THE PERFECT STORM: HOW MORTGAGE-BACKED SECURITIES, FEDERAL DEREGULATION, AND CORPORATE GREED PROVIDE A WAKE-UP CALL FOR REFORMING EXECUTIVE COMPENSATION

Janice Kay McClendon*

I. INTRODUCTION

The underpinnings of the global financial crisis can be traced back to the development of primary and secondary residential housing mortgage markets and the securitization of these mortgages into investment-grade mortgage-backed securities ("MBS" or "MBSs"). For decades, U.S. government-sponsored enterprises ("GSE" or "GSEs"), and more recently, the private financial industry, created, held and sold trillions of dollars in MBSs.[1] With homeownership rates and property values at record levels,[2] AAA-rated MBSs became highly sought-after investments by individuals, pension funds, hedge funds, investment banks, insurers, and government entities around the world.[3] MBSs retained their investment grade rating

* Janice Kay McClendon, Professor of Law, Stetson University College of Law. B.A., 1987, University of Texas; J.D., 1996, University of Utah College of Law; LL.M., 1997, New York University School of Law. This article is dedicated to my mother, Corrine Elizabeth Bochard-Maschler, who made all things possible. She will be missed every day for the rest of my life. I thank Professor Darryl Wilson for his comments and suggestions on earlier drafts. I also thank my research assistant Tristan Overcashier for his assistance. This article was supported by a generous research grant from Stetson University College of Law.

1. *Infra* notes 65-106 and accompanying text.

2. Jo Carrillo, *Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages*, 5.1 BERKELEY BUS. L. J. 1, 4 (2008) (citing a 2007 report from the Bureau of the Census); Rachel D. Godsil & David V. Simunovich, *Protecting Status: The Mortgage Crisis, Eminent Domain, and the Ethic of Homeownership,* 77 FORDHAM L. REV. 949, 956-57 (2008) ("In 2006, 68% of all American households owned their homes.").

3. *See* David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1009 (2006) ("GSEs, as the dominant purchasers of residential mortgages, have effectively standardized prime residential mortgages by promulgating buying guidelines. Such standardization has led to increases in the liquidity and attractiveness of mortgages as investments to a broad array of investors.").

even though, in recent years, the underlying mortgages were made to increasingly less credit-worthy homeowners.

As predominantly subprime borrowers defaulted on their mortgage obligations, housing sales and values plummeted. In January 2008, the National Association of Realtors announced that 2007 evidenced the largest drop in existing home sales in twenty-five years.[4] By the end of 2008, home prices had fallen by about twenty percent,[5] the biggest decline in seven decades.[6] Furthermore, with economists predicting a continuing decline in home values into 2010, there appeared to be no end in sight.[7] With negative equity positions, prime and subprime homeowners across the country defaulted on their mortgage payment obligations. In 2008, over three million residential home mortgage foreclosure proceedings were filed, and over two million Americans lost their homes.[8]

With millions of foreclosures looming,[9] the housing boom that supported securitization went bust. MBSs became toxic assets. At first, the devaluation effects were limited to the direct players in the mortgage crisis.[10] Then, as financial industry players went under or faced record illiquidity levels,[11] credit lines to businesses and consumers shut down, and all of corporate America felt the economic pinch.[12] Some companies, such

4. *See* William Douglas, *Home Foreclosures in 2008 – How Bad Was it Really?*, EzineArticles.com, Jan. 18, 2009, http://ezinearticles.com/?Home-Foreclosures-in-2008---How-Bad-Was-it-Really?&id=1893262 ("Home foreclosures rose 81 percent over the number of foreclosures in 2007 . . . . One of the keys to remember about the drop in value that many of these areas are seeing due to the number of foreclosures is that prices are down by 20 percent.").

5. *Id.*

6. Bob Willis, *U.S. Existing Home Sales Rise on Record Price Slump*, Bloomberg.com, Jan. 26, 2009, http://www.bloomberg.com/apps/news?pid=20670001&refer=home&sid=a9w6qyDggjL0.

7. *See* David Wyss & Beth Ann Bovino, *A Deep and Long Recession*, Business Week, Jan. 23, 2009, *available at* http://www.businessweek.com/investor/content/jan2009/pi20090123_496930.htm (estimating a 43% drop in average home prices by early 2010).

8. Alan Zibel, *Meltdown 101: How a Mortgage Aid Plan Might Work*, S.F. Gate, Feb. 13, 2009, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2009/02/13/national/a140801S55.DTL.

9. Tom Eley, *US Home Foreclosures Mount as Recession Deepens*, World Socialist Web Site, Jan. 17, 2009, http://www.wsws.org/articles/2009/jan2009/econ-j17.shtml.

10. *See* Ryan Barnes, *The Fuel that Fed the Subprime Market Meltdown*, Investopedia.com, May 31, 2009, http://www.investopedia.com/articles/07/subprime-overview.asp (discussing the initial effects of the subprime mortgage crisis).

11. Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. Banking Inst. 5, 61-71 (2009); Ronald D. Utt, *The Subprime Mortgage Market Collapse: A Primer on the Causes and Possible Solutions*, The Heritage Foundation, Apr. 22, 2008, http://www.heritage.org/research/economy/bg2127.cfm.

12. Lisa Scherzer, *Credit Card Companies Shut Down Consumers' Lines*, SmartMoney.com, May 8, 2008, http://www.smartmoney.com/spending/deals/credit-card-companies-shut-down-consumers-lines-23036/.

as Home Depot, attempted to shore up their operations by implementing massive layoffs, wage freezes, or reductions in remaining employees' salaries.[13] Other companies, like Circuit City, shut their doors in what seemed to be a matter of days.[14] Companies like General Motors faced inevitable bankruptcy reorganization.[15] International conglomerates lost thirty-three percent of their value in a matter of months.[16]

Americans faced the worst recession since the Great Depression.[17] More than 2.6 million Americans lost jobs in 2008, and the unemployment rate was headed for double digits in 2009.[18] Americans who had not felt the direct blow of a layoff or cutback were affected in other ways, including trillions of dollars in U.S. stock market losses,[19] skyrocketing credit card rates,[20] the reduction of employer-provided retirement and welfare benefit plans,[21] or newfound reduced or negative equity positions in

13. Willis, *supra* note 6.

14. Andrea Chang & Martin Zimmerman, *Circuit City to Close 567 Remaining U.S. Stores*, L.A. TIMES, Jan. 17, 2009, *available at* 2009 WLNR 928804.

15. Richard A. Posner, *A Failure of Capitalism*, THE ATLANTIC, May 20, 2009, *available at* http://correspondents.theatlantic.com/richard_posner/2009/05/a_failure_of_capitalism_v--doing_too_much_at_once.php; *see also* Neil King Jr. & Sharon Terlep, *GM Collapses into Government's Arms*, WALL ST. J., June 2, 2009, at A1 ("[GM] became the second-largest industrial bankruptcy in history [on June 1, 2009] . . . .").

16. Mark Pittman & Bob Ivry, *U.S. Taxpayers Risk $9.7 Trillion on Bailout Programs*, BLOOMBERG.COM, Feb. 9, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aNDaPlDwNZak ("The worst financial crisis in two generations has erased $14.5 trillion, or 33 percent, of the value of the world's companies since Sept. 15 . . . .").

17. Sen. Bernie Sanders, *Gambling on Wall Street*, POLITICO, July 21, 2009, http://www.politico.com/news/stories/0709/25169.html ("We are in the midst of the worst economic crisis since the Great Depression."); Pittman & Ivry, *supra* note 16.

18. Willis, *supra* note 6; Julianna Goldman, *Obama Aides Fault Bank Opposition to New Regulations*, BLOOMBERG.COM, Oct. 19, 2009, http://www.bloomberg.com/apps/news?pid=20670001&sid=aowzfXjzjOtM ("[T]he unemployment rate rose to 9.8 percent [in September 2009] . . . .").

19. *See* Heather Landy, *The Stock Slump of 2008: Wrecking Ball to Wealth*, WASH. POST, Jan. 11, 2009, at F5 (reporting $7 trillion in U.S. stock market losses in 2008); Manny Mogato, *Global Financial Market Losses $50 Trillion: ADB Study*, Mar. 9, 2009, *available at* http://www.reuters.com/article/GCA-Economy/idUSTRE5281FN20090309 ("The global financial crisis slashed the value of financial assets worldwide by $50 trillion last year . . . .").

20. *See* Drew Griffin & Kathleen Johnston, *Credit Card Holders Livid About 'Rate Jacking,'* CNN, Dec. 18, 2008, http://www.cnn.com/2008/US/12/17/credit.card.rates/ (reporting that thousands of credit card customers are seeing increasing credit card rates).

21. Emily Brandon, *31 Companies That Have Cut or Changed Their 401(k) Match*, U.S. NEWS & WORLD REPORT, Jan. 12, 2009, http://www.usnews.com/blogs/planning-to-retire/2009/1/12/31-companies-that-have-cut-or-changed-their-401k-match.html; *see also* Pension Rights Ctr., Pension Publ'ns, *Companies that Have Changed Their Defined Benefit Pension Plans*, http://www.pensionrights.org/pubs/facts/company_list.html (last visited Oct. 5, 2009) (showing that twenty publicly-traded companies, including Motorola and Boeing,

their personal homes.[22] All of this was happening at a time when seventy-eight million American baby boomers were nearing retirement age.[23]

Much of the blame for the MBS-generated global financial crisis and the ensuing recession was placed on financial industry executives who took millions of dollars in bonuses for short-term corporate gains.[24] In 2007, two of the top-ten highest paid CEOs work in the financial industry: John Thain, Merrill Lynch CEO, received $83 million; and Lloyd Blankfein, Goldman Sachs CEO, received $54 million.[25] In 2008, there was more of the same, with Lloyd Blankfein receiving $42.9 million and James Dimon, JPMorgan Chase CEO, receiving $35.7 million.[26] Other senior executives also profited handsomely. In 2008, New York City Wall Street investment bank employees made approximately $18.5 billion in bonuses—the sixth largest bonus pool on record.[27] According to pay expert Graef Crystal, author of *The Crystal Report on Executive Compensation*, "top executives at Wall Street investment banks Goldman Sachs, Merrill Lynch, Morgan Stanley, Bear Stearns and Lehman received a combined $613 million, or an average of $123 million at each firm."[28] These multi-million dollar bonuses were primarily related to past MBS originations or sales that produced short-term corporate gains and were paid under existing contractual agreements, even though these financial institutions were

announced significant reductions in their traditional pension plans in 2008).

22. *See* Les Christie, *20% of Homeowners 'Underwater'*, CNNMONEY.COM, May 6, 2009, http://money.cnn.com/2009/05/05/real_estate/underwater_homeowners/ (explaining that "21.8% of all U.S. homes, representing more than 20 million residences, were in a 'negative equity' or 'underwater' position," meaning they "owe more on their mortgage debt than they can sell their homes for.").

23. *See* Boomers International, *About Boomers*, http://www.boomersint.org/bindex.html ("In the US, between the end of World War II and 1964, 78 million baby boomers were born and now are part of the 'Boomers' generation.") (last visited Oct. 5, 2009).

24. Eric Petroff, *Who is to Blame for the Subprime Crisis?*, INVESTOPEDIA.COM, http://www.investopedia.com/articles/07/subprime-blame.asp (last visited Oct. 8, 2009); Maria Bartiromo, *Nell Minow on Outrageous CEO Pay – and Who's to Blame*, BUSINESS WEEK, Mar. 2, 2009, at 15, *available at* http://www.businessweek.com/print/magazine/content/09_09/b4121015457000.htm.

25. Claudia H. Deutsch, *A Brighter Spotlight, Yet the Pay Rises*, N.Y. TIMES, Apr. 6, 2008, at B1; Frank Bass & Rita Beamish, *Bailed-Out Executives Got $1.6 Billion in 2007*, HUFFINGTON POST, Dec. 22, 2008, http://www.huffingtonpost.com/2008/12/22/bailedout-executives-got-_n_152773.html; *The Highest Paid CEOs of 2007: AP*, HUFFINGTON POST, Aug. 21, 2008, http://www.huffingtonpost.com/2008/08/21/the-highest-paid-ceos-of_n_120500.html; *Executive Compensation 2007*, USA TODAY, http://www.usatoday.com/money/graphics/ceo-comp/flash.htm (last visited Nov. 1, 2009).

26. Kaja Whitehouse, *Top NY Execs Made $1.2B*, N.Y. POST, June 22, 2009, at 26.

27. *Many HR Pros Want Obama's Limits on Exec Pay to Go Further*, HR.BLR.COM, Feb. 24, 2009, http://hr.blr.com/news.aspx?id=79620.

28. Del Jones & Edward Iwata, *Top Executives' Pay Takes a Hit; Bailout Plan Seeks to Rein in Compensation, Exit Packages*, USA TODAY, Oct. 2, 2008, at Money 4B.

reporting then-current multi-billion dollar quarterly and annual losses.[29]

Reacting to the catastrophic collapse of the financial industry and the deepening recession, the U.S. federal government enacted two major pieces of legislation. In October 2008, President Bush signed into law the Emergency Economic Stabilization Act ("EESA").[30] This legislation empowered the U.S. Department of Treasury ("Treasury") to use up to $700 billion in taxpayer dollars to bailout the financial industry.[31] This would raise the government's commitment to solving the financial crisis to $9.7 trillion, more than enough money to pay off ninety percent of all home mortgages.[32] The Treasury's overall program was titled the Troubled Asset Relief Program ("TARP").[33] The first $350 billion of TARP funds was released to the Bush administration in October 2008, and the remaining $350 billion was released to the Obama administration in January 2009.[34] In February 2009, President Obama signed into law the American Recovery and Reinvestment Act ("ARRA").[35] ARRA was primarily an economic stimulus act, committing $819 billion in government spending and tax measures. It also contained, however, further legal requirements and restrictions for financial institutions receiving TARP bailout funds.[36]

To address perceived abuses by financial industry executives, both EESA and ARRA contain temporary executive compensation and corporate governance restrictions for certain TARP recipients, which are generally financial institutions that receive TARP bailout funds in excess of designated thresholds.[37] For example, EESA restrictions limit annual

29. *See* Josh Fineman & Bradley Keoun, *Merrill Lynch Posts Fourth Straight Quarterly Loss*, BLOOMBERG.COM, July 17, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=atGti_UmcPnM&refer=home (detailing Merrill Lynch's worse-than-expected $4.65 billion second-quarter net loss in 2008).

30. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765-3933 (2008) (codified in scattered sections of the U.S.C.) [hereinafter EESA].

31. *Id.* at div. A, tit. I, § 115(a), 122 Stat. 3780 (stating that the Secretary of Treasury was authorized to spend up to $250 billion as of the date EESA was enacted. That amount may be increased to $350 billion if the President submits written certification to Congress that such authority is needed by the Secretary of Treasury. Thereafter, funds can be increased further to a total of $700 billion if the President submits a written report to Congress detailing the Secretary of Treasury's plan to use the additional amount, unless Congress enacts a joint resolution disapproving the expansion within 15 days of receiving the President's report).

32. Pittman & Ivry, *supra* note 16, at 1.

33. Politico Staff, *Paulson's Rescue Plan is Called 'TARP,'* POLITICO.COM, Sept. 19, 2008, http://www.politico.com/news/stories/0908/13609.html (last visited Oct. 8, 2009).

34. Deborah Solomon & Greg Hitt, *TARP Funds' Second Half Set for Release as Senate Signs Off on Request*, WALL ST. J., Jan. 16, 2009, at A3.

35. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (codified in scattered sections of U.S.C.) [hereinafter ARRA].

36. *Id.* at § 2, div. B, tit. VII, Limits on Executive Compensation, §§ 7001, 7002.

37. *See* EESA, div. A, tit. I, § 116, 122 Stat. 3783-3786 (2009) (concerning the ongoing

compensation to CEOs and other senior executive officers ("SEOs"),[38] limit excess parachute payments to departing SEOs,[39] "clawback" bonuses and other incentive-based compensation paid to SEOs where such payments are based on materially inaccurate financial statements,[40] and impose corporate governance standards that affect the functioning of bailout recipients' boards and the way they conduct risk-management assessments of executive compensation decisions.[41]

This article provides an overview of what led to the financial crisis, identifying federal deregulation of the financial industry, increasingly risky federal homeownership policies, and corporate America's love affair with short-term incentive-based compensation as the major culprits. While it examines all of these factors, the article focuses on the federal government's emphasis on controlling executive compensation as the talisman for curing the financial crisis. To that end, it examines EESA and ARRA programs and the Obama administration's comprehensive regulatory and legislative reform initiatives as they relate to executive compensation and corporate governance restrictions. It concludes that the Obama administration's regulation and oversight of the financial industry and its executive compensation structure will help the financial industry focus on its long-term profitability. But, to avoid future catastrophes in the financial industry or other critical industries, federal regulation of corporate America, and additional executive compensation and corporate governance reforms are necessary to mandate long-term corporate productivity and fully discourage excessive risk-taking for all publicly traded corporations.

