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WHEN GOOD POLICIES GO BAD: CONTROLLING RISKS POSED BY FLAWED INCENTIVE-BASED COMPENSATION

NICOLE VINCENT*

ABSTRACT

The recent Wells Fargo scandal revealed the harm that can result from flawed incentive-based compensation arrangements. Large financial institutions have both a legal and an ethical obligation to ensure that any incentive-based compensation arrangements that are in place will not encourage risky or fraudulent employee behavior. The continued existence of inappropriate and poorly structured arrangements demonstrates that existing regulations are inadequate to ensure compliance and protect consumers. Regulations should include increased penalties and should more evenly distribute the burden of oversight and compliance between the public and private sectors. In addition to regulatory reform, the government should prosecute culpable high-level executives more aggressively. Arguably, white-collar criminals are in a position to be more effectively deterred by the threat of incarceration than other types of criminals.

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I. INTRODUCTION

Recently, a scandal broke in the financial sector when the media revealed that Wells Fargo employees had been opening new bank accounts for existing customers without their knowledge.¹ Since then, former Wells Fargo employees have explained that the high-pressure atmosphere, specifically related to flawed incentive-based compensation arrangements, led many of them to fraudulently open these accounts for fear of losing their jobs if they failed to meet goals set by the company.² Large financial institutions have both a legal and an ethical obligation to ensure that any incentive-based compensation arrangements that are in place will not encourage risky or fraudulent employee behavior at the expense of consumers. The ongoing existence of these inappropriate, poorly structured incentive-based compensation arrangements demonstrates that existing regulations are inadequate to ensure compliance and protect consumers. Therefore, the government should reform existing regulations, prosecute white-collar criminals more aggressively, or undertake some combination of both to address this problem.

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act³ in 2010 to promote financial stability by, among other measures, protecting consumers from “abusive financial services practices.”⁴ In 2011, the Office of the Comptroller of the Currency, the Department of the Treasury, the Board of Governors of the Federal Reserve System Board, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Credit Union Administration, and the U.S. Securities and Exchange Commission (“Agencies”) published a joint notice of proposed rulemaking.⁵ The purpose of the proposed rulemaking was to implement § 5641(b) of the Dodd-Frank Act, which requires the appropriate regulators to prohibit any type of incentive-based compensation arrangements that encourage inappropriate

¹ Renae Merle, *Wells Fargo Boots 5,300 Employees for Creating Accounts Its Customers Didn't Ask for*, WASH. POST (Sept. 8, 2016), <https://www.washingtonpost.com/news/business/wp/2016/09/08/wells-fargo-fined-185-million-for-creating-accounts-its-customers-didnt-ask-for/>.

² Matt Egan, *Workers Tell Wells Fargo Horror Stories*, CNN (Sept. 9, 2016), <http://money.cnn.com/2016/09/09/investing/wells-fargo-phony-accounts-culture/>.

³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁴ *Id.*

⁵ Incentive-Based Compensation Arrangements of 2011, 76 Fed. Reg. 21170 (proposed Apr. 14, 2011).

risks by financial institutions covered by the Act.⁶ However, since the proposed rule was published, incentive-based compensation practices in the financial services industry have evolved.⁷ Due to those changes, the Agencies proposed a new rule in June 2016 to revise the proposed rule published in 2011 and more effectively implement § 5641(b) of the Dodd-Frank Act.⁸

While the 2016 proposed amendments are a step in the right direction toward ending flawed incentive-based compensation practices, because they include punitive features such as a clawback provision and stricter deferral requirements, more action and harsher penalties are needed to protect consumers. This Note will argue that executives in financial institutions should face criminal prosecution more frequently to serve as a deterrent. This is necessary because in light of the benefit to the bottom line these arrangements can offer the corporation, the prospect of incarceration may be the only punishment stringent enough to deter executives from implementing or approving these risky incentive-based compensation arrangements.⁹ Additionally, the Agencies should modify the proposed new rule to impose more significant penalties on executive officers or significant risk-takers, such as heightened clawback¹⁰ requirements, deferral provisions, and forfeiture.¹¹ The threat of meaningful punishment would further the deterrent effect intended by this proposed regulation. In addition to modifying the new rule, new regulatory solutions should be considered to improve efficiency in compliance and ensure meaningful enforcement.

Before turning to the new proposals, this Note will first examine the evolution of these types of incentive-based arrangements, mainly focusing on arrangements within large financial institutions; compare and contrast effective arrangements and risky ones; and offer solutions to the dangers posed by improper incentive-based arrangements. In Section II, this Note will look at incentive-based compensation arrangements and examine their characteristics, explaining how well-structured incentive-based compensation arrangements can benefit a company. Section II then will explore how flawed arrangements can expose a company to risk. In Section III, this Note will review the history and evolution of rules and regulations that have been put in place in an attempt to cure the problems caused by risky incentive-based compensation arrangements. This Note will highlight the role of penalties in the regulations aimed at these arrangements. In Section IV, this Note will discuss the

⁶ 12 U.S.C. § 5641(b) (2018) states that “the appropriate Federal regulators shall jointly prescribe regulations or guidelines that prohibit any types of incentive-based payment arrangements, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions”

⁷ Madeline Marsden, *Incentive Compensation and Proposed Rules*, FED. RES. BANK ATLANTA (Nov. 3, 2016), <https://www.frbatlanta.org/economy-matters/banking-and-finance/viewpoint/2016/11/03/incentive-compensation-and-proposed-rules>.

⁸ Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37670 (proposed June 10, 2016) (to be codified at 12 C.F.R. pt. 42).

⁹ See *infra* Section II.

¹⁰ “Clawback” provisions allow the company to take back compensation it has paid out. Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37731 (defining “clawback” as a “mechanism by which a covered institution can recover vested incentive-based compensation from a covered person.”); see *infra* note 51.

¹¹ See *infra* Section V.

factors that have resulted in the persistence of flawed arrangements despite the rules and regulations enacted to thwart them. Section IV also examines recent problems caused by persisting problems.

In Section V, this Note will propose solutions. It will argue that deterrence should be the goal of regulation and prosecution in this field. The government should prosecute executives who implement or ratify risky compensation arrangements more aggressively, as the government can accomplish deterrence through the threat of certain (if brief) incarceration. Corporate criminal liability could offer a similar deterrent effect as individual liability but with fewer evidentiary hurdles (though it should not be viewed as a substitute). In the regulatory realm, the proposed rule should require stricter penalties for executives who violate it, and those penalties should target the executives' salaries through deferral and clawback provisions. Beyond reforming current regulations, this Note will propose significant changes to the regulatory scheme to better account for the unique characteristic of the banking sector. If the private and public sectors work together to write applicable regulations, benefits accrue to both parties in the form of lower compliance costs and the conservation of government resources. Further, a form of self-policing by members of the financial sector could enhance current oversight and reduce the risk of superficial compliance by institutions. Finally, this Note will offer a brief conclusion and look to the future.

II. BACKGROUND: WHY HAVE INCENTIVE-BASED ARRANGEMENTS?

The details of incentive-based compensation arrangements may vary between institutions, but generally, all adhere to the principle of payment based on outcomes.¹² For example, a company will pay an employee a bonus if he meets a certain sales goal, thereby providing him with an incentive to sell more of the company's product. Examining the benefits that a company and an individual employee can gain through an appropriately risk-minimized arrangement is useful to understanding the need for regulating incentive-based compensation arrangements.

A. Benefits of Appropriate Incentive-Based Compensation Arrangements

Financial institutions competing for talent may find that incentive arrangements are necessary to attract and retain desirable employees.¹³ Well-structured arrangements can benefit a company by promoting better performance of the institution and individual employees.¹⁴ They can promote the health of a financial institution by aligning the interests of executives and employees with those of the

¹² See Stephen Bryan et al., *CEO Compensation After Deregulation: The Case of Electric Utilities*, 78 J. BUS. 1709, 1710 (2005); Andrew Weiss, *Incentives and Worker Behavior: Some Evidence 1* (Nat'l Bureau of Econ. Research, Working Paper No. 2194, 1987) (explaining that "[b]ecause each employee is paid in accordance with his own output, a payment schedule can be chosen to induce the optimal level of effort on the part of employees.").

¹³ Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37673.

¹⁴ *Id.*; Steven C. Caywood, *Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation*, 109 MICH. L. REV. 111, 128 (2010) (arguing that incentives are valuable because they tie the executive's salary to the corporation's wealth, rather than a fixed salary in which the only incentive for the executive is to keep his or her job).

institution's shareholders and other stakeholders.¹⁵ Simply put, rewarding employees of the financial institution for performance that benefits shareholders of the institution can benefit both employees and institutions.

