investors as stockholders nor [Institutional Investor Services] as a voting advisor owe fiduciary duties to the corporations whose policies they seek to influence.”).

<sup>178</sup> Strine, *supra* note 92, at 1775–77.

<sup>179</sup> *Id.* at 1762.

<sup>180</sup> *Id.* at 1763.

<sup>181</sup> *Chamber of Commerce v. SEC*, 412 F.3d 133, 143–44 (D.C. Cir. 2005) (quoting *Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209 (D.C. Cir. 2004)).

<sup>182</sup> *Id.* at 142.

<sup>183</sup> Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 *YALE L.J.* 1211, 1215 (1991).

<sup>184</sup> *Id.*

<sup>185</sup> *Id.* at 1221.

<sup>186</sup> *Id.*

<sup>187</sup> *Id.* at 1222–23.

<sup>188</sup> *Id.* at 1215.

circumstances.<sup>189</sup> For example, if the winners can convince the government to implement the solution and can convince the government that winners need to pay less reimbursement to the losers than is actually needed to fully compensate the losers, then they may do so. Kaldor-Hicks optimality is achieved because society is better off in the aggregate.<sup>190</sup>

As Guido Calabresi points out, however, society being better off in the aggregate in this scenario is not necessarily desirable.<sup>191</sup> When the winners and losers are not A and B, but are real people, then it becomes clear that Kaldor-Hicks optimality that is also Pareto-optimal only maintains the status quo and that status quo maintenance is not necessarily desirable.<sup>192</sup> In other words, Calabresi has made the point that the frontiers of Pareto and Kaldor-Hicks optimality can be advanced by not only economic considerations, but also by “moral, aesthetic, and altruistic” considerations.<sup>193</sup> These advances could come from “lawyer-economists,” but also should spring from physicists, engineers, psychologists, or even poets and the authors of great literature.<sup>194</sup>

In other words, public policies can override considerations of a rule’s effect on efficiency, competition, and capital formation. The caveat is that this must be made clear. Laconic yet voluminous CBA cannot be used to bolster rules whose justification is truly grounded in policy considerations.

#### B. *Wealth Distribution Concerns*

Wealth redistribution concerns are often ignored by economic analysis.<sup>195</sup> They are part of the “moral and aesthetic”<sup>196</sup> choices that Coasean analysis ignores.<sup>197</sup> Nevertheless, when Congress attempts to achieve a wealth distribution goal, some methods of achieving that goal pose less of a threat to efficiency, competition, and capital formation than others.<sup>198</sup> Consequently, consideration of distributional concerns requires an analysis of alternative methods<sup>199</sup> of achieving wealth distribution goals. For example, Congress apparently determined that shareholders have insufficient control over public companies when it

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<sup>189</sup> *Id.* at 1223

<sup>190</sup> *Id.* at 1225.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 1223.

<sup>193</sup> *Id.* at 1235.

<sup>194</sup> *Id.*

<sup>195</sup> Georgakopoulos, *supra* note 148, at 280.

<sup>196</sup> Coase, *supra* note 96, at 43.

<sup>197</sup> *Id.*

<sup>198</sup> Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC’s Stalled Mutual Fund Reform Effort*, 12 STAN. J.L. BUS. & FIN. 1, 30–31 (2006).

<sup>199</sup> The idea that regulatory agencies should consider the costs and benefits of alternative approaches and choose the least costly approach has a rich history. *See id.* at 9. (discussing the history of presidential executive orders mandating cost-benefit analysis and lowest-cost alternative regulatory approach selection).

mandated proxy-access rulemaking.<sup>200</sup> Redistributing control from management to shareholders, however, can occur in many ways.<sup>201</sup> A Coasean solution would likely involve giving shareholders a negotiable right.<sup>202</sup> A lack of alienability kills Coasean trade, which is the foundation of the theorem's position that when rights are clearly defined and transaction costs low, that people will "agree to circumvent disadvantageous assignments of rights and obligations."<sup>203</sup>