Part Two of this article provides an overview of how the government's historical support for homeownership in the primary and secondary financial markets paved the way for securitization of MBSs.[42] It addresses how the federal government's promotion of MBSs and its deregulation of the financial industry led to the securitization of a large portion of the subprime mortgage market.[43] It also describes how Wall Street and Main

---

oversight of the activities and performance of the TARP and agents of the TARP).

38. *See id.* at div. A, tit. III, § 302(a), 122 Stat. 3803-05 (placing limits on executive compensation).

39. *See id.* at div. A, tit. I, § 111(b)(2)(C), 122 Stat. 3777 (prohibiting golden parachute payments).

40. *See id.* at div. A, tit. I, § 111(b)(2)(B), 122 Stat. 3777 (allowing recovery of incentive-based compensation).

41. *See id.* at div. A, tit. I, § 111, 122 Stat. 3776-77 (dealing generally with executive compensation and corporate governance).

42. *See* Mark Landler & Sheryl Gay Stolberg, *As Fingers Point in the Financial Crisis, Many of Them are Aimed at Bush*, N.Y. Times, Sept. 20, 2008, at A15 (quoting Kenneth Rogoff, a professor of economics at Harvard University, who explained that the government's desire to make housing affordable to more Americans led to a freeing up of the lending markets); *infra* notes 64-106 and accompanying text.

43. *See* Jerry Kammer, *Now, As in S&L '80s, Deregulation Blamed*, Ariz. Republic,

Street executives played a part in the crisis, seeing a regulatory void in creating, marketing, and selling MBSs and exploiting this void to generate millions in short-term incentive-based compensation.

Part Three provides an overview of the multi-billion dollar federal bailouts as they relate to funds distributed to financial institutions.[44] It also looks at related Treasury programs established under EESA and ARRA through June 2009. Federal regulations established under EESA and ARRA provide the framework for temporary executive compensation and corporate governance restrictions on TARP recipients and for permanent regulatory and legislative restrictions on the financial industry, and, in some areas, all publicly-traded corporations. Therefore, a review of the programs is necessary to the understanding of various adopted and proposed restrictions on the financial industry.

Part Four examines EESA and ARRA's temporary restrictions on executive compensation and corporate governance.[45] It also looks at the Obama administration's June 2009 permanent regulatory and legislative initiatives as they relate to executive compensation and corporate governance standards. It then examines how EESA and ARRA's temporary restrictions were not designed to prospectively change individual or "corporate culture," and looks at the Obama administration's proposed permanent "federalization" of executive compensation corporate governance standards, with criticism primarily based on the administration's overreliance on TARP's temporary restrictions for the development of a permanent regulatory regime and its failure to go far enough to essentially eradicate short-term compensation incentives among executives and other highly-compensated employees.

Part Five concludes that the financial crisis and the public outcry over excessive executive compensation and a lack of meaningful corporate governance standards have paved the way for compensation and corporate governance reforms that go beyond the Obama administration's proposals or congressional action to date.[46] It recommends additional reforms through federal regulation, Internal Revenue Code ("Code") amendment, and the development of new listing standards by Self-Regulatory Organizations ("SROs"), such as the New York Stock Exchange, Inc. ("NYSE") and the National Association of Securities Dealers Automated

Oct. 9, 2008, at 1 (describing how Congress played an enabling role in the financial crisis by repealing the Glass-Steagall Act, allowing banks to invest heavily in mortgage-backed securities).

44. *Infra* notes 113-173 and accompanying text.

45. *Infra* notes 175-248 and accompanying text; *see also* Lucian Bebchuk, *Congress Gets Punitive on Executive Pay*, WALL ST. J., Feb. 17, 2009, at A15 (discussing limits on executive compensation related to TARP).

46. David Pitofsky & Matthew T. Tulchin, *Limiting, Clawing Back Executive Pay In The Wake of Financial Bailout*, 241 N.Y. L.J. 4 (2009).

Quotations, Inc. ("NASDAQ"). In concert with the federal government's regulation of the financial industry, these additional reforms will promote long-term corporate productivity and market sustainability.[47]

II. Promoting Homeownership At All Costs: The Fallout of Government-Sponsored Securitization Adopted by an Unregulated Financial Industry

Beginning in the spring 2008, news outlets bombarded Americans with stories recounting the collapse of another financial industry conglomerate, mortgage foreclosures, rising unemployment rates, and trillions in stock market losses.[48] Most of these stories placed the blame squarely at the feet of unscrupulous industry executives who took millions in incentive-based compensation before and after releasing record losses to the public.[49] Financial industry executives and their short-term compensation packages were the easiest targets for blame. For example, as the captains of their ships, executives were responsible for authorizing heavy trading and investing in increasingly riskier MBSs.

Further, financial industry executives walked away with millions of dollars in bonuses as their institutions reported record losses. Despite a growing number of financial industry bankruptcies, failures, and increasing MBS losses, GSE executives, financial industry CEOs, and other highly-compensated and rank-and-file employees continued to profit from past loan origination and securitization. In 2007, Fannie Mae President and CEO Daniel Mudd received $12.2 million in total compensation, and Freddie Mac paid Chairman and CEO Richard Syron nearly $19.8 million in compensation.[50] Financial industry executives like John Thain, Merrill Lynch CEO; Lloyd Blankfein, Goldman Sachs CEO; Kenneth Chenault, American Express CEO; and John Mack, Morgan Stanley CEO, were among the top 10 highest paid CEOs surveyed in 2008.[51] Other highly-compensated financial industry employees acquired over $18.5 billion in bonuses in 2008.[52] Mid-level and lower-level senior management at investment banks and insurance companies also received handsome rewards for promoting MBSs that generated short-term profits.[53] Rank-

47. Petroff, *supra* note 24.

48. Douglas, *supra* note 4; Willis, *supra* note 6; Wyss & Bovino, *supra* note 7; Eley, *supra* note 9; Scherzer, *supra* note 12.

49. Petroff, *supra* note 24; Bartiromo, *supra*, note 24.

50. Julie Hirschfeld Davis, *Congress Floats Fannie, Freddie Salary Caps*, ABC News, July 22, 2008, http://abcnews .go.com/Business/Story?id=5423870&page=1.

51. Deutsch, *supra* note 25.

52. *Many HR Pros Want Obama's Limits on Executive Pay to Go Further*, *supra* note 27.

53. *Many HR Pros Want Obama's Limits on Executive Pay to Go Further*, *supra* note

and-file commercial bank and mortgage company loan officers received bonuses for the quantity of loans, not the quality.[54] To maximize volume, loan officers and their superiors had no financial incentive to screen applicants,[55] including applicants' income documentation, credit history, credit worthiness, or long-term ability to repay.[56] All of the above profited from past short-term performance benchmarks based, in large part, on creating, buying, and selling MBSs.

But the blame does not start or stop there. Responding to questions submitted to him by Nina Eaton, Washington editor of Fortune Magazine, President Obama made the following statement:

> The truth is that there is plenty of blame to go around. Many Americans took out loans they could not afford. Others were enticed into loans they did not understand by lenders trying to make a quick profit. Investment banks bought and packaged these questionable mortgages into securities, arguing that by pooling the mortgages, the risks had been reduced. Credit agencies stamped these securities with their safest rating when they should have been labeled "Buyer Beware." And as the bubble grew, there was almost no accountability or oversight from anyone in Washington.[57]

There is indeed plenty of blame to go around. In this author's view, the blame starts at the federal level, with the federal government's unwavering support for homeownership and its deregulation of a financial industry that is incapable of self-regulating.

Predating the federal government's aggressive promotion of homeownership and deregulation efforts, MBS investments were virtually nonexistent. Commercial banks and thrifts, the historical loan originators,[58]

27; Del Jones & Edward Iwata, *CEO Pay Takes a Hit in Bailout Plan*, USA TODAY, Sept. 28, 2008, http://www.usatoday.com/money/companies/management/2008-09-28-executive-pay-ceo_N.htm (citing pay expert Graef Crystal, author of the *Crystal Report on Executive Compensation*).

54. Bartiromo, *supra* note 24, at 15.

55. Aaron Unterman, *Exporting Risk: Global Implications Of The Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 123 (2008); *see also Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Institution, Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit of the Comm. on Fin. Serv.*, 110th Cong. 6-8 (2007) (statement of Sheila C. Bair, Chairwoman, Federal Deposit Insurance Company) (discussing predatory lending).

56. Unterman, *supra* note 55, at 83-84.

57. Nina Easton, *Obama: How to Get Business Going*, FORTUNE, Apr. 19, 2009, http://money.cnn.com/2009/04/17/news/companies/obama_business.fortune/.

58. Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 FLA. L. REV. 295, 312 (2005) ("Prior to the 1990s, mortgages were almost exclusively originated and financed by heavily regulated, traditional bank-and-thrift depository institutions.").

normally held onto mortgages "from cradle to grave."[59] This practice affected their ability to expand the primary mortgage market. They originated new loans only when there were adequate deposits in customers' savings accounts or old mortgages were repaid with interest.[60] Keeping the loans on their books affected not only loan origination, but also limited the mortgage loan applicant pool. Commercial banks and thrifts generally issued new loans to only the worthiest of borrowers (prime borrowers) and rejected applicants with credit "blemishes" (subprime borrowers).[61] Within this context, there was little, if any, secondary mortgage market to support mortgage securitization.

Also, federal regulatory law limited the activities of financial industry players. The Glass-Steagall Act of 1933 prohibited any one institution from acting as both a commercial bank and an investment bank or as a bank and an insurer.[62] This mandated separation limited commercial banks, thrifts, investment banks, and insurance companies from increasing their involvement in the primary mortgage market or facilitating the creation of a secondary mortgage market.[63]

Then, based on the perceived benefits of homeownership,[64] the federal government changed the financial industry landscape through the creation of numerous federal and private agencies and programs dedicated to the protection and promotion of homeownership.[65] At the top of the list,

59. Moran, *supra* note 11, at 32.

60. Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 Real Prop. Prob. & Tr. J. 765, 766 (2005) ("Until as late as the 1960s, mortgage lending occurred on a predominantly local scale; neighborhood banks and savings and loans lent homeowners money that was financed by the savings of people in the community where the mortgage property was located. Lenders held these loans in their portfolios until maturity or the sale of the property. The availability of mortgage money was linked to the amount of savings in the community.").

61. James D. August et al., *Survey of Finance Companies, 1996*, 83 Fed. Res. Bull. 543, 549 (1997).

62. Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 32, 48 Stat. 162.

63. Harvey L. Pitt, *Bringing Financial Services Regulation into the Twenty-First Century*, 25 Yale J. on Reg. 315, 317 (2008) ("In the first 100 days of the New Deal, Congress passed the Glass-Steagall Act, created the Federal Deposit Insurance Corporation, and mandated separation of commercial and investment banking.").

64. *See* Godsil & Simunovich, *supra* note 2, at 949 ("Property ownership ties one to the larger community in myriad ways. As compared to renters, homeowners—even those with the same income, education, and other socioeconomic characteristics—tend to be more civically active and more apt to engage in market transactions linked to their homes. Losing this link to the larger market and community will harm a family's long-term prospects. When many families lose these connections, whole communities suffer.").

65. *See, e.g.*, U.S. Dep't of Agriculture, Rural and Community Development, http://www.rurdev.usda.gov/rhs/common/indiv_intro.htm (last visited Sept. 27, 2009) (describing rural homeownership programs); U.S. Dep't of Housing and Urban Dev., Fed. Housing Admin., http://www.hud.gov/offices/hsg/fhahistory.cfm (last visited Sept. 27,

federal legislation created two GSEs that can be singled out as both dominant forces behind the development of the primary and secondary mortgage markets and key players in today's financial crisis:[66] the Federal National Mortgage Association ("Fannie Mae")[67] and the Federal Home Loan Mortgage Corporation ("Freddie Mac").[68] Fannie Mae and Freddie Mac are privately owned, publicly-traded companies created and regulated by the federal government.[69] They perform two interrelated functions. First, they facilitate the growth of the primary and secondary mortgage markets by purchasing mortgages and MBSs for their own accounts.[70] Second, they issue and guarantee MBSs to domestic and foreign investors.[71]

As the first GSE on the scene, Fannie Mae initially purchased only loans that were insured by either the Federal Housing Administration ("FHA") or the U.S. Department of Veterans Affairs ("VA").[72] When

2009) (describing functions of Federal Housing Admin.); U.S. Dep't of Veterans Affairs, Home Loan Guaranty Servs., http://www.homeloans.va.gov/ (last visited Sept. 27, 2009) (listing information about Veterans Affairs home loans). An exhaustive list is beyond the scope of this article.

66. Greg Griffin, *Homeownership Push Seen as Top Culprit in Crisis*, DENVER POST, Oct. 5, 2008, at K01.

67. *See* Fannie Mae, About Fannie Mae, http://www.fanniemae.com/about/index.html (explaining Fannie Mae's congressional charter and its broad "mission to provide liquidity, stability and affordability to the U.S. housing and mortgage markets.").

68. *See* Freddie Mac, About Freddie Mac, http://www.freddiemac.com/corporate/company_profile/ ("Every day we help millions of families in neighborhoods across America buy their own homes or enjoy quality and affordable rental housing by linking them to the world's capital markets.").

69. *See* Fannie Mae, *supra* note 67 ("Fannie Mae was established as a federal agency in 1938, and was chartered by Congress in 1968 as a private shareholder-owned company."); *see also* Freddie Mac, About Freddie Mac, Frequently Asked Questions, http://www.freddiemac.com/corporate/company_profile/faqs/index.html (last visited Sept. 27, 2009) (explaining as a GSE, Freddie Mac is "a shareholder-owned company created by Congress to serve a public purpose.").

70. Fannie Mae, *supra* note 67 ("Fannie Mae operates in the U.S. secondary mortgage market. Rather than making home loans directly to consumers, we work with mortgage bankers, brokers and other primary mortgage market partners to help ensure they have funds to lend to home buyers at affordable rates. We fund our mortgage investments primarily by issuing debt securities in the domestic and international capital markets."); Freddie Mac, *supra* note 69 ("Freddie Mac supports liquidity and stability in the secondary mortgage market through two principal lines of business. Our credit guarantees business purchases residential mortgages and mortgage-related securities in the secondary mortgage market, securitizes these mortgages and subsequently sells them to investors as mortgage-backed securities. We also have a portfolio investment business that purchases mortgages for our mortgage-related investments portfolio.").

71. Reiss, *supra* note 3.

72. *See* Christopher L. Peterson, *Predatory Structures Finance*, 28 CARDOZO L. REV. 2185, 2195 (2007) (discussing predatory home loans); William G. Gale, Jonathan Gruber & Seth Stephens-Davidowitz, *Encouraging Homeownership Through the Tax Code*, TAX NOTES, June 18, 2007, http://www.taxpolicycenter.org/UploadedPDF/1001084

Fannie Mae's mission was expanded to purchasing conventional loans,[73] commercial banks and thrifts increased both their loan volume and their loan applicant pool.[74] When Freddie Mac joined Fannie Mae in 1970, both GSEs expanded the primary and secondary mortgage markets by purchasing and selling first conventional loans and then non-conventional loans.[75]

Private securitization, changes to federal laws and deregulation of the financial industry facilitated Fannie Mae, Freddie Mac and the financial industry's development and securitization of both the prime and subprime mortgage markets.[76] Private securitization began in the 1970s, with Bank of America and the investment-banking firm of Salomon Brothers creating their own bundled financial products.[77] Mortgages were purchased from

---

_Encouraging_Homeownership.pdf (finding inefficiencies and inequities in federal tax policies towards housing).

73. *See* Carrozzo, *supra* note 60, at 800 (stating that on February 14, 1972, Fannie Mae entered the conventional mortgage market, marking "the first auction of commitments for the purchase of conventional single-family mortgages."); *see also* Allie Mae, History of Fannie Mae, http://www.alliemae.org/historyoffanniemae.html (last visited Sept. 26, 2009) (noting on the timeline that in 1970 "Fannie Mae stock (FNM) [wa]s listed on the New York and Pacific Stock exchanges" and "President Nixon sign[ed] legislation authorizing Fannie Mae to purchase conventional mortgages.").

