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INITIAL REFLECTIONS ON THE POSSIBLE APPLICATION OF CONTINGENT CAPITAL IN CORPORATE GOVERNANCE

WULF A. KAAL*

ABSTRACT

The failure of systemically important financial institutions (“SIFIs”) during the 2008–2009 financial crisis may underscore possible shortcomings in corporate governance. The regulatory evaluation of contingent capital in the United States could be an opportunity to assess the possible application of contingent capital in the corporate governance of SIFIs. While regulatory initiatives in Europe and the academic debate in the United States are dominated by efforts to improve the technical design features of contingent capital securities, this Article suggests that contingent capital designs in various jurisdictions could benefit from experimentation and a learning experience that takes corporate governance applications into account. As the design features evolve and their scope and impact become clearer, possible corporate governance improvements could become more obvious.

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I. INTRODUCTION

The events that unfolded during the credit crisis of 2008–2009 lead many observers to conclude that the level of risk in the financial sector was excessive.¹ Much of the alleged market failure was blamed on risky banking practices.² Systemically important financial institutions (“SIFIs”) and their business practices played a central role in the events leading up to and during the financial crisis. The systemic relevance of these institutions caused many governments to provide bailout funding to avoid

1. See Christian Kirchner, *Wege aus der Krise der Euro-Peripherieländer* [Ways Out of the Crisis of the Euro-Peripheral Countries], *BÖRSEN-ZEITUNG* (Mar. 8, 2011), available at <http://www.boersen-zeitung.de/index.php?li=1&artid=2011046062&titel=Wege-aus-der-Krise-der-Euro-Peripherielaender>; Christian Kirchner, *Comment on Sovereign Bankruptcy in the EU in the Comparative Perspective*, *ÖKONOMISCHE ANALYSE DES EUROPARECHTS* [ECONOMIC ANALYSIS OF EUROPEAN LAW] (Peter Behrens et al. eds., 2011) (written in response to Leszek Balcerowicz’s article *Sovereign Bankruptcy in the EU in the Comparative Perspective*). For a general analysis of causal factors of the international financial markets crisis, see Christian Kirchner, *Wege aus der Internationalen Finanzmarktkrise* [Ways Out of the International Financial Crisis], 89 *WIRTSCHAFTSDIENST* 459, 459–65 (2009); Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 *CHI. J. INT’L L.* 581, 607–08 (2010); see also James E. Kelly, *Transparency and Bank Supervision*, 73 *ALB. L. REV.* 421, 423–24 (2010) (recognizing that in light of the recent crisis, critics’ concerns have focused on the role of systemic risk in financial institutions and markets).

2. See Robert P. Bartlett, III, *Making Banks Transparent*, 65 *VAND. L. REV.* (forthcoming 2012), available at <http://ssrn.com/abstract=1884437> (arguing for more transparency via disclosure in the banking sector); Dirk Heremans & Alessio M. Paces, *Regulation of Banking and Financial Markets*, in *ENCYCLOPEDIA OF LAW AND ECONOMICS: REGULATION AND ECONOMICS* (A.M. Paces & R.J. Van den Bergh eds., 2d ed.) (forthcoming 2012), available at <http://ssrn.com/abstract=1914461>. The author recognizes that the concepts of “market failure” and “excessive risk” are controversial. Whether and why markets fail is unclear. It is also unclear how excessive risk can be defined. Depending on the interpretation of these open questions, policy makers on both sides of the Atlantic may approach regulation of risk in the banking sector differently.

larger ripple effects.³ Without bailout funding, bank runs and panic in financial markets could have become a reality.⁴

The social costs of government bailouts may be significant. Government bailouts create strong incentives to externalize the cost of SIFIs' risk taking onto taxpayers. Bailouts also may distort markets if some but not all SIFIs receive bailout funds because the subsidized firm may be able to undercut their competitors.⁵ Increased competition could drive some SIFIs out of business or into riskier market segments.⁶ The implicit guarantees in a bailout may also multiply the incentives for SIFIs to increase leverage because the guarantees could make debt cheaper than equity. Increased leverage of SIFIs has the potential to increase the overall supply of money and could increase asset price distortions while hiding the mispricing of risk.⁷ Government bailouts also raise important ethical issues.⁸ Given the systemic implica-

3. Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 470 (2010) (noting that although it would be difficult to extract a consistent policy from the government's response to failing banks, a "guiding principle" became a preference for bailouts over bankruptcy and its attendant consequences); *id.* ("Lehman proved that you cannot let a large internationally active firm fail in the middle of a financial crisis.") (quoting Federal Reserve Chairman Ben Bernanke); George A. Walker, *Financial Crisis—U.K. Policy and Regulatory Response*, 44 INT'L LAW. 751, 753–54 (2010) (commenting that in the United Kingdom, the bailouts began with the Bank of England eventually nationalizing Northern Rock Bank in 2008, followed the next year by the government announcing a second support package for struggling banks); *see also* BANK OF ENGLAND, FINANCIAL STABILITY REPORT (2009) [hereinafter BANK OF ENGLAND REPORT]. *See* Wulf A. Kaal & Richard W. Painter, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States*, 40 SETON HALL L. REV. 1433, 1435–36 (2010), for a discussion on how several German banks became involved in Asset Backed Commercial Paper (ABCP) Programs. Deutsche Bank, IKB, and SachsenLB "were the leading bank sponsors with outstanding ABCP." This resulted in the eventual German government bailout of IKB, as well as WestLB, which had to be bailed out four times. *Id.*

4. *See* Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 564 (2011) ("[O]ne financial failure could induce another and, like dominoes, the financial system could collapse.").

5. *See* Erik F. Gerding, *Deregulation Pas De Deux: Dual Regulatory Classes of Financial Institutions and the Path to Financial Crisis in Sweden and the United States* 8–9 (Univ. N.M. Sch. L. Legal Stud. Res. Paper Series, Paper No. 2010–04, 2010), available at <http://ssrn.com/abstract=1548753>.

6. *Id.*

7. *See* Margaret M. Blair, *Financial Innovation, Leverage, Bubbles and the Distribution of Income*, 30 REV. BANKING & FIN. L. 225, 230–32 (2011).

8. *See* RICHARD W. PAINTER, GETTING THE GOVERNMENT AMERICA DESERVES: HOW ETHICS REFORM CAN MAKE A DIFFERENCE 164–166 (2009); Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab*, 41 MCGEORGE L. REV. 131, 159–160 (2010) (arguing that aligning the

tions of SIFIs, governments may prioritize SIFI bailouts over other entities. Government prioritization of SIFI bailouts could incentivize SIFIs to adopt similar risk profiles and correlate risks.⁹ Cheaper debt as a result of government guarantees also has the potential to increase regulatory capital arbitrage.¹⁰

Given the negative effects of government bailouts and the extra attention SIFIs may receive from governments, perhaps existing corporate governance mechanisms are not adequately addressing SIFI governance concerns. The most high profile cases of SIFI mismanagement, such as Bear Stearns, Lehman Brothers, American Insurance Group (“AIG”), and Merrill Lynch, could call into question the existing corporate governance rules pertaining to SIFIs and their management. The conduct of management in these cases may have fostered market activities and investments that turned out to be detrimental to the value of the shareholders’ investment and the stability of the world financial system. While the conduct of SIFI management in these cases may not be outright illegal, it seems to call into question the priorities and moral reasoning of SIFI management.

The issuance of contingent capital securities (“CCS”) could be a promising regulatory tool to address corporate governance shortcomings in SIFIs. Contingent capital¹¹ is an automatic mechanism for increasing capital while reducing debt with the

incentives of economic actors with the consequences of their actions is one of the important challenges in creating an economic system that does not need bailouts).

9. See Viral V. Acharya, *A Theory of Systemic Risk and Design of Prudential Bank Regulation*, 5 J. FIN. STABILITY 224 (2009).

10. See Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195 (2009); David Jones, *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues*, 24 J. BANKING & FIN. 35 (2000).