B. Risks Posed by Flawed Incentive-Based Compensation Arrangements

On the other hand, incentive-based compensation arrangements can harm an institution if the associated risks are not properly managed. If an employee's salary is made up largely of incentive payment, to the point that the employee depends on those incentives as a part of his subsistence, then the employee no longer feels that the incentive is a nice bonus if he makes his sales goals, but rather that he must make his sales goal no matter what or that he feels pressure from the company to do so.¹⁶ In the case of Wells Fargo, for example, workers reported that they faced intense pressure to meet sales quotas from the management and were even threatened with termination if they failed to sell enough products to customers.¹⁷ Further, large financial institutions carry risks of negative externalities because they are interconnected with other financial institutions, other companies, and even other markets.¹⁸ Large banks are key players in many market segments such as private securitization and derivatives and leveraged investor financing.¹⁹ If a large bank fails or experiences significant financial problems, it can start a domino effect that depresses share prices across those markets and related ones.²⁰ Therefore, the negative impact from inappropriate risk-taking can affect more than just the shareholders of the financial institution with a flawed arrangement; it can affect the health of the United States economy as a whole.²¹ For

¹⁵ Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37673–74; Caywood, *supra* note 14, at 128; Vincent K. Chong & Ian R.C. Eggleton, *The Impact of Reliance on Incentive-Based Compensation Schemes, Information Asymmetry and Organisational Commitment on Managerial Performance*, 18 MGMT. ACCT. RES. 312, 312–13 (2007) (discussing the idea that compensation schemes are based on an agency theory framework and that dysfunctional behaviors arise when the agent and the principal have different risk preferences and conflicting goals based on information asymmetry).

¹⁶ See Laura J. Keller, *Wells Fargo's Post-Scandal Pay Plan Eliminates Sales Goals*, BLOOMBERG (Jan. 10, 2017), <https://www.bloomberg.com/news/articles/2017-01-10/wells-fargo-unveils-retail-bank-pay-plan-in-response-to-scandal>. Keller reports that Wells Fargo's new compensation plan "will skew more heavily toward base salary and less toward variable bonuses," and the company will base incentives on customer service rather than the number of products sold. *Id.*

¹⁷ *Planet Money: The Wells Fargo Hustle*, NPR (Oct. 7, 2016), <https://www.npr.org/sections/money/2016/10/07/497084491/episode-728-the-wells-fargo-hustle>. A former Wells Fargo employee states that in 2009, her managers threatened to fire her and put a mark on her permanent record if she did not meet her sales quota. *Id.*

¹⁸ Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37674.

¹⁹ MARC LABONTE, CONG. RES. SERV., R42150, SYSTEMICALLY IMPORTANT OR "TOO BIG TO FAIL" FINANCIAL INSTITUTIONS 3 (2017).

²⁰ *Id.*

²¹ *Id.* at 4; see George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulations*, 16 CATO J. 17, 17–18 (1996) (stating that bank failures are perceived to be more harmful than other firms' failures because of their potential for an effect "throughout the banking system . . .").

these reasons, reducing the risks posed by incentive-based compensation arrangements is essential.

III. POST-CRISIS REGULATION

A. Initial Agency and Congressional Actions

Although these incentive systems can serve to align employee and shareholder interests, flawed incentive-based compensation arrangements were identified as one of the contributing factors to the financial crisis that began in 2007.²² To address these practices, in 2010, the Federal Banking Agencies²³ adopted a Guidance on Sound Incentive Compensation Policies based on three principles for improved incentive compensation practices.²⁴ According to these three principles, the institution should provide employees incentives that appropriately balance risk and reward, the incentives should comport with effective controls and risk-management, and, finally, the incentive programs should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.²⁵ While the Guidance on Sound Incentive Compensation Policies briefly mentioned penalties for officials of the institution, it mainly focused on supervisory policy.²⁶

Additionally, in late 2009, the Federal Reserve initiated a multi-disciplinary, horizontal review of incentive compensation practices at twenty-five large, complex banking organizations,²⁷ citing that one of its goals was to help each agency implement the Guidance on Sound Incentive Compensation Policies.²⁸ In its 2011 report on the Horizontal Review, the Reserve noted that each institution could do more to promote sound incentive-based compensation policies.²⁹

In 2010, Congress established the Consumer Finance Protection Bureau ("CFPB") in 12 U.S.C. § 5491 to "regulate the offering and provision of consumer financial

²² See Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37674 (noting that the foundation of sound risk management was undermined by the actions of employees who were in a position to expose institutions to financial risk and sought to maximize their own compensation through arrangements that failed to align employees' interests with that of the institution); see generally FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT (2011), <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> (discussing compensation arrangements that rewarded employees, including non-executives, for increasing an institution's short-term profit without sufficient recognition of the risks posed to the institution and the market as a whole).

²³ Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. 36395–96 (June 25, 2010). The Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury are the Agencies behind the guidance. *Id.*

²⁴ *Id.* at 36396.

²⁵ *Id.*

²⁶ *Id.* at 36397.

²⁷ BD. OF GOVERNORS OF THE FED. RESERVE SYS., INCENTIVE COMPENSATION PRACTICES: A REPORT ON THE HORIZONTAL REVIEW OF PRACTICES AT LARGE BANKING ORGANIZATIONS 1 (2011).

²⁸ *Id.*

²⁹ *Id.* at 2.

products or services under the Federal consumer financial laws.”³⁰ The statute requires CFPB to present an annual report to Congress regarding consumer complaints involving financial products and services received by the Bureau.³¹ As an executive agency, the CFPB is empowered to make and enforce regulations.³²

1. Dodd-Frank and Implementation

Congress passed the Dodd-Frank Act in 2010.³³ It was meant, in part, to prevent excessive risk-taking of the sort that led to the financial crisis in 2008.³⁴ The Dodd-Frank Act specifically recognizes that incentive-based compensation arrangements pose a danger, as the Act contains certain provisions aimed at regulating compensation arrangements.³⁵ One provision has a prescription that regulations require covered financial institutions to disclose the structures of their incentive-based compensation arrangements to the appropriate federal regulator to determine whether the arrangements could lead to material financial loss at the institution.³⁶ Another provision requires regulations prohibiting any type of incentive-based compensation arrangement that the regulators determine “encourages” inappropriate risks by a covered institution.³⁷

2. The First Proposed Rule

In order to implement (b) of the Dodd-Frank Act, and supplement existing efforts to curb flawed arrangements, the Agencies proposed a rule in 2011.³⁸ This proposed rule would have required that arrangements be consistent with the three principles described in the Guidance on Sound Incentive Compensation Policies: they should balance risk and financial rewards, they should be compatible with effective risk

³⁰ 12 U.S.C. § 5491(a) (2018); see *About Us*, CONSUMER FIN. PROTECTION BUREAU, <http://www.consumerfinance.gov/about-us/the-bureau/> (last visited Mar. 11, 2018) (stating that the Bureau’s aim is to strengthen the economy by protecting consumers from unfair, deceptive, or abusive practices and taking legal action against companies that violate the law).

³¹ 12 U.S.C. § 5493(b)(3)(C) (2018).

³² *Guide to Administrative Law*, LIB. CONG., <https://www.loc.gov/law/help/administrative.php> (last updated June 9, 2015).

³³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 780).

³⁴ See *Wall Street Reform: The Dodd-Frank Act*, OBAMA WHITE HOUSE ARCHIVES, <https://obamawhitehouse.archives.gov/economy/middle-class/dodd-frank-wall-street-reform> (last visited Mar. 11, 2018).

³⁵ See 12 U.S.C. § 5641 (2018).

³⁶ *Id.* § 5641(a)(1)(B). Section (A) states that an additional purpose for disclosure of the arrangements is to determine whether the arrangement “provides an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits” *Id.* § 5641(a)(1)(A).

³⁷ *Id.* § 5641(b).

³⁸ Incentive-Based Compensation Arrangements of 2011, 76 Fed. Reg. 21170 (proposed Apr. 14, 2011).

management controls, and they should be accompanied by strong corporate governance.³⁹

In order to balance risk and reward, the rule proposed adjusting the amount of the compensation award to reflect the risk that person's activities pose to the institution; deferring actual payment of the award until after the end of the performance period, with the award adjusted for losses to the company that may become apparent during the deferral period; and extending performance periods to better assess risk outcomes.⁴⁰ The rule would have prohibited arrangements that would encourage employees to expose the institution to improper risks in pursuit of excessive compensation.⁴¹ For larger financial institutions,⁴² the rule would have required deferral of fifty percent of the incentive-based compensation for executive officers for a period of three years.⁴³ To be compatible with risk management controls, the rule proposed that institutions have risk-management personnel that help to design the compensation arrangements and a system in place for monitoring those personnel.⁴⁴ For strong corporate governance, the rule would have required oversight by the board of directors and even stated that the board would be "ultimately responsible for ensuring that the covered financial institution's incentive compensation arrangements are appropriately balanced."⁴⁵ The proposed rule also contained an anti-evasion section, prohibiting institutions from evading the restrictions of the rule by indirect acts, or acts through another entity, that would be unlawful if done directly—such as classifying employees as independent contractors to circumvent the rule.⁴⁶

Most comments on the 2011 proposed rule urged stronger discouragement for risky compensation practices, such as imposing a longer deferral period for executive bonuses, basing compensation practices on factors such as an institution's bond price or spread on credit default swaps, and including more disclosure requirements.⁴⁷

³⁹ *Id.* at 21178–79.