74. *See* Carrozzo, *supra* note 60, at 799-802 (discussing the revolution of the securitization of conventional loans by Fannie Mae and the boom in loans provided).

75. *See* Emergency Home Finance Act, 12 U.S.C. §§ 1451-1459 (2000) (stating that Freddie Mac is a privately owned company that is regulated by the federal government and its primary business is to buy mortgages from lenders, package the mortgages into securities, then guarantee and sell securities to investors). *Compare* Peterson, *supra* note 72, at 2198 (discussing Fannie Mae) *and* Freddie Mac, Company Profile, http://www.freddiemac.com/corporate/company_profile/ (last visited Sept. 26, 2009) (discussing the same) *with* Ginnie Mae, About Ginnie Mae, http://www.ginniemae.gov/about/about.asp?Section=About (last visited Sept. 26, 2009) (explaining that the third GSE, the Government National Mortgage Association, or Ginnie Mae, functions differently than Fannie Mae or Freddie Mac as its stated mission is to guarantee "investors the timely payment of principal and interest on MBS backed by federally insured or guaranteed loans," which are primarily loans insured by the FHA and the VA).

76. *See* Griffin, *supra* note 66 (describing several factors leading to the financial crisis, chief among them the relaxation of lending standards); Robert Farley & Angie Drobnic Holan, *What Caused Crisis? No One Thing*, ST. PETERSBURG TIMES, Oct. 12, 2008, at 1A (discussing the myriad of factors leading to the financial crisis); Shah Gilani, *How Deregulation Eviscerated the Banking Sector Safety Net and Spawned the U.S. Financial Crisis*, MONEYMORNING.COM, Jan. 13, 2009, http://www.moneymorning.com/2009/01/13/deregulation-financial-crisis/ (pointing to deregulation as the key cause of the economic meltdown).

77. *See* JOSEPH G. NICHOLAS, MARKET-NEUTRAL INVESTING 121-22 (Kathleen Peterson ed., Bloomberg Press 2000):

> In 1978, Bob Dall, a Salomon Brothers trader, together with Stephen Joseph, created the first private issue of mortgage securities. In the deal, Bank of America sold, in the form of bonds, home loans it had made to

commercial banks or thrifts, repackaged as bonds, sorted according to risk, certified by bond-rating agencies, and either contributed to a trust where investors were the named beneficiaries or sold outright to investors.[78] In other words, the private financial industry had begun its own process of mortgage securitization, with each player in the process (commercial banks, investment banks, credit rating agencies, trustees, etc.) generating a fee.[79]

Changes in federal law and deregulation began in the early 1980s.[80] Two federal income tax law changes encouraged homeownership and financial industry creativity. First, the Tax Reform Act of 1986 continued the tax deduction for interest paid on home loans, while generally prohibiting the deduction of interest paid on other consumer loans.[81] Second, the Taxpayer Relief Act of 1997 exempted most residential home sales from capital gains tax.[82] These acts stimulated demand among consumers for new home loans and home equity loans, and commercial banks turned to the GSEs to securitize loans off the formers' books and to provide banks with the capital necessary to meet growing consumer needs.[83]

Then came two rounds of financial industry deregulation. The first round began in the early 1980s. The Depository Institutions Deregulation and Monetary Control Act of 1980 preempted state usury ceilings for most

> institutional investors. Bank of America received cash for the bonds, which it could then relend, and the original mortgage payments *passed through* to the holders of the bonds. The niche did not really take off until the fall of 1981, when Congress passed a tax break that gave thrifts an incentive to sell their mortgage loans. The only fully staffed mortgage bond trading desk on Wall Street at that time, Salomon Brothers, became a hugely profitable enterprise, and a new market emerged.

78. *Id.*

79. *See American History & Mortgage Lending Deregulation*, INVESTORVILLAGE, Feb. 23, 2008, http://investorvillage.com/ajaxmsg.asp?mid=A0D54DDD22E22ED3&print=1 (mapping the history of mortgage lending, securitization, and deregulation).

80. *See generally* U.S. COMPTROLLER OF THE CURRENCY ADMINISTRATOR OF NATIONAL BANKS, ASSET SECURITIZATION CONTROLLER'S HANDBOOK 3-4 (1997), http://www.dallasfed.org/news/ca/2005/05wallstreet_assets.pdf (discussing the emergence and growth of securitization markets).

81. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 141, 511, 100 Stat. 2085 (codified as amended at 26 U.S.C. § 163).

82. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312, 111 Stat. 788 (repealing I.R.C. § 1034 and amending § 121 to limit gain recognition to over $250,000 for single filers and over $500,000 for joint filers).

83. *See* Cathy Lesser Mansfied, *The Road to Subprime 'HEL' Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 522 (2000) (tracing the staggering increase in home equity loans in the 1980s).

home mortgage loans.[84] In the beginning, the Act accommodated higher conventional mortgage rates in states with low usury laws.[85] Later, it provided more flexibility for developing non-conventional, subprime mortgage loans, which carry higher fees, costs, and interest rates.[86] The Alternative Mortgage Transaction Parity Act of 1982 preempted state laws that restricted banks from making any mortgage except conventional fixed-rate amortizing mortgages.[87] This led to various exotic new mortgages, including adjustable rate mortgages, balloon payment mortgages, and interest-only mortgages.[88] The Secondary Mortgage Market Enhancement Act of 1984 "enable[d] private issuers of [MBSs] to compete effectively with government-related agencies,"[89] including the GSEs, "by removing some of the legal impediments to issuing private [MBSs]."[90]

The second round of deregulation began in the mid 1990s and put the last nails in the regulatory coffin.[91] The Financial Services Modernization

84. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.).

85. *See* Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 Harv. J. on Legis. 167, 175 (2007) (stating that the law permanently overrode state-imposed ceilings on mortgage rates unless states reenacted the ceilings within three years).

86. *See* Kenneth C. Johnston, James B. Greer, Julie K. Biermacher & Joseph Hummel, *The Subprime Morass: Past, Present, and Future*, 12 N.C. Banking Inst. 125, 127 (2008) (asserting that the DIDMCA fostered the growth of the subprime mortgage market); *see also* Anne Balcer Norton, *Reaching the Glass Usury Ceiling: Why State Ceilings and Federal Preemption Force Low-Income Borrowers Into Subprime Mortgage Loans*, 35 U. Balt. L. Rev. 215, 216 (2005) ("Congress's enactment of the Depository Institutions Deregulation and Monetary Control Act . . . promulgated the growth of . . . subprime lending.").

87. Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. §§ 3801-06 (2006).

88. *See Alternative Mortgage Transaction Parity Act of 1982*, Wikipedia.org, http://en.wikipedia.org/wiki/ Alternative_Mortgage_Transaction_Parity_Act_of_1982 (last visited Oct. 5, 2009) (explaining the emergence of these new types of loans under the AMTPA, which permitted loan terms that obscured the actual total cost of the loan).

89. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 Tex. L. Rev. 1369, 1385 (1991).

90. *Id.* at 1385-86

> As finally adopted, [the Act] (1) preempts certain state legal investment laws so as to permit state-regulated institutions to invest in 'mortgage related securities,' as defined in the Securities Exchange Act of 1934 (the '1934 Act'); (2) permits national banks, federal credit unions, and federal savings and loan associations to invest in privately issued mortgage-related securities; (3) preempts state blue sky laws so as to exempt such securities from registration under state securities laws to the same extent that securities issued or guaranteed by a government-related agency are exempt; and (4) amends the margin requirements of the 1934 Act to permit delayed delivery of such securities and thereby allow a forward trading market to develop.

91. *See* Robert Scheer, *McCain and the Mortgage Meltdown*, TheNation.com, Sept. 10, 2008, http://www.thenation.com/doc /20080922/scheer (quoting then-Presidential candidate Senator John McCain about recent

Act of 1999 partially repealed the Glass-Steagall Act of 1933 and effectively opened up competition among commercial and investment banks, securities and insurance companies.[92] Among other things, the Act allowed commercial banks to expand into other financial activities, such as operating an investment division or joining forces with an investment bank to securitize and sell MBSs.[93] The Commodities Future Modernization Act of 2000 deregulated the market for credit-default swaps,[94] which "are essentially insurance policies covering the losses on securities in the event of a default."[95] Underestimating the impact of this small change,[96] the deregulation of credit-default swaps encouraged investment in subprime MBSs and the purchase of insurance to secure against potential MBS losses.[97]

In addition to its deregulation efforts, the federal government also actively promoted the origination, purchasing, selling, and guaranteeing of increasingly riskier MBSs. For example, beginning in the mid-1990s, the U.S. Department of Housing and Urban Development ("HUD") increased affordable housing goals for the GSEs in an effort to increase homeownership among historically disadvantaged groups.[98] In 1995, Fannie Mae and Freddie Mac began receiving affordable housing credits from HUD for purchasing MBSs comprised primarily of mortgages made to low-income, historically disadvantaged borrowers.[99] In July 1999, HUD

---

legislation that "ended significant regulation of the financial community").

92. Gramm-Leach-Bliley Act (Financial Services Modernization Act of 1999), Pub. L. 106-102, § 101, 113 Stat. 1338.

93. *See* Griffin, *supra* note 66 (attributing the mortgage crisis in part to bank deregulations, including the 1999 Financial Services Modernization Act); Landler & Stolberg, *supra* note 42 (pointing to the Act as the most significant recent bank deregulation); Kammer, *supra* note 43 (tracing the trend of bank deregulation from the early 1980s).

94. Commodity Futures Modernization Act of 2000, Pub. L. 106-554, § 1(a)(5), 114 Stat. 2763 (codified in scattered sections of 7, 11, 12, and 15 U.S.C.).

95. David Corn, *Foreclosure Phil*, MOTHERJONES, May 28, 2008, http://www.motherjones.com/news/feature/2008/07/foreclosure-phil.html.

96. *See* Moran, *supra* note 11, at 42 (explaining that Congress' decision to exempt credit-default swaps from federal regulation was based on a "consensus . . . that the market was still very small and no systemic risk would exist since investors' inclinations to minimize their risks would protect the broader financial system.").

97. *Id.*; *see also* Griffin, *supra* note 66 (stating that companies suffered billions in losses through their trading and guaranteeing of MBSs).

98. *See* Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending: Minority Home Ownership May Increase*, N.Y. TIMES, Sept. 30, 1999, at C2 (announcing that Fannie Mae eased its lending requirements in a move to increase mortgage opportunities for low-income consumers); *see also* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2095 (2007) (discussing predatory loans).

99. *See* Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis*, WASH. POST, June 10, 2008, at A1, (criticizing HUD for encouraging risky lending by requiring Fannie

proposed that fifty percent of GSE loan activity originate from low and moderate-income borrowers.[100] In 2005, HUD again ratcheted up Fannie Mae and Freddie Mac's affordable housing goals for the next four years, from fifty percent to fifty-six percent.[101] Due in part to the increased goals and financial incentives, from 2004 through 2006, the GSEs purchased $434 billion in MBSs containing large percentages of subprime mortgages.[102]

Finally, in 2004, the Securities and Exchange Commission ("SEC") made what observers believe to be the single biggest regulatory mistake leading to the financial crisis.[103] The SEC exempted the then five largest investment banks (Goldman Sachs, Merrill Lynch, Lehman Brothers, Bear Stearns, and Morgan Stanley) from leverage constraints and certain valuation rules.[104] As an example of the exemption's impact, when Bear Stearns collapsed in March 2008, after buying massive amounts of MBSs and other collateral debt obligations, it had a debt-to-asset ratio of 33-to-1.[105] Other exempted firms had similar debt-to-asset ratio increases.[106]

Financial industry creativity, a virtually nonexistent federal regulatory structure, eviscerated state control, federal government encouragement, pre-2006 record low interest rates, and record high home values caused commercial banks to increase volume in prime and subprime mortgage origination.[107] Further, mortgage lenders joined commercial banks and investment banks as a new cottage industry that spurred on the prime and subprime mortgage markets.[108] The financial industry packaged increasingly risky loans as MBSs. A handful of conflicted credit rating

Mae and Freddie Mac to significantly increase their investment in subprime loans).

100. Holmes, *supra* note 98.

101. HUD Housing Goals, 24 C.F.R. § 81.12 (2004).

102. Republican Caucus, Comm. on the Budget, *Roots of the Financial Crisis: The Role of Government Policy* 6 (Jan. 8, 2009), *available at* http://www.house.gov/budget_republicans/press/2007/pr20090108rootcauses.pdf ("From 2004 through 2006, the two GSEs purchased $434 billion in securities backed by subprime loans. In 2004 alone, the Fannie and Freddie purchased $175 billion in subprime mortgage securities, which accounted for 44 percent of the market that year.").

103. *See* Julie Satow, *Ex-SEC Official Blames Agency for Blow-up of Broker-Dealers*, N.Y. Sun, Sept. 18, 2008, at B1 (blaming the SEC for causing the meltdown of major broker-dealers by relaxing regulation); *see also* Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. Times, Oct. 2, 2008, at A1 (discussing the SEC's deregulation of brokerage units' debt and its effects).

104. *See* Satow, *supra* note 103 (discussing these exemptions).

105. Griffin, *supra* note 66.

106. *See* Labaton, *supra* note 103 (discussing the effects of the exemptions granted to the five major brokerage firms).

107. *See* Carrillo, *supra* note 2, at 4 (discussing the various new mortgage types that fueled the steep increase in home ownership).

108. *See* Dennis Hevesi, *Giving Credit Where Credit was Denied*, N.Y. Times, June 8, 1997, at Real Estate 1 (discussing the emergence and explosion of the subprime market).

agencies gave the MBSs AAA-investment grade ratings. Fannie Mae, Freddie Mac, individuals, and investment bankers subsequently bought the MBSs.[109]

With all the players in place, the subprime mortgage market spree hit its zenith at the height of the U.S. housing boom. From 2003 to 2007, U.S. subprime mortgages increased 292 percent, from $332 billion to $1.3 trillion, and most of that activity was due to the private sector's entrance into the subprime secondary market.[110] Fannie Mae and Freddie Mac, however, held their own and aggressively developed a primary and secondary mortgage market that, in part, targeted subprime borrowers.[111] Along the way, every loan origination or sale generated fees for the respective players and bonuses were given for volume sales. As the loans or MBSs became riskier, fees and bonuses went higher.

In conclusion, the financial industry's reliance on short-term productivity benchmarks and greed played a role in the financial crisis. But, it was primarily the federal government's abdication of its role in regulating the financial industry and its adoption of increasingly risky homeownership goals for the GSEs and other federal agencies and programs that created an environment of corporate reckless abandonment.[112] In this case, the federal government "chicken" came before the multi-million dollar payout "egg."

III. THE COST OF AGGRESSIVE HOMEOWNERSHIP POLICIES, DEREGULATION & CORPORATE GREED: BAILING OUT THE FINANCIAL INDUSTRY

The mortgage market began unraveling at the end of 2007. In July 2007, Fannie Mae and Freddie Mac shares traded above $60.[113] By mid-

109. *See* Unterman, *supra* note 55, at 84 (detailing the types of loans included in MBSs and pointing out that these loans shifted risk from the mortgage originator to the lender).

110. CTR. FOR RESPONSIBLE LENDING, A SNAPSHOT OF THE SUBPRIME MARKET, at 1 (2007), http://www.responsiblelending.org/mortgage-lending/tools-resources/snapshot-of-the-subprime-market.pdf (last visited Oct. 5, 2009).

111. *See, e.g.*, Holmes, *supra* note 98, at C2 (discussing an easing of credit requirements by Fannie Mae and the potential pitfalls associated with the change); Leonning, *supra* note 99, at A1 (describing policies implemented by Fannie Mae and Freddie Mac which targeted the subprime loan market and the implications of those changes); REPUBLICAN CAUCUS, *supra* note 102, at 4-8 (discussing the effects of creating a market for subprime loans as result of the purchasing of securitized subprime loans by Fannie Mae and Freddie Mac).

112. *See* REPUBLICAN CAUCUS, COMM. ON BUDGET, *supra* note 102, at 1-13 (discussing the role of the federal government in the housing crisis).

113. MARK JICKLING, CRS REPORT FOR CONG., FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP, at CRS-2, n.2, (2008), *available at* http://fpc.state.gov/documents/organization/110097.pdf.