11. For purposes of this Article, the term “contingent capital” or “contingent capital securities” (“CCS”) will be used. There are other names for the same concept. See SQUAM LAKE WORKING GROUP ON FINANCIAL REGULATION, AN EXPEDITED RESOLUTION MECHANISM FOR DISTRESSED FINANCIAL FIRMS: REGULATORY HYBRID SECURITIES 2 (2009) [hereinafter SQUAM LAKE WORKING GROUP], available at <http://www.cfr.org/economics/expedited-resolution-mechanism-distressed-financial-firms-regulatory-hybrid-securities/p19002> (referring to “regulatory hybrid securities”); *CoCo Nuts: Lloyds is First Out of the Gate with a New Kind of Capital*, ECONOMIST, Nov. 5, 2009, available at http://www.economist.com/node/14816673?story_id=14816673 (referring to “contingent convertibles” or “CoCos”); Mark J. Flannery, *Stabilizing Large Financial Institutions with Contingent Capital Certificates* (October 6, 2009) (unpublished comment) (on file with University of Florida, Department of Finance, Insurance and Real Estate) (referring to “contingent capital certificates”); Julie Dickson, *Remarks at Financial Services Invitational Forum: Too-big-to-fail and Embedded Contingent Capital* 4 (May 6, 2010), <http://www.osfi-bsif.gc.ca/app/>

long-term benefit of lowering leverage.¹² By internalizing bank failure costs, contingent capital could help minimize moral hazard,¹³ help avoid financial contagion,¹⁴ and limit systemic risk.¹⁵ The conversion feature of contingent capital shows great promise to provide an institution-specific mechanism for general risk control¹⁶ and could enhance regulatory capital requirements by

DocRepository/1/eng/speeches/jdlh20100506_e.pdf (referring to “embedded contingent capital”).

12. John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 806 (2011) (promoting contingent capital as an alternative to bankruptcy or bailouts). Coffee suggests a contingent capital design where “(1) The conversion ratio would be deliberately designed to protect the debt holders from loss by instead diluting the existing equity holders, and (2) the debt security would convert into a fixed return preferred stock with cumulative arrearages and significant voting rights.” Coffee avers that converting the debt security into preferred stock creates a “countervailing voting constituency to offset the voting power of risk-tolerant common shareholders, thereby reducing the pressure on corporate managers to accept greater risk and leverage.” Under Coffee’s proposal, conversion would be triggered when the common stock price significantly decreases. *Id.*

13. See Mark J. Flannery, No Pain, No Gain? Effecting Market Discipline via “Reverse Convertible Debentures,” 15 (Nov. 2002) (unpublished manuscript) (Program on International Financial Systems at Harv. L. Sch.) (“Frequent trigger evaluations eliminate moral hazard incentives and expose the RCD to surprisingly low default risk.”), available at <http://bear.warrington.ufl.edu/flannery/No%20Pain,%20No%20Gain.pdf>.

14. GOLDMAN SACHS GLOBAL MARKET INST., EFFECTIVE REGULATION: PART 5: ENDING “TOO BIG TO FAIL” (2009) [hereinafter GOLDMAN SACHS, EFFECTIVE REGULATION], <http://www2.goldmansachs.com/our-thinking/public-policy/regulatory-reform/effect-reform-part-5.pdf> (showing what could have happened if contingent capital had been in place during the recent economic crisis.). The authors also note that if the appropriate triggers are in place, it could prevent bank runs; though if the trigger is based on market prices, it could worsen bank runs. *Id.* at 5–6.

15. Coffee, *supra* note 12, at 806 (suggesting that contingent capital should be designed to create a standard for SIFIs).