## V. JUSTIFICATION FOR THE COURT'S WATCHDOG ROLE

The SEC's failure in *Business Roundtable* was, in some respects, inevitable. The President signed the Dodd-Frank Act on July 21, 2010.<sup>204</sup> The Act required the promulgation of more than one hundred new rules, the creation of five new offices, and the performance of more than twenty studies and reports.<sup>205</sup> It also imposed new responsibilities including oversight of the over-the-counter derivatives market, registration of municipal advisors and security-based swap participants, and new disclosure and risk-retention requirements for asset-backed securities, among other things.<sup>206</sup> The SEC had proposed or adopted rules for three-quarters of the mandatory rulemaking provisions in Dodd-Frank by the close of fiscal year 2011.<sup>207</sup> The agency had also begun to move forward, by this time, on discretionary rulemaking provisions of the bill (like the proxy access rule).<sup>208</sup>

The Dodd-Frank Act authorized budgetary increases to cover this increased workload, but because congressional appropriations fell short of the amount authorized, the agency has largely proceeded with this overwhelming amount of rulemaking "almost entirely with existing staff" much of whose time has been taken away from "other critical responsibilities."<sup>209</sup> In fact, due to the 2005-2007 budget cuts, the additional funding merely brought the SEC's staff back to its 2005 level.<sup>210</sup> The SEC undoubtedly has well-trained

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<sup>200</sup> Daily Comp. Pres. Docs., *Remarks on Signing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 2010 DCPD-201000617, p. 2,

<http://www.gpo.gov/fdsys/browse/collection.action?collectionCode=CPD&browsePath=2010%2F07&isCollapsed=false&leafLevelBrowse=false&isDocumentResults=true&ycord=234>.

<sup>201</sup> *Id.*

<sup>202</sup> Georgakopoulos, *supra* note 148, at 319.

<sup>203</sup> *Id.*

<sup>204</sup> Daily Comp. Pres. Docs., *supra* note 200, at 3.

<sup>205</sup> U.S. SEC. & EXCH. COMM'N, *supra* note 3, at 2.

<sup>206</sup> *Id.*

<sup>207</sup> U.S. SEC. & EXCH. COMM'N, FY 2011 PERFORMANCE & ACCOUNTABILITY REPORT 3 (Nov. 15, 2011), *available at* <http://www.sec.gov/about/secpar/secpar2011.pdf>.

<sup>208</sup> *Id.*

<sup>209</sup> Khuzami, *supra* note 6; *see also* U.S. SEC. & EXCH. COMM'N, *supra* note 3, at 2.

<sup>210</sup> U.S. SEC. & EXCH. COMM'N, *supra* note 3, at 1.

staff and a wealth of rulemaking experience, but the staff is also accustomed to a normal level of rulemaking responsibility.<sup>211</sup>

The courts play a critical role in overseeing this important rulemaking process. The Dodd-Frank Act recognizes the complexity and nuance of the American banking and financial system.<sup>212</sup> It prescribes a broad review of the system through a series of technical studies.<sup>213</sup> It also prescribes a broad regulatory system governed by agency rulemaking.<sup>214</sup> Congress found the flexibility and viscosity of agency rulemaking preferable to more rigid and permanent Congressional mandates.<sup>215</sup> Agencies, however, do not remove the debate from the public forum. They only limit it to the notice and comment process and other rulemaking processes.<sup>216</sup> The law has long provided a minimum threshold of study and reasoning that is necessary to all rulemaking.<sup>217</sup> While it is understandable that some rules will fall through the cracks given the Sisyphean task imposed on the SEC by Congress, the courts should not relax their standards to accommodate a logjam of rules at the valve. The rules proposed will eventually meet the threshold and they cannot all be expected to do so within the first year of the Act's passage. As the idiom goes, "Rome wasn't built in a day."<sup>218</sup>

## VI. INCENTIVE-BASED COMPENSATION RULES AND CLAWBACK PROVISIONS AS ILLUSTRATIONS

This article will now look at incentive-based compensation rules and Dodd-Frank's clawback provisions to illustrate some of the economic concerns that must be addressed in order for the rules to pass judicial review. If the promulgating agency's consideration of "efficiency, competition, and capital formation" includes analysis of the rule's impact on Coasean trade and analysis of the reciprocal effects of the rule, then the rule should be more likely to pass judicial review. These issues will be explored below.