July 2008, the GSEs' share value had fallen by sixty percent or more,[114] with the GSEs reporting over $12 billion in losses by September 2008.[115] By July 2008, major financial institutions reported initial losses of approximately $435 billion (primarily based on subprime-laden MBSs).[116]

The multi-billion dollar corporate losses led to a long and distinguished list of financial industry failures. On the brink of bankruptcy, Bear Stearns' share value declined from $20 billion in January 2007 to about $3.5 billion in March 2008. To avoid Bear Stearns' bankruptcy, in March 2008, the Federal Reserve brokered a deal between JP Morgan Chase and Bear Stearns where the former bought out the latter for a mere $2 a share (approximately $236 million).[117] Indymac Bank, a subsidiary of Independent National Mortgage Corporation ("Indymac"), was placed into receivership in July 2008. Indymac's failure was the fourth largest bank failure in U.S. history, and the second largest failure of a regulated thrift.[118] In September 2008, banking regulators facilitated the sale of Washington Mutual Inc., which as of that date was the largest savings bank and biggest U.S. bank failure.[119] Also in September 2008, 150-year-old Lehman Brothers filed for Chapter 11 bankruptcy.[120] This series of events was only the beginning of the end for many financial institutions.[121]

114. *Id.*

115. David Ellis, *U.S. Seizes Fannie and Freddie, Treasury Chief Paulson Unveils Historic Government Takeover of Twin Mortgage Buyers, Top Executives Are Out*, CNN MONEY, Sept. 7, 2008, http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm.

116. Josh Fineman & Bradley Keoun, *Merrill Lynch Posts Fourth Straight Quarterly Loss*, BLOOMBERG.COM, http://www.bloomberg.com/apps/news?pid=20601087&sid=atGti_UmcPnM&refer=home (last updated July 17, 2008).

117. Robin Sidel, Dennis K. Berman & Kate Kelly, *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis*, WALL ST. J., Mar. 17, 2008, at A1; *see also* Joseph Giannone & Dane Hamilton, *Fed Comes to Bear Stearns' Rescue; Shares Dive*, REUTERS, Mar. 14, 2008, http://www.reuters.com/article/businessNews/idUSN1438968020080314?feedType=RSS&feedName=businessNews (discussing the financing of the Bear Sterns' acquisition).

118. *FACTBOX: Top Ten U.S. Bank Failures*, REUTERS, Sept. 25, 2008, http://www.reuters.com/article/ousivMolt/idUSTRE48P0YC20080926.

119. *Id.*

120. Michael Liedtke, *Grown Over 150 Years, Lehman End Came Swiftly*, INT'L BUS. TIMES, Sept. 15, 2008, http://www.ibtimes.com/articles/20080915/grown-over-150-years-lehman-end-came-swiftly_all.htm (discussing the descent of Lehman Brothers into bankruptcy).

121. *See Subprime Crisis Impact Timeline*, WIKIPEDIA.ORG, http://en.wikipedia.org/wiki/Subprime_crisis_impact_timeline (last visited Oct. 5 2009) (listing dates and descriptions of major events of the subprime crisis); *see also* The Mortgage Lender Implode-O-Meter, http://ml-implode.com/ (listing the then 363 major U.S. lending operations that have imploded since late 2006) (last visited Oct 5, 2009).

A. *Initial Federal Intervention*

Prior to EESA and ARRA's enactment, Congress and the Bush administration adopted a piecemeal federal relief strategy, which allowed some financial institutions to fail and saved only those industry players that were deemed critical to financial recovery. The government decided the GSEs and AIG were critical and thus saved them from bankruptcy filings or certain corporate ruin.

Congress and the Bush administration determined that Fannie Mae and Freddie Mac were too big to fail. After all, Fannie Mae and Freddie Mac owned or guaranteed about half of the $12 trillion mortgage market.[122] Further, investors worldwide owned $5.2 trillion of debt securities backed by Fannie Mae and Freddie Mac.[123] The Chinese government alone owned hundreds of billions of dollars worth of Fannie Mae and Freddie Mac bonds.[124]

To save the GSEs, in July 2008, President Bush signed into law the Housing and Economic Recovery Act.[125] The Act created a new GSE regulator, the Federal Housing Finance Agency ("FHFA"), and placed the GSEs under the FHFA's regulatory authority. The Act also gave the Treasury the authority to advance up to $200 billion to stabilize Fannie Mae and Freddie Mac.[126]

In September 2008, the federal government stepped in again and essentially nationalized the GSEs.[127] Fannie Mae and Freddie Mac were placed in a government-operated conservatorship, with the FHFA as the conservator,[128] having "veto power over all major [GSE] decisions, including [decisions regarding the] hiring and firing of executives,

122. *See* Ellis, *supra* note 115 ("All told, [Fannie Mae and Freddie Mac] own or back $5.4 trillion worth of home debt - half the mortgage debt in the country.").

123. Charles Duhigg, *A Trickle That Turned into a Torrent*, N.Y. TIMES, July 11, 2008, at C1 (discussing the turmoil at Fannie Mae and Freddie Mac).

124. Maureen Thacik, *5 Dumb Fannie Mae Bailout Assertions That Are Actually Secretly Smart*, GAWKER, Sept. 8, 2008, http://gawker.com/5047007/5-dumb-fannie-mae-bailout-assertions-that-are-actually-secretly-smart.

125. Housing and Economic Recovery Act of 2008, Pub. L. 110-289, 122 Stat. 2654.

126. *Id.* at tit. I, § 1117, 122 Stat. at 2683.

127. See Kathleen M. Howley, *Freddie Mac, Fannie Mae Bailout Lowers Mortgage Rates*, BLOOMBERG.COM, Sept. 8, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aFL16l3QSSIY&refer=home (discussing the bailout of Fannie Mae and Freddie Mac); *cf.* Jickling, *supra* note 113, at CRS-3, 4 ("Common shareholders have lost their voting rights and nearly all their investment, and dividends on preferred and common shares have been suspended. On the other hand, the government action benefits the holders of debt issued or guaranteed by the GSEs, who receive 'security and clarity' that the 'conserved entities have the ability to fulfill their financial obligations.'").

128. Howley, *supra* note 127.

[executive] compensation and pricing."[129]

Of course, the FHFA's conservatorship could not turn back years of the GSEs' guarantees on, and ownership and securitization of, increasingly riskier MBSs. In 2008, Fannie Mae reported a $58.7 billion loss,[130] and a first quarter 2009 loss of $23.2 billion.[131] For 2008, Freddie Mac reported over $50 billion in losses,[132] and a first quarter 2009 loss of $9.9 billion.[133] By March 2009, Fannie Mae and Freddie Mac had already received $60 billion in federal funds.[134] In May 2009, Fannie Mae indicated that it required "$19 billion in additional government aid as job losses grew and risky loans made in the housing boom went bad at an unnerving pace."[135] Also in May 2009, Freddie Mac requested an additional $6.1 billion in aid.[136] The Obama administration indicated that federal aid to the two GSEs may exceed $147 billion by September 2010.[137]

As the largest insurance company in the United States,[138] AIG's continuing viability was also deemed critical to national and global interests. AIG got into trouble by spreading out into trading and guaranteeing MBSs through its subsidiary, AIG Financial Products ("AIG FP"). AIG FP held and marketed MBSs, and under credit-default swaps, insured against losses on those and other types of collateral debt obligations, making it vulnerable on two fronts.[139] AIG FP built up a

129. James R. Hagerty, *Fannie Insider Gets CEO Job, But no Raise*, Wall St. J., Apr. 21, 2009 at A6; Press Release, Federal Housing Finance Agency, Fact Sheet: Questions and Answers on Conservatorship (Sept. 3, 2008), at 3, http://www.treas.gov//press/releases/reports/fhfa_consrv_faq_090708hp1128.pdf.

130. News Release, *Fannie Mae Reports Fourth-Quarter and Full-Year 2008 Results* (Feb. 26, 2009), http://www.fanniemae.com/media/pdf/newsreleases/form10k_newsrelease_022609.pdf.

131. News Release, *Fannie Mae Reports First-Quarter 2009 Results* (May 8, 2009), http://www.fanniemae.com/media/pdf/newsreleases/q12009_release.pdf.

132. News Release, *Freddie Mac Reports Fourth Quarter and Full-Year 2008 Financial Results* (Mar. 11, 2009), http://www.freddiemac.com/news/archives/investors/2009/2008er-4q08.html.

133. News Release, *Freddie Mac Releases First Quarter 2009 Financial Results* (May 12, 2009), http://www.freddiemac.com/news/archives/investors/2009/2009er-1q09.html.

134. Associated Press, *Fannie Mae Says It Needs $19 Billion More in Aid*, N.Y. Times, May 9, 2009, at B4.

135. *Id.*

136. Tami Luhby, *Freddie Mac Needs Another $6.1 B in Aid, Total Bailout Comes to $51.7 Billion as Mortgage Financier Reports a $9.9 Billion Quarterly Loss*, CNN Money, May 12, 2009, http://money.cnn.com/2009/05/12/news/companies/Freddie_results/index.htm?postversion=2009051218.

137. Associated Press, *supra* note 134.

138. *See* Bill Saporito, *How AIG Became Too Big to Fall*, Time, Mar. 30, 2009, at 24 (discussing the aftermath of the AIG bailout and its effects).

139. *Id.*

portfolio of $2.7 trillion in derivatives, including substantial MBSs.[140] Then, in 2008, when all the MBS chips came crumbling down, AIG's $6.9 billion in insurance earnings was unable to absorb its losses, including AIG FP's initial $40.4 billion in losses.[141]

After Moody's and S&P's September 2008 downgrade of AIG's credit rating,[142] the Federal Reserve lent $85 billion to the financial conglomerate to forestall its potential bankruptcy filing.[143] This was only the beginning of AIG "loans," which, as of May 2009, led to U.S. taxpayers owning an eighty percent equity stake in the company.[144]

B. EESA & ARRA Come to The Rescue

Realizing that piecemeal bailouts would not rescue a systemically failing financial industry,[145] EESA was signed into law on October 3, 2008.[146] A newly created Treasury agency, the Office of Financial Stability, is responsible for running TARP in consultation with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation ("FDIC"), the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and the Secretary of HUD.[147] EESA provides that the TARP bailout period generally terminates on December 31, 2009, but can be extended to October 3, 2010 (meaning two years of government funding, intervention, and oversight of the financial industry).[148]

Initially, TARP was designed to purchase toxic assets, predominantly MBSs, from financial institutions.[149] The original intent, however, faced a

140. *Id.*

141. *Id.*

142. *See* Tony Monroe, *AIG in Focus as Financial Meltdown Spreads*, REUTERS, Sept. 16, 2008, http://www.reuters.com/article/topNews/idUSN1551938520080916 (discussing the effects of AIG's ratings downgrade).

143. Griffin, *supra* note 66.

144. *See* James Pethokoukis, *New York Fed Selects Trustees for AIG Stake*, REUTERS, Jan. 16, 2009, http://www.reuters.com/article/businessNews/idUSTRE50F7L220090116 (discussing the New York Federal Reserve's appointment of trustees to oversee the U.S. Government's stake in AIG); *see also* Sean Lengell, *Geithner Says AIG Bailout 'Complicated'*, WASH. TIMES (DC), May 21, 2009, at A11 (discussing the details of the AIG bailout) and Liam Pleven, Matthew Karnitschnig & Deborah Solomon, *U.S. Revamps Bailout of AIG*, WALL ST. J., Mar. 2, 2009, at A1 (same).

145. *Emergency Economic Stabilization Act of 2008, Legislative History*, WIKIPEDIA.ORG, http://en.wikipedia.org/wiki/Emergency_Economic_Stabilization_Act_of_2008 (last visited Oct. 7, 2009) (discussing EESA).

146. EESA, 122 Stat. 3765 (2008).

147. *Id.* at div. A, tit. I, § 104(b), 122 Stat. 3771.

148. *Id.* at div. A, tit. I, § 120, 122 Stat. 3788.

149. *See* Rick Newman, *How TARP Began: An Exclusive Inside View*, U.S. NEWS & WORLD REP., May 14, 2009, http://www.usnews.com/blogs/flowchart/2009/05/14/how-tarp-

stark reality. There was no way to place a fair market value on these assets, and there were no buyers other than the federal government.[150] The Treasury's approach quickly morphed into establishing programs under which financial institutions and companies in failing industries (*e.g.*, the automotive industry) would receive a capital infusion in exchange for the federal government's receipt of preferred equity interests, plus a stated rate of return on the investments.[151]

Originally, there were five programs established under TARP: the Capital Purchase Program ("CPP"); the Systematically Significant Failing Institutions Program ("SSFIP"), the Targeted Investment Program ("TIP"), the Automotive Industry Financing Program, and the Term Asset-Backed Securities Loan Facility ("TALF"). Four of the original five provided direct relief to the financial industry.[152] The CPP was the largest program.

began-an-exclusive-inside-view.html (discussing the origins of the TARP).

150. *Id.*

151. *Id.* (quoting David Nason, a senior Treasury Dep't official during the Bush administration: "The reason the TARP morphed from asset purchases to injecting capital is really quite practical. Asset purchases were taking longer than we had hoped, and it was more complicated with the vendors. Also, we needed to be in lockstep with our brethren around the world. The U.K., France, and Germany were prepared to guarantee the liabilities of the banking sector and were going to deploy capital into their banks."); *see also* Press Release, U.S. Dep't of Treas., *Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update* (Nov. 12, 2008), http://www.treas.gov/press/releases/hp1265.htm (last visited Sept. 21, 2009):

> As credit markets froze in mid-September, the Administration asked Congress for broad tools and flexibility to rescue the financial system. We asked for $700 billion to purchase troubled assets from financial institutions. At the time, we believed that would be the most effective means of getting credit flowing again. During the two weeks that Congress considered the legislation, market conditions worsened considerably. It was clear to me by the time the bill was signed on October 3rd that we needed to act quickly and forcefully, and that purchasing troubled assets – our initial focus – would take time to implement and would not be sufficient given the severity of the problem. In consultation with the Federal Reserve, I determined that the most timely, effective step to improve credit market conditions was to strengthen bank balance sheets quickly through direct purchases of equity in banks.

152. *See* FIN. STABILITY OVERSIGHT BD. QUARTERLY REPORT TO CONGRESS FOR THE QUARTER ENDING JUNE 30, 2009 SUBMITTED PURSUANT TO SECTION 104(G) OF THE EMERGENCY STABILIZATION ACT OF 2008 (2009), at 36, *available at* http://www.financialstability.gov/docs/FSOB/FINSOB-Qrtly-Rpt-063009.pdf [hereinafter FIN. STABILITY OVERSIGHT BD. QUARTERLY REPORT, SECOND QUARTER 2009] (detailing the Oversight Board's second quarter review of TARP). The financial industry also received indirect relief under the Automotive Industry Financing Program. As of May 8, 2009, the Treasury had released over $24.7 billion in total loans under this program, including loans to GMAC and Chrysler Financial. *See* FIN. STABILITY OVERSIGHT BD. QUARTERLY REPORT TO CONGRESS FOR THE QUARTER ENDING MAR. 31, 2009 SUBMITTED PURSUANT TO SECTION 104(G) OF THE EMERGENCY STABILIZATION ACT OF 2008 (2009), at 51, *available at*

It was designed to "invest up to $250 billion in U.S. banks that are healthy, but desire an extra layer of capital for stability or lending."[153] According to the Financial Stability Oversight Board's second quarter of 2009 report to Congress, as of June 30, 2009, the "Treasury had invested approximately $203 billion under the CPP in senior preferred shares or other senior securities of 649 financial institutions, in 48 states . . . ."[154]

The SSFIP was short-lived and essentially used only to provide further bailout funds to AIG.[155] Under the program, the Treasury initially invested $40 billion in AIG in exchange for AIG senior preferred shares and warrants to purchase common stock.[156] As part of the agreement, AIG's outstanding debt to the Federal Reserve was restructured.[157] By March 31, 2009, AIG had received over $170 billion in federal funds, including additional TARP funds.[158]

The TIP was designed to "stabilize the financial system by making investments in institutions that are critical to the functioning of the financial system," regardless of whether the institution is deemed healthy (as required under the CPP).[159] The program was not designed to be widely

http://www.financialstability.gov/docs/FSOB/FINSOB-Qrtly-Rpt-033109.pdf [hereinafter FIN. STABILITY OVERSIGHT BD. QUARTERLY REPORT, FIRST QUARTER 2009] ("[O]n January 16, 2009, Treasury made a $1.5 billion loan to a special purpose entity created by Chrysler Financial to finance the extension of new consumer auto loans . . . .").

153. U.S DEP'T OF TREAS., *Road to Stability, Capital Purchase Program*, FINANCIALSTABILITY.GOV, http://www.financialstability.gov/roadtostability/capitalpurchaseprogram.html (last visited Oct. 7, 2009).