⁴⁰ *Id.* at 21179.

⁴¹ *Id.* at 21204 § 42.5(b). The proposed rule states that compensation would be excessive when "amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed by the covered person." *Id.* at 21178. The factors to be considered when making this determination include "[a]ny connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse" *Id.*

⁴² For financial institutions, this term means covered institutions with total consolidated assets of \$50 billion or more. *Id.* at 21173.

⁴³ *Id.* at 21180.

⁴⁴ *Id.* at 21179. The rule notes that these controls are important because employees may seek to increase their own individual compensation by inappropriately influencing "the risk measures, information, or judgments used to balance" the employee's compensation. *Id.* at 21180.

⁴⁵ *Id.*

⁴⁶ *Id.* at 21183.

⁴⁷ Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37670, 37677 (proposed June 10, 2016) (to be codified at 12 C.F.R. pt. 42). These types of comments generally came from private individuals, community groups, members of Congress, labor federations, and pension funds. *Id.*

Comments from covered financial institutions and financial industry associations favored guidelines rather than rules to implement the Dodd-Frank Act, and some opposed the deferral provisions, suggesting they would harm an institution's ability to attract and retain key employees.⁴⁸

Following the 2011 proposed rule, foreign jurisdictions implemented a number of rules to address compensation practices, most of which were stronger than the 2011 proposed rule.⁴⁹ Some covered financial institutions operate in both foreign and domestic markets and therefore are subject to the rules of every jurisdiction in which the institution meets the standard for coverage.⁵⁰ In June 2013, the European Union adopted rules requiring, among other measures, that up to one hundred percent of the variable remuneration shall be subject to clawback.⁵¹ The potential for an executive to lose compensation that he has already received presents a significant deterrent effect for engaging in risky behavior. Numerous jurisdictions with heavy financial presence, including Canada, Australia, and Switzerland, adopted similarly enhanced rules and guidelines.⁵²

B. Evolving Needs in Regulating Compensation Arrangements

Because of the international evolution in compensation practices, the Agencies recognized the need for consistency between United States and foreign rules⁵³ and therefore proposed a new rule in June 2016.⁵⁴ This new proposed rule was based on the 2011 proposed rule; it retained the three key principles, but made changes to reflect international developments in incentive compensation policies.⁵⁵

⁴⁸ *Id.*

⁴⁹ *Id.* at 37678.

⁵⁰ *Id.* at 37677–78.

⁵¹ See Council Directive 2013/36, of the European Parliament and of the Council of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, art. 94(n)(1), 2013 O.J. (L 176) 338, 389.

⁵² For example, in Canada, see OFF. OF THE SUPERINTENDENT OF FIN. INST. CORP. GOVERNANCE, GUIDELINES (2013) (promulgating guidelines for the large institutions regulated by Canada's OSFI), but see John Tuzyk & Faye Ghadiani, *Canadian Clawbacks: Increasing but Still Voluntary*, BLAKES (Jan. 16, 2014), <http://www.blakes.com/English/Resources/Bulletins/Pages/Details.aspx?BulletinID=1867> (noting that Canada does not legislatively mandate clawbacks rendering them unenforceable under contract law; however, clawback provisions have become more prevalent in Canada likely due to the influence of the OSFI guidelines). In Switzerland, see *FINMA Publishes Circular on Remuneration Schemes*, FINMA (Nov. 10, 2009), <https://finma.ch/en/news/2009/11/mm-rs-verguetungssysteme-20091111/> (noting that Switzerland's Financial Market Supervisory Authority ("FINMA") "welcomes 'clawback' and 'malus' arrangements."), but see *FINMA Redefines Corporate Governance Guidelines for Banks*, FINMA (Nov. 1, 2016), <https://www.finma.ch/en/news/2016/11/20161101-mm-rs-corporate-governance-bei-banken/> (noting that FINMA decided not to introduce a clawback clause in the updated "Remuneration schemes" circular).

⁵³ Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37678.

⁵⁴ *Id.*

⁵⁵ *Id.* at 37679; see *supra* note 38.

As part of the risk/reward balance, the new rule would apply the three-year deferral period to “significant risk-takers” in addition to the executive officers already included in the 2011 proposed rule,⁵⁶ thereby applying these safeguards more broadly. Deferred compensation is compensation that is paid to the employee at a later date than which it is earned.⁵⁷ The new rule includes forfeiture and downward adjustment provisions that would subject unvested, deferred compensation awards to reduction if certain adverse outcomes were to occur.⁵⁸ Significantly, the new rule would also require clawback provisions in arrangements for senior executive officers and significant risk-takers.⁵⁹ Clawbacks are mechanisms “by which a covered institution can recover vested incentive-based compensation from a senior executive officer or significant risk-taker if certain events occur.”⁶⁰ Officers or significant risk-takers would trigger these mechanisms if they engaged in misconduct resulting in significant financial or reputational harm, fraud, or intentional misrepresentation of information used to determine their incentive-based compensation.⁶¹

Regarding strong corporate governance, the new proposed rule required that the board of directors obtain a written assessment of the institution’s incentive-based compensation arrangements, including the institution’s risk control and compliance policies.⁶² Yet, the 2011 proposed rule’s disclosure and recordkeeping requirements were less detailed than those of the 2016 proposed rule.⁶³

⁵⁶ Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37680.

⁵⁷ See Jonathan Eaton & Harvey S. Rosen, *Agency, Delayed Compensation, and the Structure of Executive Remuneration*, 38 J. FIN. 1489, 1489 (1983) (stating that “[t]o relate an executive’s reward more closely to his performance, firms can delay a large component of compensation until better information is available, so that the amount of remuneration becomes dependent upon indicators of performance.”).

⁵⁸ Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37804, § 42.7(b)(2)(i). The adverse outcomes are:

- (i) Poor financial performance attributable to a significant deviation from the [covered institution’s] risk parameters set forth in the covered institution’s policies and procedures;
- (ii) Inappropriate risk-taking, regardless of the impact on financial performance;
- (iii) Material risk management or control failures;
- (iv) Non-compliance with statutory, regulatory, or supervisory standards results in: (A) Enforcement or legal action . . . brought by a federal or state regulator or agency; or (B) A requirement that the covered institution report a restatement of a financial statement to correct a material error; and
- (v) Other aspects of conduct or poor performance as defined by the covered institution.

Id. at 37804–05, § 42.7(b)(2)(ii)–(v).

⁵⁹ *Id.* at 37805, § 42.7(c).

⁶⁰ *Id.* at 37681.

⁶¹ *Id.*

⁶² *Id.* at 37806, § 42.10.

⁶³ Incentive-Based Compensation Arrangements of 2011, 76 Fed. Reg. 21170 (proposed Apr. 14, 2011).

C. Current State of Regulation

The federal government's response to problems with incentive-based compensation arrangements have been largely regulatory. The CFPB serves as a (weak) outside source of oversight on financial institutions.⁶⁴ The proposed rules to implement Dodd-Frank's reporting requirements and prohibitions on risk-prone arrangements focus on controlling risks through internal supervision and balancing risk and reward.⁶⁵ The 2016 rule proposed heightened penalty provisions that would be imposed if undesirable outcomes occur as a result of flawed arrangements and notably recognizes the need for an anti-evasion provision.⁶⁶ Although this evolution suggests that the government has recognized the problems with relying on institutional self-governance, current and proposed regulations do not impose strong enough penalties to de-incentivize risky compensation arrangements. Therefore, it is necessary to consider further measures to address these risks, both by modifying the current proposed rule and by implementing structural regulatory changes to encourage more efficiency and interaction between the regulatory bodies and the financial institutions being regulated.

IV. CONTINUING PROBLEMS WITH INCENTIVE-BASED ARRANGEMENTS

Despite currently enforced rules and the specter of future regulations, recent events demonstrate that financial institutions are able to continue implementing incentive-based compensation practices that expose the company to significant risks and fail to align the interests of employees with those of both the shareholders and the larger market affected by the institution. Such arrangements can also affect consumers, especially if sales goals pressure employees to sell customers banking products they may not want or need.

A. The Wells Fargo Example

The scandals involving Wells Fargo provide an example of the persistent problem with risky compensation arrangements and lack of internal oversight. Employees at Wells Fargo engaged in "cross-selling," or selling additional products to the same customer.⁶⁷ Cross-selling is attractive to banks because acquiring new customers is much more expensive than retaining existing ones and simply selling more products to those existing customers is more profitable.⁶⁸ Of course, cross-selling relies on the bank's employees to sell the additional products to their customer.⁶⁹ The employees must go beyond simply meeting the customers' banking demands and convince them

⁶⁴ Consumer Financial Protection Bureau, USA.GOV, <https://www.usa.gov/federal-agencies/consumer-financial-protection-bureau> (last visited Feb. 28, 2018).