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<sup>211</sup> *Id.* at 2.

<sup>212</sup> *Id.* at 4.

<sup>213</sup> *Id.* at 2.

<sup>214</sup> *Id.*

<sup>215</sup> See 12 U.S.C. § 5512(b) (Supp. 2012).

<sup>216</sup> 5 U.S.C. § 553(c) (2006)

<sup>217</sup> *Id.*

<sup>218</sup> JOHN BARTLETT, FAMILIAR QUOTATIONS 160 (Emily Morison Beck ed., Little, Brown and Co. 15th ed. 1980) (1882).

A. *Incentive-Based Compensation Rules*

Section 956 of the Dodd-Frank Act applies, generally, to banks with over \$1 billion in assets.<sup>219</sup> It does two things. First, it mandates rulemaking that will require disclosure of “the structures of all incentive-based compensation arrangements . . . sufficient to determine whether the compensation structure . . . provides . . . excessive compensation . . . or could lead to material financial loss.”<sup>220</sup> Second, it mandates rulemaking prohibiting “any types of incentive-based payment arrangement . . . that . . . provid[es] . . . excessive compensation . . . or that could lead to material financial loss . . . .”<sup>221</sup> On April 14, 2011, the relevant agencies proposed rules that would define “excessive compensation” as compensation that is “unreasonable or disproportionate to . . . the amount, nature, quality, and scope of services performed by the covered person.”<sup>222</sup> This definition came with a seven-factor test that looks, generally, at: (1) the amount and (2) history of the compensation; (3) the financial condition of the organization; (4) compensation at comparable organizations; (5) the cost/benefit tradeoff of postemployment compensation; (6) connections with fraud, breach of duty, or insider abuse; and (7) any other relevant factors.<sup>223</sup> The key words in these rules seem to be “unreasonable” and “disproportionate.”<sup>224</sup> While the rules set up somewhat of a standard by referencing comparable practices, this amounts to a rule that whatever the industry standard evolves into will become the law.

The proposed rules would ban compensation that “could lead to material financial loss” by prohibiting arrangements that “could lead to material financial loss.”<sup>225</sup> This rule does little more than restate the text of the statute, but it comes with three standards that must be met.<sup>226</sup> The compensation arrangement must (1) balance risk and financial rewards, (2) be compatible with effective controls and risk management, and (3) be supported by strong corporate governance.<sup>227</sup> While the company is assumedly responsible for conducting the balancing test and evaluating the strength of its governance, law enforcement personnel will inevitably investigate these judgment calls. Law enforcement personnel will, of course, have the benefit of hindsight.

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<sup>219</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 956(f), 12 U.S.C. § 5641(f) (Supp. 2012) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>220</sup> *Id.* at § 5641(a).

<sup>221</sup> *Id.* at § 5641(b).

<sup>222</sup> Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21170-01, 21178 (proposed Apr. 14, 2011) (to be codified in scattered sections of 12 & 17 C.F.R.).

<sup>223</sup> *Id.*

<sup>224</sup> *Id.*

<sup>225</sup> *Id.*

<sup>226</sup> *Id.*

<sup>227</sup> *Id.*



If private solutions are inadequate, then some government intervention may be appropriate. In 2005, economist Raghuram Rajan predicted the invidious systemic risk that manifested in 2008.<sup>228</sup> Rajan identified heavily short-term weighted incentives as the problem and made a strong case for the inability of the private sector to correct the problem.<sup>229</sup> Often, the need for investigation of potential government solutions is apparent, but the means to achieve the end are not. An in-depth dissection of the means or wisdom of implementing incentive-based compensation rules, however, is beyond the scope of this article.<sup>230</sup>

Incentive-based compensation rules that amount to an edict to accurately predict the future seem, at first blush, unlikely to be the product of sufficient consideration of efficiency, competition, and capital formation. Investing decisions are always based on imperfect information and a balancing of risk and reward possibilities.<sup>231</sup> Assumedly, the social costs imposed on the public by the TARP bailout made clear the need for the government to force companies to internalize the costs of insufficiently weighing “tail”<sup>232</sup> or long-term risks. As we know from Coase, however, this is the touchstone and not the end of the inquiry.<sup>233</sup> Bankers often must make decisions that “could lead to a material financial loss.” The issue is whether or not and how the federal government can facilitate internalization to the bankers of social costs that may result from the banker’s decisions.