154. FIN. STABILITY OVERSIGHT BD. QUARTERLY REPORT, SECOND QUARTER 2009, *supra* note 152, at 30.

155. Press Release, U.S. Dep't of Treas., *Treasury Announces New Policy To Increase Transparency in Financial Stability Program* (Jan. 28, 2009), http://www.financialstability.gov/latest/tg04.html; *see also* FIN. STABILITY OVERSIGHT BD. QUARTERLY REPORT, FIRST QUARTER 2009, *supra* note 152, at 9 (discussing the general application of programs such as the SSFIP to entities such as AIG); FIN. STABILITY OVERSIGHT BD. QUARTERLY REPORT, SECOND QUARTER 2009, *supra* note 152, at 48 (showing that no further action was taken under programs such as the SSFIP).

156. *See* Press Release, U.S. Dep't of Treas., *Treasury to Invest in AIG Restructuring Under the Emergency Economic Stabilization Act* (Nov. 10, 2008), http://www.financialstability.gov/latest/hp1261.html (detailing the purchase of senior preferred stock from AIG).

157. FIN. STABILITY OVERSIGHT BD. QUARTERLY REPORT, FIRST QUARTER 2009, *supra* note 152, at 50.

158. *See* Mary Williams Walsh, *A.I.G. Lists Banks It Paid With U.S. Bailout Funds*, N.Y. TIMES, Mar. 15, 2009, at A1, A14 ("Ever since the insurer's rescue began, with the Fed's $85 billion emergency loan last fall, there have been demands for a full public accounting of how the money was used. The taxpayer assistance has now grown to $170 billion, and the government owns nearly 80 percent of the company.").

159. U.S. DEP'T OF TREAS., ROAD TO STABILITY, TARGETED INVESTMENT PROGRAM (UPDATED SEPT. 9, 2009), http://www.financialstability.gov/roadtostability/targetedinvestmentprogram.html (last

used, and as of March 31, 2009, only Bank of America and Citigroup had received TIP funds. The funds released to these institutions were, however, substantial. For example, Bank of America and Citigroup each qualified for billions of dollars in additional funding under this program.[160]

The last of the original programs targeting the financial industry, the TALF, is a joint program sponsored by the Treasury and the New York Federal Reserve. It was designed to support "securitization markets for key types of consumer and small business credit and, thereby, assist in making [] credit more available and affordable."[161] Its original focus was on newly or recently-originated AAA-rated asset-backed securities supported by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration.[162] More than $8 billion was distributed under the program during the first quarter of 2009,[163] and almost $24 billion was distributed during the second quarter of 2009.[164]

In 2009, the Treasury implemented two additional programs that provided capital to financial institutions: the Capital Assistance Program ("CAP"); and the Public-Private Investment Program ("PPIP"). In February 2009, the Treasury announced the terms and conditions of CAP, which is described as "a core element of the [Obama] Administration's Financial Stability Plan."[165] The purpose of the program "is to restore confidence throughout the financial system that the nation's largest banking institutions have a sufficient capital cushion against larger than expected future losses, should they occur due to a more severe economic environment, and to support lending to creditworthy borrowers."[166] CAP has two components: mandatory assessment or stress testing for the nineteen largest bank holding companies, and potential additional funding through the purchase of equity interests for eligible financial institutions.[167]

---

visited Oct. 9, 2009) (identifying broader eligibility considerations for TIP participants).

160. *See* FIN. STABILITY OVERSIGHT BD., QUARTERLY REPORT, FIRST QUARTER 2009, *supra* note 152, at 44-47 (discussing Treasury's actions regarding Bank of America, Citigroup, and AIG).

161. *Id.* at 26.

162. *Id.* at 27.

163. FIN. STABILITY OVERSIGHT BD., QUARTERLY REPORT, FIRST QUARTER 2009, *supra* note 152, at 28 (documenting the issuance of $8.3 billion of credit card and asset-back securities).

164. FIN. STABILITY OVERSIGHT BD., QUARTERLY REPORT, SECOND QUARTER 2009, *supra* note 152, at 36 ("$23.9 billion in TALF loans extended during the quarterly period...").

165. U.S. DEP'T OF TREAS., ROAD TO STABILITY, CAPITAL ASSISTANCE PROGRAM (2009), http://www.financialstability.gov/roadtostability/ capitalassistance.html (last visited Oct. 9, 2009).

166. *Id.*

167. White Paper, U.S. Dep't of Treas., *The Capital Assistance Program and Its Role in the Financial Stability Plan* (Feb. 25, 2009), at 2, http://www.treas.gov/press/releases/reports/tg40_capwhitepaper.pdf.

In March 2009, the Treasury announced details of PPIP.[168] The program is a joint program sponsored by the Treasury, FDIC, and Federal Reserve, and includes a securities purchase program designed to remedy the illiquidity in the secondary markets for certain MBSs, and a loan purchase program designed to create a market for troubled loans on bank and thrift balance sheets.[169] The Financial Stability Oversight Board outlined details of the program in its second quarter 2009 report, including criteria for two sub-programs entitled the Legacy Securities Program and the Legacy Loans Program, with $75 to $100 billion in TARP funds available but yet to be distributed under the programs.[170]

Together, the aforementioned TARP programs were designed to recapitalize the financial industry, increase business and consumer lending, and deal with toxic MBSs remaining on institutions' balance sheets. Under various programs, by the end of June 2009, the top nine bailout recipients received a massive influx of capital: Bank of America received $45 billion; Bank of New York Mellon $3 billion; Citigroup, Inc. $45 billion; Goldman Sachs Group, Inc. $10 billion; JP Morgan Chase $25 billion; Merrill Lynch $10 billion (diverted to Bank of America with its acquisition of the former); Morgan Stanley $10 billion; State Street $2 billion; and Wells Fargo $25 billion.[171] Billions more were distributed to smaller institutions.

Going into the fall 2009, the success or failure of the TARP bailouts cannot be determined. According to Neil Barofsky, the special inspector general for the TARP program, a year into the program, "there is little question that the dramatic steps taken by Treasury, the Federal Reserve and the FDIC through TARP and related programs . . . played a significant role in bringing the system back from the brink of collapse."[172] However,

168. Press Release, U.S. Dep't of Treas., *Treasury Department Releases Details on Public Private Partnership Investment Program* (Mar. 23, 2009), http://www.financialstability.gov/latest/tg65.html.

169. *Id.*

170. FIN. STABILITY OVERSIGHT BD., QUARTERLY REPORT, SECOND QUARTER 2009, *supra* note 152, at 44.

171. Andrew M. Cuomo, Atty. Gen. State of NY, *No Rhyme or Reason: The 'Heads I Win, Tails You Lose' Bank Bonus Culture*, July 30, 2009, at 6, *available at* http://www.oag.state.ny.us/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf [hereinafter *Cuomo Report*].

172. Opinion, *Commentary: TARP, One Year Later*, MORNING SUN, Oct. 7, 2009, http://www.themorningsun.com/articles/2009/10/07/opinion/srv0000006573114.prt (quoting Barofsky's testimony before the Senate Banking Committee); *see also* Brian Wingfield, *Birthday for a Bailout*, FORBES.COM, Oct. 2, 2009, http://www.forbes.com/2009/10/01/tarp-anniversary-bailout-business-washington-tarp.html ("Despite signs of recovery, the economy is by no means on stable footing. The FDIC now thinks U.S. bank failures will balloon to $100 billion in losses through 2013, rather than the previous estimate of $70 billion.").

without dealing with questionable MBSs remaining on their balance sheets, larger financial institutions reported record 2009 quarterly profits from new lending activities, while other, predominantly smaller, institutions were collapsing under the weight of their MBS holdings.[173]

In its quarterly report for the quarter ending June 30, 2009, the Financial Stability Oversight Board addressed the complexities of evaluating EESA programs, including reduced demand for credit due to weaker economic activity, reduced supply of credit because of the creditworthiness of borrowers, restrained lending in anticipation of future losses, and the impact of TARP repayments.[174] Only time will tell whether the trillions of dollars in capital infusions (under TARP and other federal programs and initiatives) will revitalize our financial industry and strengthen the economy, or whether the federal government continued throwing good money after bad with no resulting long-term economic growth and sustainability.

IV. Executive Compensation Excesses & the Financial Industry's Corporate Governance Failure: Enacted and Proposed Reforms & Their Limitations

A. *EESA, ARRA, Obama Administration Proposals & Congressional Legislation Aimed at Curbing Perceived Greed & Misdeed*

EESA served as the launching point for imposing temporary executive compensation and corporate governance restrictions on certain TARP recipients by focusing in on the roles of executive compensation and corporate governance in the financial crisis. EESA amends Internal Revenue Code ("Code") Sections 162(m) and 280G to limit the deductibility of compensation paid to certain executive officers employed by financial institutions that sell assets under TARP.[175] EESA also subjects certain financial institutions to executive compensation and corporate governance restrictions.[176]

173. *Commentary: TARP, One Year Later*, *supra* note 172. (quoting Barofsky: "[T]he so-called 'toxic' assets that helped cause this crisis for the most part remain right where they were [in the fall 2008] – on the banks' balance sheets; and it is becoming more and more clear that the commercial real estate market might be the next proverbial shoe to drop, threatening to increase the pressure on banks and small businesses alike yet again."); Pat Garofalo, *Geithner: TARP Repayment Means Toxic Asset Plan May Fizzle*, The Wonk Room, (June 2, 2009), http://wonkroom.thinkprogress.org/2009/06/02/geithner-ppip-fizzle/.

174. Fin. Stability Oversight Bd., Quarterly Report, Second Quarter 2009, *supra* note 152.

175. EESA, div. A, tit. III, § 302, 122 Stat. 3803-06.

176. *Id.* at div. A, tit. I, § 111, 122 Stat. 3776-77.

Code Section 162(m) generally restricts the deductibility of non-performance-based compensation for certain top corporate executives of publicly-traded corporations.[177] The compensation deduction for the CEO, as well as the next four most highly-compensated employees, is limited to $1 million per year unless compensation payments above that benchmark are performance-based and meet additional statutory requirements (including shareholder approval and compensation committee independence requirements).[178] Code Section 280G generally limits the deductibility of corporate executives' excess parachute payments and imposes a twenty percent excise tax on executives for the excess amount.[179] An "excess parachute payment," often referred to as a golden parachute payment, is defined as a payment made to certain individuals due to a change of control or ownership and exceeds three times their average annual compensation for the five years predating the event invoking the payment.[180]

EESA's two Code amendments temporarily reduce certain TARP recipients' deductions for executive compensation and expand the reach of the excess parachute payments restriction.[181] The EESA addition to 162(m) "generally reduces the $1 million deduction to $500,000 for [the TARP period] and provides that certain original exceptions to the deduction limitation, including the exception for performance-based compensation, are not applicable."[182] The reduction applies to public and private financial institutions that have sold more than $300 million in total assets to the Treasury under TARP (the nine largest TARP recipients noted earlier, as well as other financial institutions).[183] Affected employees include the financial institution's CEO, chief financial officer ("CFO"), and the three next highest-compensated officers. EESA's $500,000 limit is not retroactive; in other words, it does not apply to compensation due under pre-existing employment contracts. Code Section 280G(e), as added by EESA, generally retains the deductibility limitations for excess parachute payments but expands the trigger points to bankruptcy, liquidation, involuntary terminations of covered executives, or receivership of the employer corporation.[184]

177. I.R.C. § 162(m) (2009).

178. *Id.*; *see also* 26 C.F.R. § 1.162-27 (2004).

179. I.R.C. §§ 280G, 4999.

180. I.R.C. § 280G(b)(2).

181. EESA, div. A, tit. III, § 302, 122 Stat. 3803-06.

182. I.R.S. Notice 2008-94, 2008-44 I.R.B. 1070.

183. I.R.C. § 162(m) normally applies to only publicly-traded companies. EESA temporarily expands its reach to private financial institutions.

184. *See* Treas. Notice 2008-TAAP, Oct. 14, 2008, http://www.treas.gov/press/releases/2008101495019994.htm; *see also* U.S. DEP'T OF TREAS., The Latest, http://www.financialstability.gov/

EESA also employs the following executive compensation and corporate governance restrictions on TARP recipients during the period in which the Treasury holds an equity or debt position in the financial institution: (1) Limits on compensation that exclude incentives to SEOs to take unnecessary and excessive risks that threaten the value of the financial institution;[185] (2) recovery of any bonus or incentive compensation paid to SEOs based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate (the "clawback");[186] (3) a prohibition on making excess parachute payments to any SEO;[187] and (4) in the case of a financial institution that has sold to the Treasury more than $300 million in equity or debt, a prohibition from entering into any new employment contract with an SEO providing any exit compensation in the event of involuntary termination from employment, bankruptcy filing, insolvency, or receivership.[188]

The Treasury first addressed EESA's executive compensation and corporate governance restrictions in Treasury Notice 2008-PSSFI, published on October 14, 2008, and applicable to TARP recipients participating in the SSFIP (essentially AIG).[189] Under that guidance, the Treasury formulated the following rules to disincentivize unnecessary risk taking:

> (1) promptly, and in no case more than 90 days, after the purchase under the program, the financial institution's compensation committee, or a committee acting in a similar capacity, must review the SEO[190] incentive compensation arrangements with such financial institution's senior risk officers . . . to ensure that the SEO incentive compensation arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution; (2) thereafter,

latest/tg04.html (last visited Oct. 9, 2009).

185. EESA, *d*iv. A, tit. I, § 111(b)(2)(A), 122 Stat. 3777.

186. *Id.* div. A, tit. I, § 111(b)(2)(B); *see also* Interim Final Rule, Tarp Capital Purchase Program, 73 Fed. Reg. 62205-01, § 30.6 (Q-6)(Oct. 20, 2008), *available at* 2008 WL 4612833 (amended by Interim Final Rule, TARP standards for Compensation and Corporate Governance, 74 Fed. Reg. 28394-01(June 15, 2009) (codified at 31 C.F.R. § 30)) (requiring participating financial institutions to hold compensation for SEOs during the relevant time period subject to "clawback").

187. EESA, § 111(b)(2)(C), 122 Stat. 3777; *see also* Interim Final Rule, Tarp Capital Purchase Program, *supra* note 186, §§ 30.8, 30.9 (Q-8 and Q-9) (prohibiting participating companies from making "golden parachute" payments).

188. EESA, § 111(c), 122 Stat. 3777.

189. Treas. Notice 2008-PSSFI, at 1 (Oct. 4, 2008), http://www.treas.gov/press/releases/reports/exec%20comp%20pssfi%20notice%20revised.pdf.

190. "Senior executive officer" means a "named executive officer" as defined in Item 402 of Regulation S-k under federal securities laws and who meets certain other definitional requirements. *See id.* at 2.

> the compensation committee . . . must meet at least annually with senior risk officers . . . to discuss and review the relationship between the financial institution's risk management policies and practices and the SEO incentive compensation arrangements; and (3) the compensation committee . . . must certify that it has completed the reviews of the SEO incentive compensation arrangements required under (1) and (2) above.[191]

To meet EESA's clawback requirement, the Treasury notice requires that "SEO bonus and incentive compensation . . . are subject to recovery or 'clawback' by the financial institution if the payments were based on materially inaccurate financial statements *or any other materially inaccurate performance metric criteria*[,]" with the italicized language being considerably broader than EESA's statutory requirement (emphasis added).[192]

Following the Treasury's initial guidance, both the Treasury and Congress instituted additional temporary executive compensation and corporate governance restrictions.[193] The Treasury was the first to add requirements based, in large part, on the financial industry's perceived misuse of TARP funds. AIG, for example, used part of its bailout funds to repay debts owed through financial trades to other banking institutions, including $12.9 billion to Goldman Sachs, $11.9 billion to Societe Generale, $11.8 billion to Deutsche Bank, $8.5 billion to Barclays, $6.8 billion to Merrill Lynch, and $5.2 billion to Bank of America.[194] These payments led some to question whether the AIG bailout was in fact an AIG creditor bailout.[195] AIG then paid out $165 million in retention bonuses to executives at AIG FP, the division that engaged in the MBS transactions that brought AIG to the brink of disaster.[196] Finally, AIG spent over $440,000 for a week-long sales conference at a California resort (a relatively insignificant amount that generated significant adverse publicity).[197]

Reacting to reports that bailout funds were being used incorrectly,[198]

191. *Id.* at 3.

192. *Id.* at 5; *see also* Interim Final Rule, Tarp Capital Purchase Program, *supra* note 186 (providing additional guidance for certain TARP recipients under the CPP consistent with the prior guidance issued for financial institutions participating in the SSFIP).