⁶⁵ See, e.g., Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37711.

⁶⁶ *Id.* at 37690.

⁶⁷ Yasar F. Jarrar & Andy Neely, *Cross-Selling in the Financial Sector: Customer Profitability Is Key*, 10 J. TARGETING MEASUREMENT & ANALYSIS FOR MARKETING 282, 282 (2002).

⁶⁸ *Id.*

⁶⁹ *Id.* at 287.

to buy more products,⁷⁰ such as additional accounts, credit cards, or home-equity loans.

In the wake of the news that Wells Fargo employees had opened thousands of sham accounts⁷¹—accounts existing customers had neither asked for nor even knew were being opened in their names—employees have begun to comment on the immense pressure to sell “solutions” and hit sales goals for which they would receive bonuses.⁷² Employees reported that they were expected to sell eight new products per day, which was then raised to twenty new products per day; if they did not hit their goals, Wells Fargo would threaten them with termination.⁷³ This intense pressure to hit sales goals resulted in extremely risky and fraudulent conduct—the opening of the sham accounts—because employees were unable to meet such exacting goals legitimately.⁷⁴ Employees were tacitly encouraged to commit fraud while the CEO looked the other way.⁷⁵

B. The Aftermath of Wells Fargo

After the sham accounts came to light, Wells Fargo fired over five thousand employees.⁷⁶ The organization fired only one area president, meaning the vast majority of those fired were low-level employees.⁷⁷ While no one would argue that those employees who committed the fraudulent acts should not have been fired, arguably those in positions of oversight should have been punished as well. The CFPB ordered Wells Fargo to pay restitution to all victims, a \$100 million fine to the CFPB’s Civil Penalty Fund, a \$35 million penalty to the Office of the Comptroller of the Currency,

⁷⁰ *Id.* at 287–88 (emphasizing that employee sales skills are essential to cross-selling success and that managers must discipline customer-service representatives to “discuss the benefits of full account coverage” and “take ownership of the customer.” (footnote omitted)).

⁷¹ *In re* Wells Fargo Bank, N.A., CFPB No. 2016-CFBP-0015, states that the Bureau concluded that Wells Fargo employees opened 1,534,280 accounts “that may not have been authorized and that may have been funded through simulated funding, or transferring funds from consumers’ existing accounts without their knowledge or consent.” *Id.* at *5.

⁷² See Michael Corkery & Stacy Cowley, *Wells Fargo Warned Workers Against Sham Accounts, but ‘They Needed a Paycheck’*, N.Y. TIMES (Sept. 16, 2016), <https://www.nytimes.com/2016/09/17/business/dealbook/wells-fargo-warned-workers-against-fake-accounts-but-they-needed-a-paycheck.html>; see also *Planet Money*, *supra* note 17.

⁷³ *Planet Money*, *supra* note 17.

⁷⁴ See Corkery & Cowley, *supra* note 72.

⁷⁵ See Stacy Cowley & Jennifer A. Kingson, *Wells Fargo to Claw Back \$75 Million from 2 Former Executives*, N.Y. TIMES (Apr. 10, 2017), <https://www.nytimes.com/2017/04/10/business/wells-fargo-pay-executives-accounts-scandal.html>.

⁷⁶ Laura J. Keller et al., *Wells Fargo’s Stars Thrived While 5,000 Workers Got Fired*, BLOOMBERG (Nov. 3, 2016), <https://www.bloomberg.com/news/articles/2016-11-03/wells-fargo-s-stars-climbed-while-abuses-flourished-beneath-them>.

⁷⁷ *Id.*

and \$50 million to the City and County of Los Angeles.⁷⁸ In relation to Wells Fargo's revenue,⁷⁹ these fines are negligible.

CEO John Stumpf appeared in front of the Senate Banking Committee and the House Financial Services Committee, where members of Congress from both political parties sharply criticized him for the scandal.⁸⁰ After pressure from the Senate Committee, the board of directors of Wells Fargo announced that it would claw back \$41 million of Stumpf's pay in the form of unvested stock awards.⁸¹ The board has since announced Stumpf's decision to retire.⁸² He will be entitled to a \$24 million supplemental cash balance plan.⁸³ Considering his salary, these measures are hardly punitive.⁸⁴ However, in April 2017, Wells Fargo's board announced it would claw back an additional \$75 million in compensation from Stumpf and the former head of community banking, Carrie L. Tolsted.⁸⁵ These clawbacks are the largest in banking history.⁸⁶ Wells Fargo also released a "Sales Practices Investigation Report" at the time of the clawbacks⁸⁷ that stated the "root cause of sales practice failures was the distortion of [Wells Fargo's] sales culture and performance management system, which, when combined with aggressive sales management, created pressure on employees to sell unwanted or unneeded products to customers"⁸⁸

⁷⁸ *In re* Wells Fargo Bank, N.A., CFPB No. 2016-CFBP-0015.

⁷⁹ Adam Davidson, *How Regulation Failed with Wells Fargo*, NEW YORKER (Sept. 12, 2016), <https://www.newyorker.com/business/currency/the-record-fine-against-wells-fargo-points-to-the-failure-of-regulation>.

⁸⁰ Bob Bryan, *Wells Fargo CEO John Stumpf Got Raked over the Coals by Congress for over 4 Hours*, BUS. INSIDER (Sept. 29, 2016), <http://www.businessinsider.com/wells-fargo-ceo-john-stumpf-house-financial-services-congress-hearing-2016-9>.

⁸¹ Geoff Colvin, *Wells Fargo CEO John Stumpf's \$41 Million 'Clawback' Isn't What It Appears*, FORTUNE (Oct. 3, 2016), <http://fortune.com/2016/10/03/john-stumpf-wells-fargo-clawback/>.

⁸² Matt Krantz, *Wells Fargo CEO Stumpf Retires with \$134M*, USA TODAY (Oct. 12, 2016), <https://www.usatoday.com/story/money/markets/2016/10/12/wells-fargo-ceo-retires-under-fire/91964778/>.

⁸³ Wells Fargo & Co., 2016 Proxy Statement (Form 14A) (Mar. 16, 2016). The supplemental cash balance plan provides benefits in addition to the standard pension awards and may provide benefits in excess of Internal Revenue Code limits. *Id.* at 64–65.

⁸⁴ *See id.* at 39; Nomi Prins, Opinion, *Ex-Wells Fargo CEO John Stumpf Deserves Jail—Not a Plush Retirement*, GUARDIAN (Oct. 14, 2016), <https://www.theguardian.com/commentisfree/2016/oct/14/john-stumpf-retirement-wells-fargo-ceo-jail-time> (reporting that "[f]or his penance, all Stumpf had to do was forfeit [\$41 million] in restricted stock awards," while his exit payout is currently valued at around \$134 million).

⁸⁵ *See* Cowley & Kingson, *supra* note 75.

⁸⁶ *Id.*

⁸⁷ *See generally* INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., SALES PRACTICES INVESTIGATION REPORT (2017), <https://www.wellsfargo.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf>.

⁸⁸ *Id.* at Overview.

At present, it does not appear the government will pursue criminal charges against Stumpf. Before the Wells Fargo scandal, in the wake of the economic crisis of 2008, the government engaged in very little criminal prosecution.⁸⁹ Private litigation between shareholders or injured customers in lieu of government prosecution may serve to restore the plaintiffs, but it also often ends in settlements rather than judicial opinions, which can provide guidance as to the legality of the institution's behavior.⁹⁰

Arguably, even if the proposed rule had been implemented, it would not have prevented the scandal because the rule relies too heavily on internal self-policing—and the outside watchdog groups, such as the CFPB, pale in size and resources compared to the institutions they are responsible for monitoring.⁹¹ Those in responsible positions also historically have not been subject to any meaningful criminal punishment in a way that would likely deter others from implementing such arrangements or at least provide incentives to make sure such arrangements were not ongoing. Therefore, solutions that rely on deterring executives from implementing flawed incentive systems through the threat of prosecution or significant monetary penalties, as well as regulatory solutions, will be more effective.

V. PROPOSED SOLUTIONS

This Section proposes solutions through both criminal liability and regulatory changes, both with a focus on deterrence as the underlying theory. Deterrence through the threat of punitive measures is proposed as a solution to risky incentive systems because of the nature of these systems—they require significant planning and analysis and can be modified if problems arise. Therefore, executives responsible for implementing incentive systems have the opportunity to conduct a cost-benefit analysis of the sort that makes deterrence effective if the potential punishments are strong enough.