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<sup>228</sup> Raghuram G. Rajan, *Has Financial Development Made the World Riskier?*, in 2005 PROC., FED. RESERVE BANK OF KAN. CITY 313, 346 (2005) (Explaining generally that the new model of banking encourages investment managers to misalign prices and leave themselves exposed to long-term and “tail” risk.).

<sup>229</sup> *Id.* at 348–49 (Private investors may not encourage their fund managers to invest for the long-run because the investor’s themselves have too much interest in the short term and because the herd mentality of investment management coupled with easy job mobility among investment managers dampens their regard for long-term risks.).

<sup>230</sup> For more in-depth discussion of incentive-based and executive compensation in the wake of the financial crisis, see, e.g., Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915 (2010); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247 (2010); Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, in HANDBOOK OF THE ECONOMICS OF FINANCE 106–07 (forthcoming April 17, 2012), available at <http://ssrn.com/abstract=2041679>; Kevin J. Murphy & Michael C. Jensen, *CEO Bonus Plans: And How to Fix Them* (Harvard Business School NOM Unit, Working Paper No. 12-022, USC Marshall School of Business, Working Paper No. FBE 02-11, 2011), available at <http://ssrn.com/abstract=1935654>; Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129 (2003).

<sup>231</sup> Rajan, *supra* note 228, at 316.

<sup>232</sup> *Id.* (A course of action has “tail” risk when it is likely to consistently produce excellent returns, but it carries with it a slight possibility of “severe adverse consequences.” Rajan argues that these “severe adverse consequences” are not properly dealt with by the private sector. He suggests that government prodding could force bankers to consider all risks. This would be necessary, in his mind, because heavily short-term weighted, incentive-based compensation has encouraged bankers to give short shrift to consideration of long-term and “tail” risk.).

<sup>233</sup> See generally Coase, *supra* note 96.

Judicial review requirements are meant to ensure accountability and intellectual rigor in the process of resolving the issue.<sup>234</sup> The accountability standard imposed mandates consideration of whether the rule minimizes transaction costs and whether the benefit of the new system exceeds the cost of the renovations to the status quo, among other considerations.<sup>235</sup> This means state law issues must be resolved and numerous considerations of implementation must be addressed. Ultimately, the court, however, is not going to evaluate whether or not the benefit actually outweighs the cost or whether identifiable moral and aesthetic considerations are sufficient to trump economic concerns. The court will demand, however, that a good faith confrontation of all of these considerations, particularly the negative ones, has been sufficiently performed.<sup>236</sup>

Dodd-Frank mandates that the relevant agencies, including the SEC, enact rules to prohibit “types of incentive-based payment arrangement[s]” that “could lead to material financial loss.”<sup>237</sup> A rule that merely tracks the language of the statute by banning arrangements that “could lead to material financial loss” and provides an amorphous, three-part factor test including (1) balancing risk and financial rewards, (2) compatibility with effective controls and risk management, and (3) strong corporate governance support<sup>238</sup> seems, on its face, unlikely to be the product of sufficient economic consideration. This rule provides a standard that involves primarily qualitative judgment-calls as to whether the rule has been broken.<sup>239</sup>

On one hand, tracking language used by Congress would seem to ensure that a rule stays true to Congressional intent. On the other, if Congress meant to enact exactly what it said, then it could have simply enacted the language rather than deferring to agency rulemaking. Congress’s reason for deferring to the agency was, among other reasons, to subject the proposal to rigorous consideration of efficiency, competition, and capital formation.<sup>240</sup> Assumedly, the considerations are generally likely to change the rule into a tailored solution, rather than a naked restatement of the statute.

### B. *Clawback Rules*

New clawback provisions are another key change to compensation incentives under Dodd-Frank. A clawback provision allows a company to “claw back” compensation that it

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<sup>234</sup> See Jim Rossi, *Waivers, Flexibility, and Reviewability*, 72 CHI.-KENT L. REV. 1359, 1374 (1997).