193. Sheri Qualters, *Companies Seek to Alter Bonuses, Compensation*, NAT'L L.J., Mar. 2, 2009, at 6.

194. Saporito, *supra* note 138.

195. Tyler Cowen, Op-Ed., *Why Creditors Should Suffer, Too*, N.Y. TIMES, Apr. 5, 2009, at B1.

196. Saporito, *supra* note 138.

197. Kammer, *supra* note 43.

198. *See, e.g.*, Stevenson Jacobs, *Bailed-Out Execs Still Fly Corporate Jets*, THE HUFFINGTON POST, Dec. 21, 2008, http://www.huffingtonpost.com/2008/12/21/bailed-out-

on February 4, 2009, the Treasury announced additional conditions "designed to ensure that public funds are directed only toward the public interest in strengthening our economy . . . and not toward inappropriate private gain."[199] The heightened restrictions apply differently to financial institutions seeking "exceptional assistance" (like AIG and Bank of America) versus financial institutions participating in more limited, generally available capital access programs.[200] The new Treasury requirements do not apply retroactively to previously executed TARP contracts but instead to any future financing arrangements under TARP.[201]

Companies receiving exceptional assistance, like AIG, Bank of America and Citigroup, are subject to numerous additional restrictions. SEO cash compensation is limited to $500,000, as opposed to simply denying tax deductions above the $500,000 amount.[202] The only exception is for restricted stock awards that cannot vest until government bailout funds are repaid in full, plus interest.[203] Compensation structure and strategy must be fully disclosed and subject to a nonbinding "Say on Pay" shareholder resolution.[204] The "clawback" is extended from the top five SEOs to twenty additional executives "if they are found to have knowingly engaged in providing inaccurate information relating to financial

execs-still-fl_n_152727.html (detailing the use of private airplanes by executives of companies which had received TARP funds).

199. Press Release, U.S. Dep't of Treas., *Treasury Announces New Restrictions on Executive Compensation* (Feb. 4. 2009), http://www.treasury.gov/press/releases/tg15.htm; *see also* John Martini, *U.S. Department Of The Treasury Announces Further Executive Compensation Restrictions For Financial Institutions Participating In The TARP*, MONDAQ, Feb. 26, 2009, *available at* 2009 WLNR 3710580 ("According to Treasury and statements made by President Obama and Secretary Geithner, these conditions seek to strike a balance between 'the need for strict monitoring and accountability on executive pay' and the need for financial institutions to attract talented executives.").

200. *See* Press Release, *supra* note 199

> Generally available programs have the same terms for all recipients, with limits on the amount each institution may receive and specified returns for taxpayers. The goal of these programs is to help ensure the financial system as a whole can provide the credit necessary for recovery, including providing capital to smaller community banks that play a critical role in lending to small businesses, families and others. The previously announced Capital Purchase Program is an example of a generally available capital access program. If a firm needs more assistance than is allowed under a widely available standard program, then that is exceptional assistance. Banks falling under the 'exceptional assistance' standard have bank-specific negotiated agreements with Treasury. Examples include AIG, and the Bank of America and Citi transactions under the [TIP].

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.*

statements or *performance metrics* used to calculate their own incentive pay" (emphasis added).[205] The excess parachute payments restriction is expanded from the top five SEOs to the top ten senior officers and limited to no greater than one year's compensation, compared to the previous limit of three years' worth.[206] Finally, the board of directors is required to "adopt a company-wide policy on any expenditures related to aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events" (collectively, luxury expenditures).[207]

For institutions participating in most generally available capital asset programs, there were a few additional requirements—only the extended clawback and luxury expenditures provisions noted above are the same.[208] The expanded $500,000 compensation limitation does not apply where the company fully discloses its compensation structure and explains how it does not encourage excessive and unnecessary risk taking and there is a non-binding Say-on-Pay shareholder resolution.[209] The ban on excess parachute payments is not extended past the top five SEOs but adopts the one-year compensation limitation.[210]

Not satisfied with the Treasury's additional requirements,[211] Congress added executive compensation and corporate governance restrictions in ARRA, beefing up EESA and, for the first time, applying some of these restrictions retroactively to financial institutions that already received TARP funds.[212] First, TARP recipients generally may not pay bonuses, retention awards and incentive compensation to certain SEOs until corporate obligations are satisfied under TARP.[213] An exemption exists for long-term restricted stock awards that do not exceed in value one-third of an employee's annual compensation (a pittance for SEOs) and do not fully vest until the TARP period is concluded. Another exemption exists for

205. *Id.*
206. *Id.*
207. *Id.*
208. *Id.*
209. *Id.*
210. *Id.*
211. Deborah Solomon & Mark Maremont, *Bankers Face Strict New Pay Cap, Stimulus Bill Puts Retroactive Curb on Bailout Recipients, Wall Street Fumes*, WALL ST. J., Feb. 14, 2009 ("Sen. Dodd said in a statement that 'the decisions of certain Wall Street executives to enrich themselves at the expense of taxpayers have seriously undermined public confidence in efforts to stabilize the economy . . . . With vigorous oversight by the Treasury Department and by Congress, these tough new rules will help ensure that taxpayer dollars no longer effectively subsidize lavish Wall Street bonuses.'"); *see also* Joseph E. Bachelder III, *How Recovery Legislation Amends Executive Pay Limits*, N.Y. L.J., Apr. 14, 2009, at 3 (explaining the effect of the February, 2009 amendments to EESA).
212. ARRA, div. B, tit. VII, §7002, 123 Stat. 521 (2009).
213. Bachelder, *supra* note 211.

certain pre-existing employment contracts.[214] The number of executives per company subject to the restriction depends upon the amount of TARP assistance received, from only the most highly-paid employee for financial institutions that receive less than $25 million in TARP assistance to the SEOs and the next twenty most highly-paid employees for those receiving $500 million or more.[215] Second, ARRA requires the Treasury to review bonuses and incentive compensation to SEOs and the next twenty most highly-paid employees paid before February 18, 2009 (the effective date of ARRA).[216] If the Treasury finds that the bonuses were not justified, it is empowered to negotiate with TARP recipients and/or executives to obtain compensation reimbursements (perhaps publicly shaming them into repayments).[217] Third, ARRA prohibits excess parachute payments, as defined under EESA, to any SEO and the next five most highly-compensated employees, regardless of the amount of TARP assistance received.[218] This provision is much more restrictive than EESA's original restriction. For example, AARA does not contain a grandfather provision to address pre-existing contractual agreements.[219] Fourth, ARRA mandates that all TARP recipients "permit a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the [SEC]," during the period in which any obligation arising from financial assistance provided under TARP remains outstanding.[220] Under SEC guidance, the shareholder vote would occur at the annual meeting of shareholders for which proxies are solicited.[221] Fifth, ARRA requires the establishment of a board compensation committee that is comprised exclusively of independent directors.[222] The Committee must meet at least semiannually to evaluate employee compensation plans in light of any risk posed to the company. Finally, similar to a parallel

214. ARRA, div. B, tit. VII, § 7001, 123 Stat. 516 (2009) (exempting written contracts for incentive compensation executed on or before February 11, 2009, subject to the authority of the Treasury Secretary to determine the validity of the contract).

215. *Id.*

216. *Id.*

217. *Id.*; *see also* Bachelder, *supra* note 211.

218. *Id.*

219. Thomas W. White, Gail C. Bernstein & David A. Lugis, *Economic Stimulus Act Establishes New Executive Compensation and Governance Standards for TARP Recipients*, Email Alerts (WilmerHale, Washington, D.C.), Feb. 18, 2009, http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=8790.

220. ARRA, div. B, tit. VII, § 7001, 116 Stat. 516. This provision applies to proxy statements filed after February 17, 2009, other than definitive proxy statements relating to preliminary proxy statements filed on or before February 17, 2009.

221. U.S. Sec. & Exch. Comm'n, American Recovery and Reinvestment Act of 2009 (2009), http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm.

222. ARRA, div. B, tit. VII, § 7001 (exempting companies receiving less than $25 million of TARP funding).

requirement under EESA,[223] ARRA requires that TARP recipient CEOs and CFOs provide written certification of compliance by the company with all ARRA requirements.[224]

With the legislation set in place, over the next several months, the Obama administration and the Treasury took actions to implement EESA and ARRA's requirements and develop a plan to regulate the financial industry. In early June 2009, President Obama appointed Kenneth Feinberg as the Special Master in charge of overseeing compensation practices for TARP recipients receiving exceptional assistance.[225] On June 15, 2009, the Treasury issued its Interim Final Rule on TARP Standards for Compensation and Corporate Governance.[226] The rule "implements and expands upon Title VII of ARRA, which amended the EESA executive compensation provisions."[227] In addition to reiterating and implementing the standards established under ARRA, the rule outlines the powers and responsibilities of Special Master Feinberg as they relate to financial institutions that received exceptional assistance: review of compensation payments made to the top five SEOs and the next twenty most highly-compensated employees of TARP recipients, review of compensation structures for all executive officers and the 100 most highly-compensated employees, power to interpret EESA and the Interim Final Rule and the review of bonuses paid before ARRA's effective date, and the power to negotiate repayments if payments were contrary to public interests.[228]

223. EESA, div. A, tit. I, § 111, 122 Stat 3776-77.

224. ARRA, div. B, title VII, § 7001, 116 Stat. 516. In the case of a TARP recipient whose securities are publicly traded, the certification must be provided to the SEC, together with annual filings required under the securities laws. For non-public companies, the certification must be filed with the Treasury. *See also* Bachelder, *supra* note 211, at 9. *But see Dodd Letter to SEC Details Effective Dates of "Say on Pay" and Compliance Certification*, CCH FIN. CRISIS NEWS CTR., Feb. 23, 2009, at ¶ 6, http://www.financialcrisisupdate.com/2009/02/dodd-letter-to-sec-details-effective-dates-of-Say-on-Pay-and-compliance-certification.html ("Senator Dodd said that, because the certification requirement relates to compliance with executive compensation and corporate governance standards that Treasury has yet to establish, this requirement has not become effective. Thus, CEOs and CFOs need not certify as to their company's compliance until the standards have been established.").

225. Brady Dennis, *Pay Package for AIG Chief to Be Approved, Compensation Czar to Back $10.5 Million*, WASH. POST, Oct. 2, 2009, at A16 ("Feinberg, who was named czar in June, has sole discretion to set compensation for the five top senior executives plus the 20 highest-paid people after them at each of seven bailed-out companies – AIG, Citigroup, Bank of America, General Motors, Chrysler, Chrysler Financial and GMAC. Under the administration's initiative to curb excessive pay, each company also must receive his approval for how it pays the rest of its 100 most highly compensated employees."); Deborah Solomon, *White House Set to Appoint a Pay Czar*, WALL ST. J., June 5, 2009, at A2.

226. FIN. STABILITY OVERSIGHT BD., QUARTERLY REPORT, SECOND QUARTER 2009, *supra*, note 152, at 50.

227. *Id.*

228. U.S. Dep't of Treas., Special Master for Executive Compensation,

On June 17, 2009, the Obama administration released its permanent financial regulatory reform plan ("Reform Plan"),[229] which lays out its comprehensive plan to reform the financial industry, including future regulatory and legislative initiatives that regulate key financial industry players, such as the credit rating agencies, and the creation of a consumer protection agency.[230] Further, the Reform Plan calls for the Treasury and HUD to develop recommendations on the future structure and viability of Fannie Mae and Freddie Mac.[231]

The Reform Plan contains several initiatives that affect executive compensation and corporate governance standards. Under the auspice of strengthening capital and other prudential standards for all banks and bank holding companies, the plan directs federal regulators to "issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions."[232]

As part of its regulatory efforts, the Reform Plan calls for increasing SEC disclosure requirements regarding executive compensation.[233] In the past, the SEC carved out an exemption to its detailed executive compensation disclosure requirements if publishing the data would put a corporation at a competitive disadvantage in its industry.[234] Corporations generally interpreted this as justification for not reporting short-term performance-based goals, which essentially provided them with further motivation to structure executive compensation based on short-term performance.[235] While the Reform Plan's SEC disclosure directive lacks specificity, increased requirements may include revoking this exemption for financial firms and requiring the reporting of all performance-related

http://www.financialstability.gov/about/spcMaster.html (last visited Oct. 7, 2009).

229. U.S. Dep't of Treas., Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter Reform Plan]; Press Release, U.S. Dep't of Treas., *President Obama To Announce Comprehensive Plan For Regulatory Reform* (June 17, 2009), http://www.financialstability.gov/latest/tg_06172009.html.

230. Reform Plan, *supra* note 229 at 46, 55.

231. *Id.* at 41.

232. *Id.* at 11 (emphasis omitted); *see also id.* at 13 ("Strengthen Supervision and Regulation of Securitization Markets[:]…Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans." (emphasis omitted)).

233. *Id.* at 30.

234. *See* Gretchen Morgenson, *If the Pay Fix Is In, Good Luck Finding It*, N.Y. Times, Sept. 7, 2008, at B1, B7 (describing a perceived "loophole" in the disclosure requirement).

235. *See id.* (detailing low participation: in 2007, 62 percent of companies disclosed long-term incentive pay but only 47 percent of companies disclosed short-term incentive pay).

goals and benchmarks.

As a backstop to executive compensation and corporate governance regulatory efforts, the plan supports legislation in two areas "to increase transparency and accountability in setting executive compensation."[236] First, the plan indicates the Obama administration's willingness to "support legislation requiring *all public companies* to hold non-binding shareholder resolutions on the compensation packages of [SEOs]" (emphasis added).[237] And second, it proposes legislation "giving the SEC the power to require that [financial industry] compensation committees are more independent" and giving the SEC the power to adopt an expansive independence standard.[238]

The Obama administration's support for non-binding Say-on-Pay shareholder resolutions is long-standing. In 2007, the Shareholder Vote on Executive Compensation Act passed the House of Representatives and then-Senator Obama sponsored the bill in the Senate before it died in committee.[239] In February 2009, following Obama administration

236. Reform Plan, *supra* note 229, at 30.

237. *Id.* at 11, 73:

> Public companies should be required to implement "say on pay" rules, which require shareholder votes on executive compensation packages. While such votes are nonbinding, they provide a strong message to management and boards and serve to support a culture of performance, transparency, and accountability in executive compensation. Shareholders are often concerned about large corporate bonus plans in situations in which they, as the company's owners, have experienced losses. Currently, these decisions are often not directly reviewed by shareholders – leaving shareholders with limited rights to voice their concerns about compensation through an advisory vote. To facilitate greater communication between shareholders and management over executive compensation, public companies should include on their proxies a nonbinding shareholder vote on executive compensation. Legislation that would authorize SEC "say on pay" rules for all public companies could help restore investor trust by promoting increased shareholder participation and increasing accountability of board members and corporate management. It would provide shareholders of all public U.S. companies with the same rights that are accorded to shareholders in many other countries."

238. *Id.* at 30 ("Under this legislation, compensation committees would be given the responsibility and the resources to hire their own independent compensation consultants and outside counsel. The legislation would also direct the SEC to create standards for ensuring the independence of compensation consultants, providing shareholders with the confidence that the compensation committee is receiving objective, expert advice.").

239. H.R. Comm. on Fin. Serv., Executive Compensation, http://www.house.gov/financialservices/ExecutiveCompensation.html (last visited Oct. 7, 2009); The Libr. of Cong., Thomas Bill Summary and Status – S.1181, http://thomas.loc.gov/cgi-bin/bdquery/z?d110:SN01181:|/bss/110search.html (last visited Oct. 7, 2009) (last major action by Senate: referred to Senate committee); Govtrack.us, H.R. 1257: Shareholder Vote on Executive Compensation Act,

directives, SEC Chairwoman Mary Schapiro named Kayla Gillen as senior advisor responsible for spearheading projects on proxy access and Say-on-Pay shareholder resolutions.[240] The practice became temporarily mandatory for certain TARP recipients under Treasury guidance issued under EESA and then under ARRA statutory requirements. Further, the Obama administration is well aware of support for this practice by corporate governance groups and institutional investors, with their efforts producing Say-on-Pay proposals at over 100 companies in 2009.[241]

The support for legislation authorizing the SEC to enact compensation committee independence requirements is based on several factors. First, the Obama administration is well aware of compensation committee conflict of interest issues. For example, in 2006, the Congressional Committee on Oversight and Government Reform investigated the independence of compensation consultants at the 250 largest publicly-traded companies from 2002 to 2006.[242] Its report includes findings that the use of conflicted consultants is pervasive (113 of the Fortune 250 companies used conflicted consultants), and that the use of conflicted consultants resulted in executive pay increases two times faster than cases where independent consultants are used.[243] Second, support for this legislation is likely based, in part, on past, albeit broader, failed congressional legislation. In 2008, the Corporate Executive Compensation Accountability and Transparency Act,[244] introduced by then-Senator Hillary Clinton, would have required the SEC to establish specific disclosure requirements that define "independence" for purposes of public companies and their compensation consultants.[245] Third, support for this legislation is based on concerns about the SEC's potential lack of authority to promulgate general corporate governance standards outside of disclosure

http://govtrack.us/congress/bill.xpd?bill=h110-1257 (last visited Oct. 7, 2009).