A. Deterrence Through Criminal Liability

Holding individuals such as executives and managers criminally liable for crimes proximately caused by bad policies for which they are responsible would effectively deter these individuals from ratifying incentive arrangements they know to be flawed. The threat of incarceration will be a more effective deterrent than the fines imposed by regulatory violations, and although harsh, incarceration is justified in light of the immense effect large financial institutions have on our economy. Relying on financial institutions themselves or agencies to monitor incentive-based compensation arrangements to ensure that they do not expose the company to risk is not an effective solution, as demonstrated both by historical evidence and a simple comparison of the relative size and resources of the institutions to the agencies tasked with monitoring

⁸⁹ David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1411 (2014) (noting the “surprising dearth” of individual penalties and suggesting that the government has moved toward eschewing individual liability and endorsing entity liability).

⁹⁰ *Id.* at 1414; James Rufus Koren, *Wells Fargo's \$142-Million Sham Accounts Settlement: What You Need to Know*, L.A. TIMES (July 11, 2017), <http://www.latimes.com/business/la-fi-wells-fargo-settlement-20170710-htmlstory.html>.

⁹¹ See Davidson, *supra* note 79 (discussing the relative lopsidedness of the “watchdogs and those they watch” and noting that the CFPB's budget is roughly \$600 million a year, while Wells Fargo, just one of the many institutions the CFPB must monitor, pulls in revenues of more than \$80 billion annually).

them.⁹² Under current regulations, those in positions of power can, through willful blindness or superficial ethics and risk management training, insulate themselves from any fallout if the policies backfire.⁹³

Deterrence, as a theory of punishment, seeks to prevent crime by punishing a wrongdoer and thus encourages those who might be tempted to commit the same crime to engage in a cost-benefit analysis of sorts, which leads them to refrain from crime.⁹⁴ General deterrence seeks to deter others through the punishment of one defendant, while specific deterrence seeks to deter the defendant re-offending through punishment.⁹⁵ Some scholars have suggested that deterrence as a theory of punishment is unsound because there is little to suggest, and indeed it seems unlikely, that the majority of criminals actually engage in a mental cost-benefit analysis prior to committing a crime.⁹⁶

However, a white-collar criminal differs from a “street-crime” offender in a number of respects. Some of these key differences suggest that white-collar offenders, especially those in high-powered positions such as executives at financial institutions, can be effectively deterred.⁹⁷ White-collar criminals, specifically high-level executives, are arguably much more likely than other criminals to engage in just the sort of cost-benefit analysis on which the theory of deterrence relies.⁹⁸ While the majority of street crimes involve the offender making a quick, often physically affirmative choice of action within a short time frame, white-collar crimes are generally schemes requiring a series of (non-physical) choices over a moderate to

⁹² *Id.*

⁹³ See Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 492 (2003) (stating that “firms engaged in legally prohibited, but potentially profitable, conduct can reduce or eliminate liability” while giving an “appearance of legitimacy to . . . stakeholders and the marketplace at large . . . by mimicking an effective compliance system, without reducing the incidence of prohibited conduct within the firm.”); Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law’s “Duty of Care as Responsibility for Systems”*, J. CORP. L. 949, 958 (2006).

⁹⁴ See JEREMY BENTHAM, PRINCIPLES OF PENAL LAW 396, 402 (J. Bowring ed., 1843). Bentham states that in regard to the proportion between crimes and punishments, “[i]n matters of importance, every one calculates. Each individual calculates with more or less correctness, according to the degrees of his information, and the power of the motives which actuate him; but all calculate.” *Id.*

⁹⁵ SANFORD H. KADISH ET AL., CRIMINAL LAW AND ITS PROCESSES (9th ed. 2012).

⁹⁶ Paul H. Robinson & John M. Darley, *The Role of Deterrence in the Formulation of Criminal Law Rules: At Its Worst When Doing Its Best*, 91 GEO. L.J. 949, 953 (2003) (suggesting that deterrence fails because it rests on the faulty expectation that potential criminals both are aware of the law and make rational, self-interested choices.).

⁹⁷ See Paul H. Robinson & John M. Darley, *The Utility of Desert*, 91 NW. U. L. REV. 453, 468 (1997). The authors state that “[m]ore than because of the threat of legal punishment, people obey the law . . . because they fear the disapproval of their social group if they violate the law . . .” *Id.*

⁹⁸ Richard A. Posner, *Optimal Sentences for White-Collar Criminals*, 17 AM. CRIM. L. REV. 409, 410 (1980).

lengthy time frame.⁹⁹ High-level officials will certainly play a role in designing and overseeing the incentive-based compensation arrangements within their company, and these roles likely present opportunities for deliberation and weighing of consequences, whether innocuous or criminal.

1. Why Individual Liability for High-Level Managers Is Appropriate

Criminal liability should be imposed on executives or managers in responsible positions of oversight for compensation arrangements. This is appropriate because (1) they are in positions to modify arrangements that encourage risky behavior, and (2) they generally stand to gain the most from these arrangements; therefore, the deterrent effect would balance the incentive to keep profitable (though risky) arrangements in place. While some form of punishment is certainly appropriate for lower-level employees who engage in significantly risky behavior, such as fraud, the best protection for consumers and the larger market will come through eliminating the flawed arrangements before lower-level employees engage in the risky behavior that the arrangements encourage.

CEOs and similarly situated executives at financial institutions are, like many white-collar criminals, in positions of trust.¹⁰⁰ An agency relationship exists between executives (the principals) and the employees below them in the hierarchy of the institution (the agents).¹⁰¹ Because institutions have numerous principals with discrete interests, from CEOs to board members, who are significantly removed from the agents, the “acting-for” relationship between the two groups is much more asymmetrical and insulated than a traditional agency relationship.¹⁰²

“Street-crime” offenders, such as those who perpetrate robbery or assault, harm their victims directly. White-collar offenders, in positions of trust, “induce victims to part with their money or property with lies, misrepresentations, and deceptions rather than with brute force.”¹⁰³

Not taking the threat of punishment into account, the cost-benefit analysis for the individual may weigh in favor of commission of the crime (or concealment of the wrongdoing), whereas for the corporation, honesty would be more profitable long-term.¹⁰⁴ A significant penalty and a possibility of prosecution for an institutional

⁹⁹ Travis Hirschi & Michael Gottfredson, *Causes of White-Collar Crime*, 25 CRIMINOLOGY 949, 953 (1987).

¹⁰⁰ See Susan P. Shapiro, *Collaring the Crime, Not the Criminal: Reconsidering the Concept of White-Collar Crime*, 55 AM. SOCIOLOGICAL REV. 346, 347 (1990).

¹⁰¹ *Id.* at 354.

¹⁰² *Id.* at 349–50. Shapiro explains that “trust or fiduciary rules do not provide substantive guidance regarding the exercise of the myriad agency roles that proliferate in complex societies.” *Id.* at 350 (citations omitted); see Jonathan R. Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 315, 319 (1991).

¹⁰³ See Shapiro, *supra* note 100, at 350. “Instead of cultivating mechanical technology to break into a secured building, trustee ‘burglars’ cultivate social technology to become trusted organizations . . . rich with opportunity for exploiting their positions for personal or corporate advantage.” *Id.*

¹⁰⁴ See John Braithwaite, *Challenging Just Deserts: Punishing White-Collar Criminals*, 73 J. CRIM. L. & CRIMINOLOGY 723, 728 (1982) (discussing a hypothetical scientist who unlawfully

officer in a responsible position would serve to de-incentivize the officer's concealment of or willful insulation from the wrongdoing, thereby tipping the cost-benefit analysis in favor of refraining.¹⁰⁵

2. Corporate Criminal Liability

Although the theory of *respondeat superior* allows criminal liability to attach to a corporation for criminal acts performed by certain employees acting within the scope of their employment and on behalf of the corporation,¹⁰⁶ punishing the corporation may result in collateral damage. A punitive fine imposed on a corporation may be passed on to innocent parties,¹⁰⁷ such as to consumers in higher prices, to shareholders in reduced dividends, or, in extreme circumstances, to the destruction of the entire corporation.¹⁰⁸ Each of these results can have a dampening effect on the market as a whole. In light of the gargantuan resources of these large financial institutions, most monetary punishments amount to little more than a bump in the road.¹⁰⁹ However, that is not to say that corporate liability should be abandoned in favor of individual liability alone.¹¹⁰ Although corporate liability may not have a strong enough deterrent effect to tip the scales of the cost-benefit analysis on its own, it can be an effective addition to individual liability, especially in light of the damage corporate sanctions can have on consumer trust.¹¹¹ Of course, punishment of an executive official will undoubtedly

conceals safety studies for a product to save her job, while the company would benefit more in the long-term from disclosure).