<sup>235</sup> See, e.g., 15 U.S.C. § 77b(b) (Supp. 2012).

<sup>236</sup> See generally cases cited, *supra* note 2.

<sup>237</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 956(b), 12 U.S.C. § 5641(b) (Current through P.L. 112-54 (excluding P.L. 112-40) approved 11-12-11).

<sup>238</sup> Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21170-01, 21178 (proposed Apr. 14, 2011) (to be codified in scattered sections of 12 & 17 C.F.R.).

<sup>239</sup> *Id.*

<sup>240</sup> *Cf.* cases cited, *supra* note 2.

has already paid out.<sup>241</sup> These new provisions do not modify the Sarbanes-Oxley Act provisions.<sup>242</sup> Instead, they impose a new form of clawback on the system. The Sarbanes-Oxley clawback statute, however, likely affects the meaning of the Dodd-Frank clawback statute.

The Sarbanes-Oxley Act of 2002 mandates that if a company issues financial statements and then later restates those financials because the original financials were produced by misconduct that led to noncompliance with the securities laws in a material way, then the CEO and CFO must return bonuses that they previously received.<sup>243</sup> More specifically, the CEO and CFO must return “any bonus or other incentive-based or equity-based compensation” received during the “12-month period following” the issuance of the noncompliant financials.<sup>244</sup> They must also return to the company “any profits realized from the sale of securities of the issuer during that 12-month period.”<sup>245</sup>

The Sarbanes-Oxley clawbacks had the purpose of preventing “CEOs or other officers” from profiting from “erroneous financial statements.”<sup>246</sup> President Bush recommended that “CEO bonuses and other incentive-based forms of compensation should be disgorged.”<sup>247</sup> According to Senate Report 107-205, the provisions are designed to “prevent CEOs or CFOs from making large profits by selling company stock, or receiving company bonuses, while management is misleading the public and regulators about the poor health of the company.”<sup>248</sup>

Dodd-Frank mandated rulemaking that would establish a new, two-part clawback rule.<sup>249</sup> First, companies must disclose “the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws.”<sup>250</sup> Second, if the company needs to restate its financials, then the policy must provide that “the issuer will recover from any current or former executive officer [incentive-based compensation tied to the financial disclosures that is] received during the 3-year period [preceding the restatement].”<sup>251</sup> So, the issuer must disclose its policy on

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<sup>241</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 15 U.S.C. § 78j-4 (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>242</sup> See The Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243(a) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>243</sup> *Id.*

<sup>244</sup> *Id.*

<sup>245</sup> *Id.*

<sup>246</sup> S. REP. NO. 107-205, at 26 (2002), available at <http://www.gpo.gov/fdsys/pkg/CRPT-107srpt205/pdf/CRPT-107srpt205.pdf>.

<sup>247</sup> *Id.*

<sup>248</sup> *Id.*

<sup>249</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 15 U.S.C. § 78j-4 (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>250</sup> *Id.*

<sup>251</sup> *Id.*

incentive-based compensation that is tied to its public financial disclosures and must have a policy for taking that compensation back if a restatement occurs.<sup>252</sup>

1. *The Clawback Problem*

The Sarbanes-Oxley provisions faced a difficult interpretational problem at the time that Dodd-Frank was passed. This problem is best exemplified in *SEC v. Jenkins*.<sup>253</sup> A contextual interpretation of Section 954 of Dodd-Frank can explain both how the new Dodd-Frank clawback fixes the problem with the Sarbanes-Oxley clawback and why Dodd-Frank contains an entirely new provision rather than a modification of the old one.