16. Raghuram G. Rajan, *Too Systemic to Fail: Consequences, Causes, and Potential Remedies* 25, 28 (Bank for Int’l Settlements, Working Papers No. 305, 2010), available at <http://www.bis.org/publ/work305.pdf> (“[C]ontingent capital is like installing sprinklers [W]hen fire threatens, the sprinklers will turn on.”). But see Christian Koziol & Jochen Lawrenz, *Contingent Convertibles: Solving or Seeding the Next Banking Crisis?*, 36 J. BANKING & FIN. 90, 91 (2012) for a suggestion that CoCo bonds may “create negative externalities . . . in the sense that” the destabilizing risk-shifting problem induced by CoCo bonds may overcompensate the stabilizing effect of providing a pre-committed recapitalization to banks. *Id.* Through the use of a “dynamic continuous-time framework” the authors conclude that “the beneficial impact of CoCo bonds crucially hinges on the assumption if bank managers have substantial discretion over the bank’s business risk.” *Id.* at 101. The authors contend that if complete contracts can be written, CoCos are clearly beneficial. If allowing for incomplete contracts, however, the authors argue that “CoCo bonds always distort risk tak-

creating a regime for providing countercyclical regulatory capital.¹⁷

The design features of contingent capital securities are not fully developed.¹⁸ The evolving design of contingent capital securities in various jurisdictions could have an effect on the nascent market in contingent capital securities, other financial markets, future bailouts, moral hazard, risk taking by managers, and the perception of systemic risk and operational risk in SIFIs. Possible contingent capital rules should attempt to balance these interests.

In the United States, section 165(b) of the Dodd-Frank Act authorizes the Board of Governors of the Federal Reserve to utilize contingent capital.¹⁹ Section 115(c) of the Dodd-Frank Act requires a study on the feasibility of contingent capital in the United States.²⁰ The language of section 115(c) does not

ing incentives. Therefore, equity holders have incentives to take excessive risks Thus, CoCos may be an example where individually rational decisions can have systemically undesirable outcomes." *Id.*

17. See William C. Dudley, President & CEO, Fed. Reserve N.Y., Some Lessons from the Crisis, Remarks at the Institute of International Bankers Membership Luncheon (Oct. 13, 2009), available at <http://www.newyorkfed.org/newsevents/speeches/2009/dud091013.html> (proposing that CCS can be used to adequately capture risk).

18. See *id.*; Christoph Henkel & Wulf A. Kaal, *Sequential Contingent Capital Triggers in Europe and the United States*, 49 SAN DIEGO L. REV. (forthcoming 2012) (recognizing that contingent capital designs are not fully developed and suggesting a modification to Coffee's approach by separating the trigger events for a voting rights increase after conversion).

19. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, § 165(b)(1)(B), 124 Stat. 1376, 1404, 1423 (codified as amended at 12 U.S.C. § 5365 (Supp. IV 2011)).

20. *Id.* § 115(c) (codified as amended at 12 U.S.C. § 5325):

CONTINGENT CAPITAL.—(1) STUDY REQUIRED.—The Council shall conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for non-bank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), which study shall include—

(A) an evaluation of the degree to which such requirement would enhance the safety and soundness of companies subject to the requirement, promote the financial stability of the United States, and reduce risks to United States taxpayers;

(B) an evaluation of the characteristics and amounts of contingent capital that should be required;

(C) an analysis of potential prudential standards that should be used to determine whether the contingent capital of a company would be converted to equity in times of financial stress;

(D) an evaluation of the costs to companies, the effects on the structure and operation of credit and other financial markets, and other economic effects of requiring contingent capital;

directly address the possible application of contingent capital in a corporate governance context. In subsection (A), the Act provides for “an evaluation of the degree to which such [a contingent capital] requirement would enhance the safety and soundness of companies subject to the requirement, promote the financial stability of the United States, and reduce risks to United States taxpayers.”²¹ The evaluation of “safety and soundness of companies subject to the requirement”²² could include an assessment of the possible application of contingent capital in corporate governance.

Regulatory initiatives in Europe and the academic debate in the United States focus on improving the technical design features of contingent capital securities. Given the importance of technical design features, possible applications of CCS for corporate governance are mostly ignored. In fact, it is tempting to ignore broader implications and possible applications of contingent capital and focus exclusively on technical design features and the economics of a design, or launch directly into a critique or evaluation of broader implications and possible applications without a full evaluation of technical design aspects. Either approach seems suboptimal.