¹⁰⁵ See U.S. DEP'T OF JUSTICE, U.S. ATTORNEYS' MANUAL § 9-28.200 (2008), <http://www.justice.gov/opa/documents/corp-charging-guidelines.pdf>. The guidelines emphasize that “[b]ecause a corporation can act only through individuals, imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing. Only rarely should provable individual culpability not be pursued, particularly if it relates to high-level corporate officers” *Id.*

¹⁰⁶ KATHLEEN F. BRICKEY & JENNIFER TAUB, *CORPORATE AND WHITE COLLAR CRIME* 24–25 (6th ed. 2011); see *N.Y. Cent. & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 494 (1909).

¹⁰⁷ W.B. Fisse, *The Social Policy of Corporate Criminal Responsibility*, 6 *ADEL. L. REV.* 361, 405 (1977).

¹⁰⁸ Mary Kreiner Ramirez, *The Science Fiction of Corporate Criminal Liability: Containing the Machine Through the Corporate Death Penalty*, 47 *ARIZ. L. REV.* 933, 947 (2005).

¹⁰⁹ For example, the CFPB will require Wells Fargo to pay out \$185 million in fines, which amounts to 3.3% of the \$5.6 billion in net income Wells Fargo made in the second quarter of 2016. See John C. Coffee, Jr., *SEC Enforcement: What Has Gone Wrong?*, *CLS BLUE SKY BLOG* (Jan. 2, 2013), <http://clsbluesky.law.columbia.edu/2013/01/02/sec-enforcement-what-has-gone-wrong/> (characterizing enforcement actions as “issuing modest parking tickets for major frauds.”); but see Eric Holder, *Don't Indict WorldCom*, *WALL ST. J.*, July 30, 2002, at A14 (opining that corporate fines that are essentially death penalties for corporations harm “innocent Americans,” and “prosecutors must not give in to the pressures of the day and feel compelled to indict more corporations simply because they can.”).

¹¹⁰ See U.S. DEP'T OF JUSTICE, *supra* note 105, at 9-28.200(B) (stating that “prosecutors should not limit their focus solely to individuals or the corporation, but should consider both as potential targets.”).

¹¹¹ See Michael Corkery, *Wells Fargo Says Customers Shied Away After Scandal*, *N.Y. TIMES* (Oct. 14, 2016), <https://www.nytimes.com/2016/10/15/business/dealbook/wells-fargo->

have a detrimental effect on shareholders in the short term; in the long term, punishing offenders where deterrence is realistically possible and hopefully effective makes more sense. This supports the conclusion that punishment would be most effective for those individuals in responsible positions in the institution.

3. Sentencing for Optimal Deterrence

Punishments for corporations in the form of monetary penalties simply fail to have the same deterrent effect as the threat of even brief incarceration for an individual.¹¹² The Federal Sentencing Guidelines' tough stance on white-collar criminals reflects the idea that deterrence for white-collar criminals can best be achieved through certain (though often short) prison terms.¹¹³ Even before the Sentencing Reform Act of 1984¹¹⁴ reduced sentencing disparities and abolished parole, partially in an effort to reduce "coddling" of white-collar criminals,¹¹⁵ courts have recognized that the certainty of prison time upon conviction is key to effectuate deterrence among white-collar defendants.¹¹⁶ The Guidelines' designation of white-collar crime as "serious" and meriting prison time also reflects the idea that society is willing to recognize white-collar crime as equally worthy of punishment as street crimes.¹¹⁷

says-customers-shied-away-after-scandal.html; Aaron Klein, *Wells Fargo Shakes Consumers' Trust in Banks*, WALL ST. J. (Sept. 22, 2016), <https://www.wsj.com/articles/wells-fargo-shakes-consumers-trust-in-banks-1474561080>; Jonnelle Marte, *After Wells Fargo, Can You Trust Your Bank?*, WASH. POST (Sept. 20, 2016), <https://www.washingtonpost.com/news/get-there/wp/2016/09/20/after-wells-fargo-how-much-can-you-trust-your-bank/>.

¹¹² See Frank O. Bowman, III, *Drifting down the Dnieper with Prince Potemkin: Some Skeptical Reflections About the Place of Compliance Programs in Federal Criminal Sentencing*, 39 WAKE FOREST L. REV. 671, 674 (2004) (noting that monetary punishments for corporate criminal liability "simply do not engage the emotions in the way that confinement of a human being in a cell does.").

¹¹³ U.S. SENTENCING COMM'N, GUIDELINES MANUAL, ch. 1, pt. A, at 8 (2009). The guidelines explain:

Under pre-guidelines sentencing practice, courts sentenced to probation at an inappropriately high percentage of offenders guilty of certain economic crimes . . . that in the Commission's view are "serious." The Commission's solution to this problem has been to write guidelines that classify as serious many offenses for which probation was frequently given and provide for at least a short period of imprisonment in such cases. The Commission concluded that the definite prospect of prison, even though the term may be short, will serve as a significant deterrent

Id.; see BRICKEY & TAUB, *supra* note 106, at 695.

¹¹⁴ 18 U.S.C. §§ 3551–86 (2012).

¹¹⁵ See BRICKEY & TAUB, *supra* note 106, at 694 (explaining that through the Sentencing Reform Act, Congress sought to address the coddling of white-collar defendants by sentencing judges who relied heavily on fines and probation).

¹¹⁶ *Browder v. United States*, 398 F. Supp. 1042, 1047 (D. Or. 1975) (doubting that "deterrence will be . . . effective until the 'executive' becomes convinced that if he embarks on a criminal adventure, he will be severely—though proportionately—punished. Certainty is the key.").

¹¹⁷ See *id.* at 1046 (suggesting that white-collar criminals must expect equal or greater punishment than street criminals because "[t]he consequences of white collar property crime

4. Prosecutorial Discretion and Deferred Prosecution as Barriers to Deterrence

The biggest hurdle that comes with using criminal prosecution of responsible individuals as a deterrent is prosecutorial discretion. Even the threat of brief incarceration is likely enough to deter an individual from pursuing a criminal course of action; however, the problem lies where there is no certainty or even any reasonable probability that the individual will be prosecuted. When the executive has the perception that there is very little risk of prosecution for his role in his company's improper incentive-based compensation schemes, he may indeed engage in the cost-benefit analysis relied on by proponents of the deterrence theory. However, he may well come to the conclusion that the benefits that spring from highly profitable incentive schemes outweigh the slight risk of prosecution and the seemingly farfetched fear of prison time. Therefore, the government must allocate resources to investigating and consistently (or at least more than rarely) prosecuting the individuals in responsible positions for fraud resulting from incentive-based compensation schemes. Deterrence will not exist without a well-founded fear of real criminal charges.¹¹⁸

One form of prosecutorial discretion is deferred prosecution. Deferred prosecution is often relied on in white-collar and corporate crime cases,¹¹⁹ but fails to provide the same deterrent effect as direct prosecution.¹²⁰ In a deferred prosecution, a prosecutor gets an indictment against an offender but defers prosecution if the offender cooperates, often by admitting wrongdoing and correcting the violations that led to the charges.¹²¹ If the prosecutor is satisfied that the offender has made the necessary changes, such as correcting the incentive-based compensation arrangements that

tend to reach a higher magnitude in direct proportion to the level of status and power held by the criminal involved.”); see generally Braithwaite, *supra* note 104.

¹¹⁸ See Brandon L. Garrett, *The Corporate Criminal as Scapegoat*, 101 VA. L. REV. 1789, 1827–28 (2015).

¹¹⁹ From 2001 to 2014, there were sixty-six cases of deferred prosecution involving financial institutions, including: Baystar Capital Management LLC (fraud), ConvergEx Group, LLC (securities fraud), Deutsche Bank AG (tax fraud), Diamondback Capital Management LLC (securities fraud), GE Funding Capital Market Services, Inc. (FCPA), German Bank HVB (tax fraud), Jefferies Group LLC (fraud), JPMorgan Chase & Co. (antitrust), Louis Berger (fraud), Mellon Bank, N.A. (theft), Merrill Lynch (false statements), Mirant Energy Trading (false commodities reporting), NETeller PLC (illegal gambling), and Prudential Equity Group (securities fraud). *Id.* at 1816 n.110; see also Joseph Warin, *2014 Year-End Update on Corporate Deferred Prosecution and Non-Prosecution Agreements*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 18, 2015), <https://corpgov.law.harvard.edu/2015/01/18/2014-year-end-update-on-corporate-deferred-prosecution-and-non-prosecution-agreements> (reporting that “[t]he decade-long trend favoring the use of [deferred prosecution agreements] is expected to explode in 2015 . . .”).

¹²⁰ See Alan Vinegrad, *Government Likely to Go After Corporations*, NAT’L L.J., Mar. 10, 2003, at A27, A28; see also Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311, 333 (2007).