In *Jenkins*, the SEC filed complaints alleging that various officers of CSK Auto Corporation engaged in a scheme that violated the securities laws in civil and criminal ways.<sup>254</sup> These complaints alleged that the officers “concealed the scheme” from the CEO, Maynard L. Jenkins.<sup>255</sup> Consequently, the SEC could not argue that Jenkins intentionally or recklessly participated in the scheme but did seek to claw back compensation received by Jenkins.<sup>256</sup> Jenkins pursued two interesting arguments. First, he contended that the clawback resulted in an unconstitutional forfeiture of property.<sup>257</sup> Though the court said, “even if these constitutional concerns have merit, the facts necessary to decide these constitutional issues cannot be decided on a motion to dismiss,” the court did provide some conjecture on the constitutional issues.<sup>258</sup> The court held that, under the law as written, the officers would have to “reimburse additional compensation received during periods of corporate non-compliance regardless of whether or not they were aware of the misconduct giving rise to the misstated financials.”<sup>259</sup> The court went on to speculate that the statute may “have aspects that could be described as either remedial or punitive, or both” and that the statute could be constitutionally valid either facially or as applied even if the recovery sought was deemed punitive.<sup>260</sup>

Second, Jenkins argued that the clawback statute produced an absurd result because under Delaware corporate law, the company would be obligated to reimburse Jenkins for both the SEC judgment and his attorney’s fees incurred in fighting the SEC as long as he had acted in “good faith” and in a manner that he “reasonably believed to be in or not opposed to the best interests of the corporation.”<sup>261</sup> According to Delaware’s state website, “More than 50% of all publicly-traded companies in the United States including 63% of the

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<sup>252</sup> *Id.*

<sup>253</sup> 718 F. Supp. 2d 1070 (D. Ariz. 2010).

<sup>254</sup> *Id.* at 1073.

<sup>255</sup> *Id.*

<sup>256</sup> *Id.*

<sup>257</sup> *Id.* at 1076.

<sup>258</sup> *Id.* at 1077.

<sup>259</sup> *Id.*

<sup>260</sup> *Id.*

<sup>261</sup> *Id.* at 1078–79 (quoting 8 DEL. CODE ANN. tit. 8, § 145(a) (2012)).

Fortune 500 have chosen Delaware as their legal home.”<sup>262</sup> Delaware law imposes mandatory indemnification if a corporate officer succeeds “on the merits or otherwise in defense of any action.”<sup>263</sup> This indemnification covers “expenses (including attorneys’ fees) actually and reasonably incurred.”<sup>264</sup> Delaware law allows corporations to expand beyond the mandatory indemnification provisions voluntarily by giving them “power to indemnify” corporate officers “against expenses (including attorney’s fees), judgments, fines and amounts paid in settlement actually and reasonably incurred” if the officer “acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation.”<sup>265</sup> Additionally, “[v]irtually every public corporation” provides “assurances to its officers and directors that they will have the absolute right to claim indemnification from the corporation when entitled to it.”<sup>266</sup> Also, “[t]his assurance is most often provided by a bylaw which obligates the corporation to indemnify to the fullest extent permitted by law.”<sup>267</sup>

Because the court properly read the Sarbanes-Oxley clawback as applying “regardless of whether or not [the executive was] aware of the misconduct giving rise to the misstated financials,” and because Jenkins had a right to indemnification (via Delaware Code Section 145(a) and the corporate bylaws) under state law, an absurd result could occur. Specifically, the SEC could win and deprive him of his compensation under federal law and return the compensation to the company.<sup>268</sup> Then, Jenkins could sue the company under state law to have the compensation returned back to him because he acted in good faith.<sup>269</sup>

The constitutional issue and the state law conflict remain unresolved. Eventually, the SEC settled with Jenkins for a fraction of the amount demanded.<sup>270</sup> The final judgment order forbids Jenkins from seeking indemnification from his company.<sup>271</sup>

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<sup>262</sup> *About Agency: Division of Corporations*, DELAWARE.GOV, <http://corp.delaware.gov/aboutagency.shtml> (last visited Mar. 18, 2013).

<sup>263</sup> DEL. CODE ANN. tit. 8, § 145(c).

<sup>264</sup> *Id.*

<sup>265</sup> *Id.* at § 145(a).

<sup>266</sup> 1 DAVID A. DREXLER ET AL., DEL. CORP. LAW & PRACTICE § 16.01 (2011).

<sup>267</sup> *Id.*

<sup>268</sup> *See generally Jenkins*, 718 F. Supp. 2d at 1077.

<sup>269</sup> DEL. CODE ANN. tit. 8, § 145(c).