240. *Say on Pay Rising on SEC Agenda*, CTR. ON EXEC. COMP., Feb. 20, 2009, http://www.execcomp.org/news/news-story.aspx?ID=470.

241. PR Newswire, *Socially Responsible Investors, Labor, Pension Funds Weigh In: 14 Bank Bailout Recipients Facing Say-on-Pay Resolutions Should Commit Now to Adopt Policy*, AJAXWORLD, Feb. 24, 2009, http://ca.sys-con.com/node/853049; Hastings Group, Among the Companies Receiving "Say on Pay" Shareholder Proposals in 2009, http://hastingsgroup.com/SOP2009.pdf (last visited Oct. 7, 2009).

242. MAJORITY STAFF OF H.R. COMM. ON OVERSIGHT AND GOVT. REFORM, 110TH CONG., EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS, i (Comm. Print 2007), *available at* http://oversight.house.gov/documents/20071205100928.pdf.

243. *See id.* at i, ii; Linda Rappaport, *Hot Issues In Executive Compensation and Corporate Governance*, 1710 PLI/CORP 717, 724 (2009).

244. S. 2866, 110th Cong. (2008).

245. Broc Romanek & Dave Lynn, *Senator Clinton's New Executive Compensation Bill*, THECORPORATECOUNSEL.NET, May 13, 2008, http://www.thecorporatecounsel.net/blog/archive/001797.html.

areas absent a statutory mandate.[246] Publicly-traded corporations generally adopt corporate governance standards that are mandated by the SROs or have become well-established, good corporate governance standards in the industry. Absent a statutory mandate, the SEC has rarely stepped into the role of developing corporate governance standards.

As this article goes to print, Special Master Feinberg, the Treasury and the SEC (among other regulatory agencies) are adopting new executive compensation limitations, corporate governance restrictions and disclosure requirements related to executive compensation. For example, in October 2009, Special Master Feinberg released his first ruling on compensation, applicable to the then remaining seven firms that received exceptional assistance under TARP (AIG, Citigroup, Bank of America, Chrysler, GM, GMAC, and Chrysler Financial).[247] The ruling includes restrictions on cash compensation bonuses, limits base salaries to $500,000 or less for more than ninety percent of the recipients' employees, and ties the vast majority of total compensation to restricted company stock.[248] It is clear from this flurry of activity that executive compensation will remain the centerpiece of the Obama administration's Reform Plan.

B. The Limitations of EESA & ARRA's Temporary Restrictions & the Obama Administration's Proposed Permanent Federalization of Executive Compensation & Corporate Governance Standards

EESA and ARRA's temporary restrictions on executive compensation and corporate governance were not designed to address the major root causes of the systemic failure of the financial industry, have had little impact on the way the financial industry conducts its business, and should not serve as a template for the Obama administration's federalization of executive compensation and corporate governance requirements. Further, the Obama administration Reform Plan's executive compensation and corporate governance standards fall short of changing corporate America's focus on the short-term. There are numerous reasons for the aforementioned conclusions.

First, with respect to TARP's oversight of recipients' financial

246. *See* Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 1013 (2004) ("[T]he SEC's power to promulgate corporate governance standards outside the realm of those mandated by federal law is uncertain.").

247. Press Release, U.S. Dep't of Treas., *The Special Master for TARP Executive Compensation Issues First Rulings* (updated Oct. 22, 2009), *available at* http://www.financialstability.gov/latest/tg_102220009e.html.

248. *Id.*

activities, many of the financial institutions that received TARP funds have repaid or are in the process of repaying TARP funds before the end of the TARP period.[249] As of August 1, 2009, ten large financial institutions and numerous smaller institutions had paid back TARP funds.[250] The early repayment is problematic because it removes financial institutions from federal government scrutiny without necessarily ensuring that the institutions have dealt with the underlying problem of selling or renegotiating their toxic MBSs or MBS guarantees.[251]

Theoretically, the Obama administration Reform Plan's regulation of the financial industry could replace TARP's temporary oversight and ensure financial viability and sustainability by setting strict standards, such as industry debt-to-asset ratio requirements. While regulation of the financial and other related industries is prominently featured in the Obama administration's Reform Plan, the vast majority of regulatory and legislative efforts to date address executive compensation and corporate governance standards related to executive compensation. This approach is problematic. It fails to acknowledge the impact of over twenty-five years of financial industry deregulation and the importance of reenacting

249. Originally, under EESA and Treasury requirements, TARP recipients participating in programs such as the CPP could not repay funds until the end of the TARP period, providing the federal government with extensive oversight. To ameliorate ARRA's heightened restrictions, Treasury guidance allows certain TARP recipients to repay funds early if the recipients can demonstrate to their respective primary regulator (e.g., the Federal Reserve, FDIC, or Office of the Comptroller of the Currency) that they are otherwise well-capitalized. *See* U.S. Dep't of Treas., *FAQs Addressing Capital Purchase Program (CPP) Changes Under the American Recovery and Reinvestment Act of 2009* (Feb. 26, 2009), http://www.financialstability.gov/docs/CPP/CPP-FAQs.pdf (answering frequently asked questions about redeeming CPP assets); *see also* Eric Dash, *Four Banks Are the First to Pay Back Aid Money*, N.Y. TIMES, Apr. 1, 2009, at B3 (describing four banks' attempts to escape regulation); Matt Jaffe, *Goldman Sachs and Other Banks Feel the Heat to Pay Back Bailout Billions*, ABC NEWS, Apr. 15, 2009, http://abcnews.go.com/Business/Politics/Story?id=7337061&page=1 (noting the competitive pressure on banks to be quick to repay TARP money); Joseph A. Giannone & Mark Felsenthal, *Banks Line Up to Throw Off TARP Yoke*, REUTERS, May 20, 2009, http://www.reuters.com/article/newsOne/idUSN1942182920090520 (detailing the Treasury's attempts to accommodate bankers' repayment efforts); Garofalo, *supra*, note 173 (questioning the prudence of the Treasury's decision to permit repayment).

250. *See* FIN. STABILITY OVERSIGHT BD., QUARTERLY REPORT, SECOND QUARTER 2009, *supra* note 152, at 4 ("[A]s of June 30, 2009, 32 institutions had repaid approximately $70 billion in principal under the CPP, of which more than $68 billion was received from the 10 largest financial institutions participating in the CPP."); Ronald D. Orol, *Geithner: We Do Not Plan to Ask For More Bank Bailout Money*, MARKETWATCH, Aug. 3, 2009, http://marketwatch.com/story/geithner-we-wont-ask-for-more-bailout-funds-2009-08-03 ("So far, a group of 10 large financial [sic], as well as a number of smaller banks, have paid back TARP funds, bringing the [TARP] fund's assets to roughly $130 billion, up from $40 billion the Treasury had available in the program in April.").

251. *See* Garofalo, *supra* note 173 (quoting Treasury Secretary Tim Geithner's concern about a toxic-asset market fizzle).

historical protections and limitations. Instead, it overemphasizes the role of executive compensation in the financial crisis. To the extent that compensation contributed to increasingly riskier investment activities, executive compensation was only a small contributing factor. Everyone from rank-and-file local loan officers at commercial banks to financial industry CEOs and GSE executives had a stake in originating and securitizing prime and subprime mortgages, with each party along the way generating fees for their respective companies and incentive-based compensation for executives, highly-compensated employees, and rank-and-file employees. Restricting executive compensation only addresses the tip of the iceberg. Moreover, the Reform Plan does not include overall restrictions on the level of compensation or how compensation must be structured. It contains a directive to federal regulators to "issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions." [252] The directive is problematic because numerous regulators will use these ambiguous, inspirational standards to establish different requirements to evaluate financial industry compensation practices, without necessarily addressing long-term versus short-term compensation design.

Second, TARP's temporary restrictions on SEO compensation failed to alter corporate governance short-term compensation practices, as evidenced by recent compensation projections and payments to highly-compensated employees who are not subject to EESA and ARRA restrictions. For example, based on profits that do not adequately reflect TARP obligations or balance sheet toxic assets, the largest investment banks were back directing billions to employee compensation within months of EESA's enactment. In the first quarter of 2009, Goldman Sachs set aside $4.7 billion for workers based on short-term performance benchmarks.[253] By July 2009, Goldman Sachs had "set aside $6.65 billion for salary, bonuses and benefits, putting the average Goldman employee on pace to earn more than $900,000" in 2009.[254] At the end of July 2009, New

252. REFORM PLAN, *supra* note 229, at 11; *see also id.* at 13 ("Strengthen[ing] Supervision and Regulation of Securitization Markets[:] . . . Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.").

253. *See* Louise Story, *After Off Year, Wall Street Pay Is Bouncing Back*, N.Y. TIMES, Apr. 26, 2009, at A1 ("Workers at the largest financial institutions are on track to earn as much money this year as they did before the financial crisis began, because of the strong start of the year for bank profits.").

254. Kevin Drawbaugh, *Congress Gets Pay Bill as Bank Bonuses Swell*, REUTERS, July 16, 2009, http://www.reuters.com/article/politicsNews/idUSTRE56F7CD20090716; *see also* Matt Taibbi, *The Real Price of Goldman's Giganto-Profits*, TRUE/SLANT, July 18,

York Attorney General Andrew Cuomo issued a report including data revealing that the first nine banks to receive bailout funds dished out nearly $33 billion in bonuses in 2008, with nearly 4,800 employees taking home bonuses over $1 million.[255] One of the more egregious examples is Citigroup, which paid 738 employees a minimum $1 million bonus at a time when the financial institution had lost $27.7 billion and had received $45 billion in TARP loans.[256] Given the financial industry's continuing short-term compensation practices, placing permanent limits on executive compensation will not change the underlying problem of structuring compensation based on short-term corporate profitability.

Third, the TARP clawback did little to solve the financial industry balance-sheet problem or recoup ill-gotten gains.[257] Clawbacks are inherently ineffective. For example, the Sarbanes-Oxley Act of 2002 ("SOX")[258] includes a clawback provision under which CEOs or CFOs will, under certain circumstances, forfeit past incentive or equity-based compensation where financial statements contain material misstatements or omissions that lead to future corporate earnings restatements.[259] SOX's clawback provision has been of little practical use. It is only enforceable by the SEC and does not provide for a corporation's or its shareholders' maintenance of a private cause of action.[260] Its application is limited to a

2009, http://trueslant.com/matttaibbi/2009/07/16/on-goldmans-giganto-profits ("So what's wrong with Goldman posting $3.44 billion in second-quarter profits, what's wrong with the company so far earmarking $11.4 billion in compensation for its employees? What's wrong is that this is not free-market earnings but an almost pure state subsidy.").

255. CUOMO REPORT, *supra* note 171, at 5; *see also* Editorial, *Banks Should Pay for Performance*, THE MIAMI HERALD, Aug. 9, 2009, at L4 (summarizing portions of the Cuomo Report's findings).

256. CUOMO REPORT, *supra* note 171, at 5; *see also* Daniel Carty, *Wall St. Salaries on Record-Setting Pace*, CBSNEWS, Oct. 14, 2009, http://www.cbsnews.com/blogs/2009/10/14/business/econwatch/entry5383886.shtml ("Twenty-three major U.S. banks and investment firms are on a pace to dole out $140 billion in compensation this year, exceeding the pre-crisis levels of 2007, according to a Wall Street Journal report.").

257. Note, however, that a corporation's voluntary adoption of a clawback policy may set a tone for good corporate governance. *See* Pitofsky & Tulchin, *supra* note 46 ("During the 2008 proxy season, almost 300 companies adopted some form of claw-back provision, a stark contrast to four years ago, when only 14 of the world's major corporations had such policies in place.").

258. Pub. L. No. 107-204, 116 Stat. 745 (codified as 15 U.S.C. §§ 7201-66 and scattered sections of 15 U.S.C.).

259. *Id.* at § 304, 116 Stat. 778 (stating that the provision applies only to restatements that result from material noncompliance with a financial reporting requirement and from misconduct).

260. *See, e.g.*, *In re* BISYS Group Inc., 396 F.Supp.2d 463, 464 (S.D.N.Y. 2005) (finding no private right of action); Kogan v. Robinson, 432 F.Supp.2d 1075, 1078 (S.D. Cal. 2006) (finding no private right of action); Neer v. Pelino, 389 F.Supp.2d 648, 652 (E.D. Pa. 2005) (finding no private right of action).

corporation's CEO or CFO. It fails to define what constitutes "misconduct," which in effect renders the disgorgement provision ineffective absent a criminal conviction.[261] Finally, it only applies where an accounting restatement is filed.[262] Within these limitations, the SEC has only been successful in one clawback case, and it involved a stock-option backdating scandal.[263]

EESA's and ARRA's temporary clawbacks may provide a little more relief than SOX's clawback, as the former apply to executives beyond the CEO and CFO, are not triggered exclusively by an accounting restatement, and apply to inaccuracies relating to other *performance metrics* (according to the Treasury's expansive interpretation).[264] However, the Treasury's recovery under EESA and ARRA's clawback is still difficult, at best.[265] It generally applies only to the top five SEOs, and is only extended to twenty additional executives where they engage in "material inaccuracies relating to other performance metrics used to award bonuses and incentive compensation" to calculate their own pay.[266] Further, disgorging ill-gotten gains is nearly impossible as funds are often dissipated prior to the commencement of a disgorgement action. Moreover, even a complete recovery of performance-based compensation will pale in comparison to multi-billion dollar corporate losses.[267] A permanent clawback provision would suffer from the same frailties.

Fourth, other TARP restrictions failed to provide additional, meaningful corporate governance standards. ARRA's compensation committee "independent director requirement" is not materially different

261. *See* Phred Dvorak & Serena Ng, *Check Please: Reclaiming Pay From Executives Is Tough to Do*, WALL ST. J., Nov. 20, 2006, at A1 (noting various companies' largely unsuccessful attempts to use the civil system to recoup bonus money).

262. *See* SEC v. Shanahan, 624 F.Supp.2d 1072, 1078 (E.D. Mo. 2008) (holding that the discovery of accounting discrepancies was insufficient and that an actual financial restatement was required prior to the SEC seeking clawback remedies under SOX § 304).

263. *See* United Health Group CEO/Chairman Settles Stock Options Backdating Case, Sarbanes-Oxley Act Release No. 20387, 92 SEC Docket 350 (Dec. 6, 2007) (reporting that UnitedHealth Group CEO William McGuire agreed to a $468 million settlement that included a $7 million civil penalty and reimbursement to the company for incentive and equity-based compensation); *see also* Complaint for Injunctive and Other Relief, SEC v. Brooks, No. 07-61526 (S.D. Fla. Oct. 25, 2007), 2007 WL 3323346 (seeking disgorgement in case involving misappropriation of company funds and alleged manipulation of profit margins).

264. Press Release, U.S. Dep't of Treasury, *supra* note 189, at 5.

265. McClendon, *supra* note 246, at 975; PATRICK J. PURCELL, THE ENRON BANKRUPTCY AND EMPLOYER STOCK IN RETIREMENT PLANS, CRS REPORT FOR CONG., at CRS-1, *available at* http://www.fpc.state.gov/documents/organization/9102.pdf.

266. Press Release, U.S. Dep't of Treasury, *supra* note 189, at 5.

267. *See* TOWERS PERRIN, CLAWBACKS—SOUND IDEA OR SOUND BITE?, http://www.towersperrin.com/tp/getwebcachedoc?webc=GBR/2008/200811/03Perspectives Clawback.pdf (discussing limited recovery under SOX clawback).

than standards already imposed by SROs, such as the NYSE and the NASDAQ.[268] With EESA, ARRA, and Treasury terms, such as "unnecessary and excessive risks," left undefined, compensation committees retain significant discretion regarding their analysis of current and future incentives and whether SEO incentives or actions promote excessive risk-taking.