As contingent capital design features evolve and their scope and impact become clearer, so may their shortcomings, ethical implications, and possible corporate governance applications. The efficient functioning of contingent capital designs could benefit from experimentation and a learning experience that takes corporate governance considerations into account.²³ Contingent capital could have the potential to change the control dynamic, the power structure, and dependencies within SIFIs. Shareholders, management, and creditors could be equally affected. Combined with other corporate governance mechanisms, CCSs, as an internal institution-specific mechanism, could help fill a void left by regulators’ seeming inability to supervise financial institutions effectively.

(E) an evaluation of the effects of such requirement on the international competitiveness of companies subject to the requirement and the prospects for international coordination in establishing such requirement; and

(F) recommendations for implementing regulations.

Id.

21. *Id.* § 115(c)(1)(A).

22. *Id.*

23. *See infra* Part VI (describing the New Institutional Approach to experimentation and a learning experience).

This Article starts with a summary of mismanagement in SIFIs, management practices, and possible corporate governance shortcomings pertaining to SIFIs. Next, it discusses briefly the benefits and potential shortcomings of proposed contingent capital designs. The Article then explores the current proposals for contingent capital designs, underscoring the need for experimentation, before sketching the possible application of contingent capital in corporate governance.

The preliminary inquiry in this Article suggests that, as the design features of contingent capital in different jurisdictions evolve, more research on the possible application of contingent capital in corporate governance could be needed.

II. GOVERNANCE CHALLENGES FOR SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

Systemically important financial institutions (“SIFIs”) played a central role in the events leading to the 2008–2009 financial crisis. Without bailout funding for SIFIs, bank runs²⁴ and panic in financial markets could have become a reality.²⁵

SIFI executives have promoted market activities and investments that turned out to be detrimental to the value of the shareholders’ investment and the stability of the world financial system. While the questionable conduct of SIFI management may not be outright illegal, it could call into question the priorities and moral reasoning of SIFI management. It is noteworthy that in the time period leading up to the credit crisis most of the SIFIs operating in world markets engaged in highly leveraged trading of high-risk financial instruments without appropriate risk parameters in place. If SIFI leaders act on an informed basis, as required by the U.S. business judgment rule, they should arguably at least know about the risks the company takes and monitor those risks.²⁶ Alas, this was not always the case, as the short summary of high profile SIFI failures below shows.

In *In re Citigroup Inc. Shareholder Derivative Litigation*, a Delaware Chancery Court opinion that provided the first detailed analysis of potential liability of directors for losses incurred as a

24. See Walker, *supra* note 3, at 753–54. Though Northern Rock did not have significant exposure to the U.S. subprime market, it was dependent on wholesale funding from inter-bank markets within the U.K. Northern Rock’s funding diminished with the reduction of wholesale lending. The lack of funding was leaked to the public through a British Broadcasting Corporation (BBC) report, thus precipitating the bank run. *Id.*

25. See *id.*; Roe, *supra* note 4.

26. See Kaal & Painter, *supra* note 3, at 1459–74 (evaluating the policy responses in Germany and the United States).

result of substantial exposure to subprime debt, shareholder plaintiffs alleged (1) breach of fiduciary duties for failing to properly monitor and manage the risk that Citigroup faced concerning problems in the subprime lending market, and (2) failure to properly disclose the company's exposure regarding subprime assets.²⁷ According to the complaint, starting in May 2005, "red flags" should have immediately alerted the defendants to problems in the real estate and credit markets.²⁸ By ignoring these warning signs, Citigroup managers allegedly overemphasized short-term profits and sacrificed the long-term viability of Citigroup.²⁹ In contrast to European developments in the context of manager risk taking during the crisis,³⁰ the Delaware Chancery court held that management's inability to predict the future and an incorrect evaluation of business risk were not violations of directors' oversight responsibilities.³¹ Risk is inherent in maximizing shareholder value, and losses in and of themselves do not suffice to hold directors personally liable for taking risks that lead to losses.³²

In 2007, Bear Stearns's head hedge-fund trader, Ralph Cioffi, created a group of funds, the Klios funds, that sold short-term debt instruments and used the proceeds to purchase collateralized debt obligations ("CDOs") backed by mortgages.³³ The short-term debt offered by the Bear Stearns fund offered higher yields than other short-term investments and came with a guarantee from other institutions. These features attracted significant investor interest.³⁴ Cioffi and Bear Stearns continued this sales strategy even after the subprime mortgage market began to falter.³⁵ Management seemed disengaged.³⁶ Most notably, while the Klios fund was collapsing, Bear Stearns's CEO at the time, James Cayne, was reported to have attended a ten-day bridge

27. 964 A.2d 106, 114 (Del. Ch. 2009).