<sup>270</sup> Press Release, U.S. Sec. & Exch. Comm’n, Former CEO to Return \$2.8 Million in Bonuses and Stock Profits Received During CSK Auto Accounting Fraud, Press Release (Nov. 15, 2011), *available at*

<http://www.sec.gov/news/press/2011/2011-243.htm>; U.S. Sec. & Exch. Comm’n, SEC Seeks Return of \$4 Million in Bonuses and Stock Sale Profits from Former CEO of CSK Auto Corp., Litigation Release No. 21149A (July 30, 2009), *available at* <http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm>.

<sup>271</sup> Final Judgment as to Defendant Maynard L. Jenkins, Case No. CV-09-01510-PHX-RJB, at 2–3 (D. Ariz., Nov. 16, 2011), *available at* <http://www.wlrk.com/docs/SECVJenkins09-cv-1510-136.pdf>.

## 2. *The Clawback Solution*

On their face, the Dodd-Frank clawback provisions may appear to require rulemaking that forces companies to adopt a policy of clawing back all previously-paid compensation that the company can lawfully claw back regardless of the circumstances.<sup>272</sup> In light of the current state of clawback rules, however, it seems more likely that the rulemaking only requires a policy that does not conflict with existing policies that are allowed under state corporate law.<sup>273</sup>

The conflict created between federal and state law may, at first glance, appear dangerously likely to eviscerate the purpose of the federal clawback provisions.<sup>274</sup> According to Senate Report 111-176, the Dodd-Frank clawbacks were intended to “clarify that all issuers must have a policy in place to recover compensation based on inaccurate accounting so that shareholders do not have to embark on costly legal expenses to recoup their losses . . . .”<sup>275</sup> In some circumstances, shareholders will save money due to such a policy. In others, they will not. For example, if a corporation sues under its recoupment policy for a modest amount, the legal fees advanced to the corporate officer to fight the corporation could consume all of the benefit of the original lawsuit. Similarly, if the SEC attempts to sue for recoupment on the corporation’s behalf, the attorney’s fees spent by the corporation on the officer’s behalf could negate the value of the lawsuit to the corporation and the shareholders. This is especially true given that under Delaware law, anytime the SEC or the corporation loses a lawsuit, the corporation will be required to pay the legal fees of its officer.<sup>276</sup>

The proper interpretation of the Dodd-Frank clawbacks would be to interpret them, not as trumping state law and establishing a non-negotiable federal mandate, but rather as a fix for the problems with the Sarbanes-Oxley clawback rules. More specifically, the Sarbanes-Oxley provisions had two problems.

First, the lack of a culpability or misconduct requirement makes the rule constitutionally questionable.<sup>277</sup> The *Jenkins* court recognized this and cited three cases where penalties that resulted in “severe and unjustified deprivation” were found unconstitutional.<sup>278</sup> At least one court has ruled that the Sarbanes-Oxley clawbacks can be properly construed as a penalty.<sup>279</sup>

Second, the state law conflicts are likely to undercut the purpose of saving shareholders money unless the rules promulgated under the Dodd-Frank clawback

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<sup>272</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 15 U.S.C. § 78j-4 (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

<sup>273</sup> See, e.g., *Jenkins v. Sec.*, 718 F. Supp. 2d 1070, 1079 (D. Ariz. 2010).

<sup>274</sup> See *id.* at 1078–79; DEL. CODE ANN. tit. 8, § 145(a) (2010).

<sup>275</sup> S. REP. NO. 111-176, at 136 (2010), available at <http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf>.

<sup>276</sup> DEL. CODE ANN. tit. 8, § 145(c).

<sup>277</sup> *Id.* at 1076.

<sup>278</sup> *Id.*

<sup>279</sup> *SEC v. Microtune, Inc.*, 783 F. Supp. 2d 867, 886–87 (N.D. Tex. 2011).

provisions are narrowly drawn and interpreted in a way that does not create an expansive and mandatory federal rule that conflicts with state law.<sup>280</sup> The mandatory provisions of Delaware law, particularly, create an imbalanced situation.<sup>281</sup> If the Dodd-Frank clawback may apply, but the executive thinks that he can win a suit, then the economics of the situation would be as follows: if the executive wins, then he pays neither judgment nor attorney's fees; if he loses, then he pays both attorney's fees and the judgment. Because the company will pay the fees as the suit progresses,<sup>282</sup> the executive can protract litigation for an imprudently long time with no out-of-pocket cost to himself in hopes of full exoneration.