The Obama administration's Reform Plan may be following that same murky path. The Reform Plan's directive to federal regulators to "issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions" is ambiguous and, potentially, unworkable.[269]

And fifth, neither the temporary restrictions nor the Obama administration's Reform Plan addresses some of the executive compensation and corporate governance problems highlighted by corporate America's love affair with short-term performance-based compensation. For example, other than the "Say-on-Pay" shareholder resolution proposed legislation, the plan's application is generally limited to financial industry players.[270] In the last decade, Americans have lost billions of dollars related to the payment of millions in short-term, mostly equity-based executive compensation and corporate governance failures in other industries, including the energy industry (Enron Corporation).[271] These experiences have demonstrated that systemic reform is needed in the executive compensation and corporate governance areas for all publicly-traded corporations.

---

268. *See* NYSE, INC., LISTED COMPANY MANUAL § 303A.05(a), http://nysemanual.nyse.com/LCM/Sections/ (follow "Section 3" hyperlink) ("Listed companies must have a compensation committee composed entirely of independent directors."); NASDAQ, INC., EQUITY RULES § 5605(d) (2009), http://nasdaq.cchwallstreet.com/ (follow "Rule 5000" hyperlink) ("Compensation of the chief executive officer of the Company must be determined, or recommended to the Board for determination, either by: (A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate; or (B) a compensation committee comprised solely of Independent Directors.").

269. Reform Plan, *supra* note 229, at 11; *see also id.* at 13 ("Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.").

270. Reform Plan, *supra* note 229, at 3-4.

271. TYSON SLOCUM, BLIND FAITH: HOW DEREGULATION AND ENRON'S INFLUENCE OVER GOVERNMENT LOOTED BILLIONS FROM AMERICANS 3 (2001), http://www.citizen.org/documents/Blind_Faith.pdf.

V. CONCLUSIONS & RECOMMENDATIONS

As noted in Part II, executive compensation was not the major catalyst for the financial crisis. Instead, a virtually nonexistent federal regulatory structure, eviscerated state control, federal government encouragement, and pre-2006 record low interest rates and record high home values were the main factors underlying the financial industry crisis. Most of these factors can be addressed by re-regulation of the financial industry and related industries, such as the credit rating agencies. The re-regulation template is already in place—the Obama Administration's Reform Plan and its requested regulatory and legislative actions could provide the framework that reigns in aggressive speculation by the financial industry and protects global financial markets.

While the author of this article does not see multi-million dollar compensation packages as inherently bad for corporate long-term productivity, she feels the opposite about short-term incentive-based compensation for executives and other highly-compensated employees. The latter has been a major catalyst in the financial crisis and various other corporate catastrophes over the last decade.[272] The directive of the Obama administration's Reform Plan to federal regulators to develop compensation standards does not go far enough in addressing this problem. Case in point, Special Master Feinberg's compensation limitations on the top seven financial institution TARP recipients require the companies to pay the vast majority of total compensation in company stock that can be sold in one-third increments after a two-year holding period, a minimum service requirement, and following TARP repayment obligations.[273] The continuing emphasis on equity-based compensation divorced from long-term holding requirements does little to change corporate pay practices already adopted by corporate America, align long-term interests of shareholders and management, or ensure corporate long-term productivity.

Federal regulation, Code amendments, and additional listing standards by the SROs can fill the gap and help solve corporate "short-termism" and corporate governance problems. Below is a list of a few additional reforms that will promote corporate long-term productivity and sustainability by reigning in short-term incentive-based compensation for key industry players and increasing board productivity. Other than federal standards adopted for critical industries, like the financial industry, the focus should be placed on Code amendments and the SROs enacting systemic reforms through the implementation of additional listing standards.[274]

272. McClendon, *supra* note 246.
273. Press Release, *supra* note 247.
274. McClendon, *supra* note 246, at 1013:

Consistent with the Joint Committee on Taxation's prior recommendations,[275] Congress needs to repeal Code Section 162(m). Code Section 162(m) has been a disaster since its enactment. To combat the growing disparity between executive and rank-and-file workers' pay, in 1993, Congress enacted Code Section 162(m)'s $1 million limitation on non-performance-based compensation for top executives at publicly-traded corporations.[276] Instead of reigning in executive pay, Code Section 162(m) had two deleterious effects. First, the limitation encouraged corporate America's adoption of short-term equity-based compensation at the expense of long-term corporate productivity.[277] Second, the redesigned compensation agreements led to a larger disparity between CEO and rank-and-file worker pay, with CEOs and other SEOs receiving millions in equity-based compensation.[278] CEO compensation is reportedly now more than 400 times the pay of rank-and-file workers.[279] Repealing Code Section 162(m) is a first step towards promoting long-term corporate

> There are at least three reasons why the SROs are better-suited to enact these types of reforms through the implementation of additional listing standards. First, government regulation, albeit through legislative or regulatory changes, is less flexible and ill-suited to responding to market changes. Second, the SEC's power to promulgate corporate governance standards outside the realm of those mandated by federal law is uncertain. Third, the SROs possess the expertise and legitimacy to adopt additional corporate governance listing standards, with the SROs historically serving as an indirect federal regulation in that realm.

275. Joint Comm. on Tax'n, 108th Cong., 1 Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, at 43 (2003) ("The Joint Committee staff recommends that the [Code Section 162(m)] limitation be repealed, and that any concerns regarding the amount and types of compensation be addressed through laws other than the Federal income tax laws.").

276. I.R.C. § 162(m) (2006) (limiting the top five highly paid employees, including the CEO and the CFO); *see The SEC and the Issue of Runaway Executive Pay: Hearing Before the S. Subcomm. on Oversight of Gov't Mgmt. of the S. Comm. on Governmental Affairs*, 102d Cong. 1 (1991) (opening statement of Sen. Carl Levin, Chairman of Subcommittee) (explaining the policy behind the Code amendment).

277. Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem* 17 (Nat'l Bureau of Econ. Research, Working Paper No. 9813, 2003), *available at* http://www.nber.org/papers/w9813; *see also* McClendon, *supra* note 246, at 994-99 (noting that the internal design of equity-based compensation promotes corporate short-termism).

278. Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 15.3 J. OF APPLIED CORP. FIN. 21, 24 (2004), *available at* http://ssrn.com/abstract=42417orDOI:10.2139/ssm; KEVIN F. HALLOCK & JUDIT TOROK, TOP EXECUTIVE COMPENSATION IN 2008 (2008), *available at* http://www.conference-board.org/publications/describe.cfm?id=1583.

279. Eve Tahmincioglu, *Can Wild CEO Pay Be Tamed? Probably Not*, MSNBC, Oct. 1, 2008, http://www.msnbc.msn.com/id/26963309/print/1/displaymode/1098; *see also* Carl Levin, *Pay Gap Between CEOs and Workers Now a Chasm*, STATE NEWS SERV., June 8, 2007, http://levin.senate.gov/newsroom/release.cfm?id=275778 ("[T]oday, the average CEO is paid nearly 400 times as much as the average worker.").

productivity.

The SROs can adopt several new listing standards that strengthen board accountability and link executive compensation to long-term performance. The SROs can adopt listing standards that mandate all board members and corporate executives maintain equity positions in the institution and thereby align board members' and executives' interests with shareholders' interests and long-term corporate productivity.[280] The SROs can also accomplish this through the enactment of additional listing standards for boards' compensation committees. SRO listing standards can mandate the use of targets for long-term productivity, where corporations are making decisions on the probability of reaching targets and whether incentives encourage acceptable risk for the corporation as a whole.[281] Further, these standards could limit reliance on equity-based compensation. For example, in a 2003 study, a commission of the National Association of Corporate Directors recommended that publicly-held companies use both qualitative and quantitative measures in compensating executives for performance, and decrease reliance on stock price as a performance measure.[282] The additional listing standards can also restrict the sale or exchange of equity-based compensation during employees' term of employment, until attainment of a certain age, or following a significant holding period, and thus discourage corporate "short-termism."[283]

280. Levin, *supra* note 279.

281. John W. White, Dir., Div. of Corp. Fin., SEC, Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009 (Oct. 21, 2008), http://www.sec.gov/news/speech/2008/spch102108jww.htm.

282. ANNALISA BARRETT & PAULA TODD, NACD BLUE RIBBON COMMISSION REPORT ON EXECUTIVE COMPENSATION AND THE ROLE OF THE COMPENSATION COMMITTEE (2003), http://www.directorsforum.com/resources/related_articles/NACD_BRC_Report.pdf.

283. McClendon, *supra* note 246, at 1030-31:

> To combat insider 'gaming,' a term adopted by Professor Hall in describing executives' ability to manipulate stock prices to their own advantage, additional listing standards can also mandate longer vesting periods, holding requirements, and specific exercise dates for all stock option grants. Currently, stock option grants are generally exercisable within two to four years following the grant date, do not include mandatory holding requirements following the exercise date, and stock acquired at exercise is immediately saleable on the open market. The lack of timing restrictions provides a perverse incentive to option holders to manipulate stock price within a short time frame. Lengthening the vesting period and limiting exercise dates to set periods during any given year alleviate some of that incentive. Mandating holding periods promotes management's long-term ownership of equity holdings. Ideally, requiring top management to retain equity holdings during their term of employment is the most effective means of focusing those executives on the long-term productivity of the corporation; however, shorter holding periods, such as attainment of a certain age or years of service, may be appropriate.

Additional listing standards can require complete board independence.[284] While most publicly-traded corporations have adopted board independence requirements that exceed the SROs' current "majority of independent directors" listing standard,[285] both the self-imposed and SROs' standards do not guarantee true board director independence. For example, a few of Citigroup's directors had multiple roles at the firm, including Robert Hernandez Ramirez, who was both a board director and chairman of the bank's Mexican subsidiary.[286] Instead of relegating the activity to the SEC and forcing its performance in a nontraditional role, the SROs can adopt listing standards requiring all board members be independent and then redefine independence to ensure that board members have limited social and economic dependence on the corporation.

Stronger efforts should be made to separate CEO and board chair positions. Where the CEO also functions as the board chair, the CEO retains disproportionate influence over board decisions. While some progress has been made through corporations' voluntary separation of the CEO and board chair positions, with approximately forty-six percent of public companies reporting that their CEOs do not serve as the board chair, these voluntary efforts are progressing at too slow of a rate, with only a five percent increase in separation from 2007 to 2008.[287] The SROs can adopt an independent chair, lead director, or presiding director corporate governance model.[288] That model can, however, be flexible, depending on

---

284. Zachary A. Goldfarb, *SEC to Examine Boards' Role in Financial Crisis*, Wash. Post, Feb. 20, 2009, at D1.

285. Shearman & Sterling, LLP, 2008 Trends In Corporate Governance of the Largest US Public Companies, General Governance Practices, 14 (on file with author and available from firm on request) (In its sixth annual survey of selected corporate governance practices of the Top 100 Companies, 2008 Trends In Corporate Governance Of The Largest US Public Companies General Governance Practices, 52 of the top 100 companies surveyed adopted and disclosed stricter standards regarding the minimum number of independent directors than required by the relevant listing standards); *see also* NYSE, Inc., *supra* note 266, at § 303A.01 ("Listed companies must have a majority of independent directors."); NASDAQ, Inc., *supra* note 266, at § 5605(b)(1) ("A majority of the board of directors must be comprised of Independent Directors as defined in Rule 5605(a)(2). The Company must disclose in its annual proxy (or, if the Company does not file a proxy, in its Form 10-K or 20-F) those directors that the board of directors has determined to be independent under Rule 5605(a)(2).").

286. Goldfarb, *supra* note 284.

287. RiskMetrics Group, Board Practices: Trends in Board Structure at S&P 1,500 Companies, (2008), http://www.riskmetrics.com/sites/default/files/BP2009.pdf.

288. The Conf. Bd. Comm'n on Pub. Trust and Private Enter., Findings and Recommendations 19 (2003), http://www.conference-board.org/pdf_free/SR-03-04.pdf (recommending that either (1) the role of the Chairman and CEO be performed by different individuals, with the Chairman being one of the independent directors; (2) the role of the Chairman and CEO be performed by different individuals, with the Chairman not a member of the management team and not directly reportable to the CEO; or (3) for those corporations that do not bifurcate the CEO and Chairman positions, the appointment or

corporate size and industry; but it must specifically delineate the chair, lead director, or presiding director's role in compensation and risk-assessment matters, so the CEO does not effectively retain power over board decisions.[289]

The SROs can adopt a listing standard that limits board members' service on multiple boards at the same time. One of the causes of the financial industry crisis was boards' failures to assess the risks associated with heavy concentrations of MBSs and other collateralized debt obligations.[290] Arguably, part of this failure is due to board members' service on multiple boards.[291] For example, several of the directors on the Bear Stearns board served on the boards of four public companies.[292] While fifty-five of the top 100 companies place a limit on the number of boards a director may serve on, it is not uncommon to find a company director serving on five or six boards.[293] With sixty-five of the top 100 companies surveyed having eight or more board meetings every year, how can a board member with multiple commitments to other companies and a total of over forty meetings a year in some cases parse through complicated and creative arrangements and make risk assessments? Limiting service on multiple boards will lead to better-educated directors.

For certain critical industries, the SROs can adopt listing standards that require board members to have experience in the industry in which they serve. Listing standards already require that audit committee members be financially literate and that at least one member of the audit committee have auditing experience.[294] Requiring board members to have experience

---

election of a presiding director); *see also* Thor Valdmanis, *Powerful Finance Execs Seek NYSE Overhaul*, USA TODAY, Sept. 25, 2003, at B1 (stating that state treasurers, pension fund managers, and finance officials were calling for a sweeping overhaul of the business practices of the NYSE including a demand that the NYSE separate the roles of chairman and CEO).

289. McClendon, *supra* note 246, at 1014 ("To achieve the desired effect, however, the additional listing standards must require that the duties of the non-executive chair, lead director, or presiding director be adequately delineated . . . ").

290. *See* Goldfarb, *supra* note 284 ("With few exceptions, boards have received little media attention as the country has sought explanations for financial firms' taking on such perilous risks. These boards . . . were ultimately responsible for the decisions of the Wall Street companies, housing firms and banks at the heart of the crisis. The boards signed off on the risks the companies took and the compensation packages awarded to top executives.").

291. *Id.*

292. *Id.*

293. *Id.*

294. NYSE, INC., Listed Company Manual, *supra* note 268, at § 303A.07:

> Each member of the audit committee must be financially literate, as such qualification is interpreted by the listed company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit

in the particular industry helps ensure that they understand management proposals, complex transactions, and the value of particular corporate executives.

In conclusion, EESA, ARRA, and the Obama administration's Reform Plan have set the tone for corporate governance reforms in the area of executive compensation and corporate governance.[295] But, actual implementation of federal regulatory and legislative reforms in this area are problematic and do not go far enough to change executive compensation "corporate culture." In evaluating and implementing systemic reform of executive compensation and corporate governance related to executive compensation, it is imperative that Congress, the Obama administration and federal regulatory agencies look at the root causes of the financial crisis and evaluate whether additional statutory, regulatory, or corporate governance standards can effectively encourage responsibility by all corporate players. Further, Congress, the Obama administration, and federal regulatory agencies must determine whether they are the best source for implementing corporate governance standards relating to executive compensation or whether another source, such as the SROs, will be more effective in implementing specific changes. Finally, a determination needs to be made regarding the expansion of reforms outside of the financial industry and to corporate America as a whole. The author of this article takes the position that federalization of permanent executive compensation corporate governance reforms is generally inappropriate and that the SROs can more effectively enact additional listing standards for all publicly-traded corporations. Further, the recommended reforms will not have the drastic effect of limiting corporations' abilities to attract talented executives, a concern expressed by many opposed to compensation

> committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment. While the Exchange does not require that a listed company's audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 401(h) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise.

295. Sheri Qualters, *supra* note 193; Greg E. Gordon, Practicing Law Institute, Preparation of Annual Disclosure Documents, *Executive Compensation Limits For Financial Institutions Participating In The Troubled Asset Relief Program*, 1710 PLI/Corp 903, 905 (2009) ("The limitations and restrictions adopted as part of the U.S. Treasury's Troubled Asset Relief Program could serve as a model for comprehensive executive compensation reform legislation. In addition, these compensation restrictions may have a wider impact to the extent non-participating companies adopt policies similar to those required by EESA or to the extent that implementation of the EESA compensation restrictions becomes the 'model' of good corporate governance.").

limitations.[296] Regardless of the means to the end, corporate America's short-term productivity rewards for high-level executives and other highly-compensated employees should be abandoned. Future reforms for all of corporate America will ensure that corporate employees are rewarded for their long-term productivity and not their generation of short-term gains.

296. Matthew Jaffe, *House Approves Executive Pay Limits*, ABC NEWS, July 31, 2009, http://i.abcnews.com/Politics/Story?id=8213911&page=1 ("The industry also contends that compensation caps will limit the ability of companies to attract top talent in a competitive field.").