¹²¹ See Benjamin M. Greenblum, Note, *What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements*, 105 COLUM. L. REV. 1863, 1864 (2005).

resulted in fraudulent behavior and possibly including payment of restitution, he may dismiss the indictment and forgo the attachment of criminal liability.¹²²

Deferred prosecutions in white-collar crime and corporate crime cases have been on the rise since the Justice Department introduced formal standards for prosecuting corporations and added a focus on the authenticity of the offender's cooperation.¹²³ Deferred prosecutions are undesirable from a deterrence perspective for a number of reasons. First, if the corporation knows it can escape liability by fixing any compliance problems during the deferral period, little incentive exists to create compensation arrangements that comply in the first place.¹²⁴ Second, deferred prosecution allows a company to avoid most of the bad publicity that results from a conviction (or at least from charges) because the indictment will likely be dismissed.¹²⁵ Finally, the majority of deferred prosecution agreements with corporations result in no individual liability, thus defeating an additional disincentive to criminal conduct.¹²⁶ If the desired result is that the corporation and responsible individuals implement proper arrangements or correct risky arrangements early, deterrence through criminal liability would be more effective than deferred prosecution.

B. Regulatory Solutions

1. Strengthening and Reforming the Current Regulations

In addition to criminal prosecution, regulations can also be set up to provide a deterrent effect through the threat of penalties. For regulatory penalties to effectively deter executives from instituting flawed incentive-based compensation arrangements, participating in them, or ignoring flawed incentive-based compensation arrangements put in place by others, the penalties must be proportionately punitive, appropriately triggered, and practically enforceable.

¹²² *Id.*; see Griffin, *supra* note 120, at 321 (describing deferred prosecution agreements as “a form of probation, or ‘pretrial diversion,’ according to which the government agrees to suspend charges against a company so long as the company fulfills every obligation set forth . . .”).

¹²³ See Memorandum from Eric H. Holder, Jr., Deputy Att’y Gen., U.S. Dep’t of Justice, to Component Heads & U.S. Att’ys (June 16, 1999), <https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2010/04/11/charging-corps.PDF>; Memorandum from Larry D. Thompson, Deputy Att’y Gen., U.S. Dep’t of Justice, to Heads of Dep’t Components (Jan. 20, 2003), http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20_privwaiv_dojthomp.authcheckdam.pdf; see also Griffin, *supra* note 120, at 323 (noting that deferred prosecutions are “not a new device, but they were rarely pursued in corporate criminal cases until the Thompson Memorandum encouraged their use as an alternative to indictment.” (footnotes omitted)).

¹²⁴ See Greenblum, *supra* note 121, at 1864.

¹²⁵ See Griffin, *supra* note 120, at 333 (stating that corporations “can use deferred prosecution combined with individual culpability as a public relations tool to distance the corporation itself from the employee offenders.”); Vinegrad, *supra* note 120, at A28 (noting that deferred prosecution provides “another means by which a corporation that has engaged in criminal wrongdoing can ultimately avoid the stigma and collateral consequences of a conviction.”).

¹²⁶ BRANDON L. GARRETT, TOO BIG TO JAIL 83 (2016) (noting that from 2001 to 2012, only eighty-nine individuals were prosecuted out of 255 deferred or non-prosecution agreements).

The most recently proposed rule by the financial Agencies is an improvement over the 2011 proposed rule, as it includes a clawback provision.¹²⁷ The threat of the bank recovering compensation from an executive in the event of undesirable outcomes could serve to de-incentivize an executive from turning a blind eye to risky incentive-based compensation arrangements, as long as the clawbacks are triggered both if the executive himself is awarded compensation via these arrangements and if he is in a position to know about the existence of these arrangements. However, in order to be effective, the amount of money subject to clawback must be proportionately punitive to the executive. If only a small percentage of an executive's pay is subject to loss due to undesirable outcomes, the executive may believe the profits that might result from the risky behavior outweigh the risk (or even the actual loss) of that amount. Additionally, if the clawback is to be truly punitive, vested compensation should be subject to clawback—the loss of unvested compensation is felt significantly less, as it is money that has not truly been “paid out” yet.¹²⁸ Further, putting clawback provisions into an executive's employment contract can make the threat of clawback much more direct and, therefore, produce more of a deterrent effect.¹²⁹ The likelihood of enforcement when clawback provisions are contained in employment contracts and not just in regulations is greater.¹³⁰

Deferral and forfeiture can serve similar goals as clawback provisions by reducing risk-taking behavior through putting part of an executive's pay at stake.¹³¹ Although the 2016 proposed rule includes these tools,¹³² for a true deterrent effect, the deferral period must be longer than suggested by the rule, which currently has a period of three years.¹³³ A longer deferral period in which unvested awards are subject to forfeiture will help align the executive's interest with those of the shareholders and the market at large,¹³⁴ and the executive will in turn be motivated to align policy carried out by lower-level employees with those interests.

¹²⁷ Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37805, § 42.7(c) (proposed June 10, 2016) (to be codified at 12 C.F.R. pt. 42).

¹²⁸ See Prins, *supra* note 84 (noting that Stumpf's exit payout is a “plush parachute,” as his only penance was forfeiting stock he did not even fully own yet).

¹²⁹ See Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 420–21 (2009) (discussing writing clawback provisions directly into employment contracts as a “bottom-up” approach to reform rather than the “top-down approach” of regulatory reform).

¹³⁰ *Id.* at 421–22.

¹³¹ See Chenyang Wei & David Yermack, *Investor Reactions to CEOs' Inside Debt Incentives*, 24 REV. FIN. STUD. 3813, 3813 (2011) (arguing that large deferred compensation plans for top managers might cause them to manage their companies conservatively, “avoiding risk and preserving liquidity . . .”).

¹³² Incentive-Based Compensation Arrangements, 81 Fed. Reg. at 37680.

¹³³ *Id.*

¹³⁴ See Cherry & Wong, *supra* note 129, at 392 (arguing that executive focus on short-term performance “often leads to opportunistic behavior, at the expense of the long-term health of the company.”); Rebecca A. Crawford, Note, *Corporate Governance Reform: How to Promote the Long-Term Health and Value of U.S. Corporations*, 5 N.Y.U. J. L. & BUS. 905, 923 (2009) (stating that “slowly vesting stock options will incentivize directors and executives to focus on the long-term health of their corporations.”).

2. Increased Regulatory Effectiveness Through Cooperative Governance

However, for these strengthened regulations to have any effect, they must be both enforceable and actually enforced.¹³⁵ Currently, the bodies charged with oversight of incentive arrangements of financial institutions are the group of financial Agencies that promulgated the 2011 and 2016 proposed rules on incentive-based compensation arrangements and, to a more general degree, the CFPB.¹³⁶ These watchdogs are relatively small in comparison to the size and resources of the financial institutions they are watching.¹³⁷ However, dramatically increasing the size of the regulatory bodies simply is not feasible.¹³⁸ Instead, the regulations should be made more effectively enforceable by emphasizing strategies that ensure companies are truly taking steps to monitor risks posed by their incentive-based compensation schemes and are not superficially complying for the sake of meeting the requirement.¹³⁹ Two forms of self-regulation could be useful in this regard: “partial” self-regulation, in which the financial institution engages in rulemaking, and “full” self-regulation, in which the financial institution engages in both rulemaking and enforcement.¹⁴⁰

3. Institution-Designed Regulations

A more interactive regulatory scheme can benefit both institutions and consumers.¹⁴¹ If financial institutions are allowed to ensure that their incentive-based

¹³⁵ An additional consideration is the moral hazard that results when the government bails out risk-taking institutions, leading to those in a position to expose the company to risks to do so with perceived impunity. See Joseph Karl Grant, *What the Financial Services Industry Puts Together Let No Person Put Asunder: How the Gramm-Leach-Bliley Act Contributed to the 2008–2009 American Capital Markets Crisis*, 73 ALB. L. REV. 371, 419 (2010); see also Ronald M. Giammarino et al., *An Incentive Approach to Banking Regulation*, 48 J. FIN. 1523, 1524 (1993) (stating that “in practice, monitoring is only imperfectly informative, and regulators are often unable or unwilling to act on the information they receive.”).

¹³⁶ Incentive-Based Compensation Arrangements of 2011, 76 Fed. Reg. 21170 (proposed Apr. 14, 2011).

¹³⁷ See Davidson, *supra* note 79.

¹³⁸ See Stanley Sporkin, *Reforming the Private Sector’s Role in Deterring Corporate Misconduct*, 60 LAW & CONTEMPORARY PROBS. 93, 94, 96 (1997) (stating that because the government is unlikely to increase its resources, in policing financial sectors “there has been and must continue to be a shared responsibility [between the government and the private sector].”).

¹³⁹ See Krawiec, *supra* note 93, at 487, 491 (arguing that many internal compliance structures “do not deter prohibited conduct within firms, and may largely serve a window-dressing function that provides both market legitimacy and reduced legal liability,” leading to an under-deterrence of corporate misconduct and a proliferation of costly—but arguably ineffective—internal compliance structures.).