The permissive state law indemnification provisions come into seemingly direct conflict with the Sarbanes-Oxley clawbacks.<sup>283</sup> Rulemaking promulgated under the Dodd-Frank clawback provisions could take the position that federal law is supreme over state law, and, consequently, states simply have the burden of dealing with the aftermath of a federal fix. As discussed earlier, we know that the federal fix will likely work the way prescription medications work because of the reciprocal nature of the problem.<sup>284</sup> That is, they solve the problem at hand but create a bevy of side effects that could be more undesirable than remedying the original problem. Proper construction and interpretation of Dodd-Frank clawback rules should not burden private negotiation, should minimize transaction costs, and should properly account for state law issues.

Both of the problems discussed could be solved by reading the Dodd-Frank clawback as providing the sole avenue for recoupment when no misconduct occurred on the part of the corporate officer being sued and by reading the imposition of a recoupment policy as being limited to recoupment allowed under state law. Because the Dodd-Frank clawback is limited to clawbacks of erroneously-paid compensation that is tied to financial disclosures, recouping that money even without a finding of misconduct is fair, in large part, because the amount originally paid was incorrect *ab initio*.<sup>285</sup> The Sarbanes-Oxley clawback rules should, consequently, be read in conjunction with the Dodd-Frank rules to provide the Dodd-Frank method as the sole method for recoupment without a finding of misconduct. The rules promulgated under the Dodd-Frank clawback should be drawn and interpreted in a way that recognizes and works with state law. Due to the reciprocal effects of upending the status quo, the amount of required economic analysis increases dramatically when proposed rules would undermine traditional, well-established state corporate governance law.

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<sup>280</sup> See DEL. CODE ANN. tit. 8, § 145(a), (c); *Jenkins*, 718 F. Supp. 2d at 1078–79.

<sup>281</sup> DEL. CODE ANN. tit. 8, § 145(a), (c).

<sup>282</sup> *Id.*

<sup>283</sup> The Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243(a) (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12); DEL. CODE ANN. tit. 8, § 145(c).

<sup>284</sup> Coase, *supra* note 96, at 2–16.

<sup>285</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 15 U.S.C. § 78j-4 (Current through P.L. 112-89 (excluding P.L. 112-55, 112-74, 112-78, and 112-81) approved 1-3-12).

## VII. CONCLUSION

This article is not an attempt to reinvent the wheel. It merely attempts to summarize economic considerations that must be confronted with each new Dodd-Frank rule. According to Professor Epstein, the law and economics movement progressed steadily for thirty years but hit a point of diminishing returns at the end of the 1980s.<sup>286</sup> Since then, the basic precepts have become refined over the course of a couple of decades. This article attempts to provide a checklist for new Dodd-Frank rules that is roughly based on what are now well-established legal principals. By following these guidelines and suggestions, policy makers should be able to increase the likelihood of a rule surviving judicial review, particularly when the review involves verifying that good faith consideration of the rule's effect on efficiency, competition, and capital formation has been performed or that the rule's costs have been subject to a good faith confrontation.

In interpreting the Administrative Procedure Act's requirements for new rules as more than mere platitudes, the D.C. Circuit has maintained accountability.<sup>287</sup> Accountability maintenance has always been one of the hallmarks of the judiciary.<sup>288</sup> This approach is not myopic. It accounts for the reality and the holistic nature of the financial regulatory system. "There is always a well-known solution to every human problem—neat, plausible, and wrong."<sup>289</sup> Luckily, we can fully trust our system of checks and balances to produce not a perfect solution, but a solution that is unrelentingly assiduous, circumspect, and thorough.

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<sup>286</sup> Epstein, *supra* note 7, at 1173.

<sup>287</sup> *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

<sup>288</sup> *See, e.g., id.*

<sup>289</sup> H. L. MENCKEN, PREJUDICES: SECOND SERIES 158 (1920).