¹⁴⁰ See Julia Black, *Decentering Regulation: Understanding the Role of Regulation and Self-Regulation in a ‘Post-Regulatory’ World*, in 54 CURRENT LEGAL PROBS. 103, 115 (M.D.A. Freeman ed., 2002).

¹⁴¹ See generally Lauren E. Willis, *Performance-Based Consumer Law*, 82 U. CHI. L. REV. 1309, 1309 (2015) (proposing that gaps in regulation can be filled by allowing the regulated entity to choose how to meet the regulation standard and more closely align the goals of the regulators and the regulated).

compensation schemes comply with the regulations through methods designed largely by the institution and approved by their regulating bodies, companies will be less likely to expend their resources designing compliance programs that are solely in places to jump through the hoops of the regulations.¹⁴² Alternatively, regulation could be designed at an industry level, or even firm-by-firm, by a panel of individuals with experience in the financial industry, as a modified form of self-regulation,¹⁴³ which would help cure problems caused by high levels of complexity in the financial sector and the regulatory agencies' inability to effectively account for that complexity. Regulations formulated primarily by the financial institution would internalize some of the costs of promulgating rules formerly borne by the agencies or at least reduce them by cutting down on the costs of research.¹⁴⁴ However, such regulation would require governmental oversight to ensure that the industry-designed rules are not self-serving, as compared to rules designed by outsiders.

4. Institution-Enforced Regulations

A similar idea involves creating an independent body charged with oversight of compensation arrangements and comprised of individuals who work in the financial industry. This body would not be a substitute for government regulation, but rather an addition to maximize efficiency and oversight.¹⁴⁵ A specialized committee like this would be able to monitor financial institutions efficiently because of its familiarity with and knowledge of the industry (as opposed to bodies with a broad range of areas for which they are responsible for monitoring).¹⁴⁶ This form of self-regulation would reduce an institution's ability to shield itself from penalties through risk-management measures that are merely put in place for the sake of compliance; a committee made up of industry insiders could effectively see through the sham.

Although this proposal presents the threat of insiders protecting each other or engaging in "back-scratching" that could undermine the effectiveness of such a

¹⁴² See Bowman, *supra* note 112, at 674–75; see also John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 MICH. L. REV. 1466, 1470–71 (1982) [hereinafter Braithwaite, *Enforced Self-Regulation*] (arguing for a form of "enforced self-regulation" in which the government would compel a company to write a set of rules "tailored to the unique set of contingencies facing that firm."); Krawiec, *supra* note 93, at 493 (explaining that to comply with traditional regulations, companies "are forced to adopt costly additional internal compliance structures in order to avoid the risk of harsh penalties when violations occur . . .").

¹⁴³ See Saule T. Omarova, *Wall Street as a Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 470–80 (2011) (proposing "embedded self-regulation" in the financial sector as an addition to governmental regulation, encouraging participation by lowering the costs of compliance).

¹⁴⁴ See Braithwaite, *Enforced Self-Regulation*, *supra* note 142, at 1471.

¹⁴⁵ *Id.*; see Anil K. Gupta & Lawrence J. Lad, *Industry Self-Regulation: An Economic, Organizational, and Political Analysis*, 8 ACAD. MGMT. REV. 416, 417 (1983) (discussing a system in which industry self-regulation is auxiliary or complementary to governmental regulation).

¹⁴⁶ See Braithwaite, *Enforced Self-Regulation*, *supra* note 142, at 1469 (arguing that "[t]he power of corporate inspectors to trap suspected wrongdoers is often greater than that possessed by government investigators.").

committee,¹⁴⁷ certain measures can ensure that self-regulation is truly in the interest of the public. For example, the self-regulating body will likely need to report to governmental regulating bodies frequently to encourage transparency and accountability and to allow the government to step in if the reports indicate emerging systemic risks.¹⁴⁸ Finally, banks may embrace the ability to regain public trust by participating in a form of self-policing, thereby furthering consumer confidence and enjoying positive publicity.

VI. CONCLUSION

Without intervention, flawed incentive-based compensation arrangements will continue to expose financial institutions and the public to serious risks. Instituting the threat of more serious penalties imposed by regulations, creating regulations that encourage more than mere superficial compliance, and pursuing criminal prosecution where appropriate can halt the current trend of incentive-based compensation arrangements that encourage risky employee behavior at financial institutions. Current and proposed regulations and increasingly lax prosecution are inadequate because they do not offer enough of a deterrent effect, a theory of punishment that could prove more successful than others in the realm of white-collar crime.

Incentive-based arrangements are standard procedure in many large companies, so a company is practically required to offer them to attract the most desirable workers in a competitive environment.¹⁴⁹ Incentive systems also serve independent goals that benefit shareholders and the public, such as rewarding profit maximization and encouraging a healthy economy through strong markets. If properly implemented and maintained, incentive-based systems can offer significant benefits that make them worthwhile, which would mean improving these systems rather than outlawing them entirely is desirable.

The government should prosecute executives responsible for incentive-based compensation arrangements that they know to be flawed and that result in fraudulent employee behavior at the expense of consumers. As articulated by the Sentencing Guidelines, the threat of short but certain jail time will have a true deterrent effect on potential white-collar offenders. Because these crimes generally occur over a relatively long period of time and involve a series of deliberate, thoughtful decisions,

¹⁴⁷ For a discussion of problems with self-interest and independence in oversight groups, see William W. Bratton, *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439 (2003).

¹⁴⁸ See Edward J. Balleisen, *The Prospects for Effective Coregulation in the United States: A Historian's View from the Early Twenty-First Century*, in GOVERNMENTS AND MARKETS 443, 465, 473 (Edward J. Balleisen & David A. Moss eds., 2010) (stating that business self-regulation works best when those responsible for it know "not only that poor performance will trigger sanctions, but also that if business institutions systematically fail to achieve regulatory objectives, a more vigorous regulatory shotgun [governmental intervention] waits in the wings."); Omarova, *supra* note 143, at 485–86 (arguing that industry self-regulation "requires that the government agency overseeing the self-regulation process maintain the strong capacity for investigation of potential malfeasance by private actors and enforcement of legal and regulatory requirements." (footnote omitted)).

¹⁴⁹ Catherine Oak, *Ten Ways to Attract and Retain Great Employees*, INS. J. (July 7, 2003), <https://www.insurancejournal.com/magazines/mag-mindyourbiz/2003/07/07/30612.htm>.

white-collar crime is uniquely suited for achieving effective deterrence through punishment.

More punitive clawbacks to vested compensation, longer deferral periods, and reformed regulatory structures would offer those in responsible positions at financial institutions an incentive both to monitor incentive-based compensation strategies for potential risk exposure and put a stop to those that expose the institution to significant risk. This would work to align the interests of executives with the interests of shareholders, as well as protect the consumer.

Further, the regulations will be more effective and foster benefits for the institution as well as the consumer if they allow the institutions to work with the government in creating the rules. If banks can tailor their monitoring and reporting of incentive-based compensation arrangements, they can save money because compliance will be more realistic and responsive to the unique demands of the financial sector and less likely to be merely superficial compliance. Additionally, the government can use the expertise of industry leaders and save on regulatory resources.

An independent oversight body made up of industry insiders, in addition to government watchdogs, is another form of interactive governance that could benefit the industry. Keeping in mind the threat of industry executives turning the other way to protect their own interests, a specialized oversight committee would be able to detect potentially risky trends caused by compensation arrangements before they result in harm to the consumer. A reduction in flawed incentive-based compensation arrangements at large financial institutions will result in better working environments for employees, sustainable long-term profitability for shareholders, and a more stable economy. For our banking system to function, the public must regain trust in its financial institutions.¹⁵⁰ Banks have historically been pillars of the community and a symbol of stability,¹⁵¹ and if bank executives continue to pursue the goal of maximizing profit at any cost, banks will never regain their place of trust in society. Banks *should* make profits—this is the proper purpose of a corporation.¹⁵² However, they must not lose sight of the vital role of public trust in this endeavor. In order to ensure the stability of our economy as a whole, the government must step in to put an end to flawed incentive-based compensation arrangements.

¹⁵⁰ See Steve Denning, *How Can Bankers Recover Our Trust?*, FORBES (Feb. 6, 2013), <http://www.forbes.com/sites/stevedenning/2013/02/06/will-we-ever-trust-bankers-again/#14707ece377d> (noting that “trust is the very foundation of banking” and that trust in banks is historically low in recent years as a result of banks’ single-minded pursuit of “bad profits” at the expense of the best interest of customers).

¹⁵¹ *Id.*

¹⁵² *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (emphasizing that “[a] business corporation is organized and carried on primarily for the profit of the stockholders.”); *but see* James R. Barth et al., *Policy Watch: The Repeal of Glass-Steagall and the Advent of Broad Banking*, 14 J. ECON. PERSP. 191, 191–204 (2000).