28. *Id.*

29. *Id.* at 123. According to the Delaware Chancery court, however, oversight liability can only be established if the plaintiff can show that either "the directors *knew* they were not discharging their fiduciary [duties] or that the directors demonstrated a *conscious* disregard for their responsibilities . . ." *Id.* (emphasis in original).

30. Kaal & Painter, *supra* note 3, at 1473-74.

31. *Citigroup*, 964 A.2d at 131.

32. *Id.*

33. See David Henry & Matthew Goldstein, *The Bear Flu: How it Spread*, BLOOMBERG BUSINESSWEEK (Dec. 19, 2007, 11:15 PM), http://www.businessweek.com/print/magazine/content/07_53/b4065000402886.htm.

34. *Id.*

35. *Id.*

36. Kate Kelly, *Bear CEO's Handling of Crisis Raises Issues: Cayne on Golf Links, 10-Day Bridge Trip Amid Summer Turnoil*, WALL ST. J., Nov. 1, 2007, at A1.

tournament in Tennessee, without a cellular phone or email.³⁷ While most SIFIs at the time engaged in some variation of this behavior, the Bear Stearns's Klios fund group bought the CDOs almost exclusively from the hedge-funds that Cioffi himself managed. This substantially inflated the returns of these funds and resulted in a Department of Justice inquiry.³⁸ Mr. Cioffi had moved \$2 million of his own money out of one of the Klios funds shortly before it collapsed.³⁹ Cioffi and his co-manager Matthew Tannin were indicted for securities fraud but were found not-guilty on all counts.⁴⁰ In part, the pursuit of profits may have induced CEO Cayne to support the highly leveraged fixed-income part of the business.⁴¹ A lack of capital in combination with the highly leveraged fixed-income business eventually led to a liquidity crisis that precipitated the sale of the company.⁴²

Similarly, American International Group ("AIG") profited from insuring mortgage-backed securities, triple-A rated securities, and CDOs backed by subprime mortgages.⁴³ The culture at AIG is said to have discouraged dissent and allowed increased risk.⁴⁴ Under the leadership of Joe Cassano, who is accused of having lacked a full appreciation of the risks AIG was taking, AIG's financial products division eventually secured \$1 trillion in CDOs. As AIG's activity in this market increased, the amount of subprime loans backing CDOs increased from 2% to 95%. Nevertheless, AIG continued securing billions in CDOs based upon the assumption that the real estate market would maintain its value. When the real estate market crashed in 2007, the owners of those securities demanded payment. AIG could not deliver on its promises and had to be bailed out by the U.S. government.

During Stanley O'Neal's tenure as CEO at Merrill Lynch, the company's exposure to CDOs increased from \$1 billion to \$40 billion in eighteen months.⁴⁵ After acquiring a subprime lender in the first quarter of 2007, Merrill Lynch was the largest under-

37. *Id.*

38. Henry & Goldstein, *supra* note 33.

39. *Id.*

40. William D. Cohan, Op-Ed., *How the Scapegoats Escaped*, N.Y. TIMES, Nov. 12, 2009, at A35.

41. William D. Cohan, Op-Ed., *A Tsunami of Excuses*, N.Y. TIMES, Mar. 12, 2009, at A29.

42. *Id.*

43. See Michael Lewis, *The Man Who Crashed the World*, VANITY FAIR, Aug. 2009, at 98.

44. *Id.*

45. See Landon Thomas Jr. & Jenny Anderson, *A Risk-Taker's Reign at Merrill Ends With a Swift, Messy Fall*, N.Y. TIMES, Oct. 29, 2007, at A1.

writer of CDOs before the crisis.⁴⁶ Despite its significant exposure to this market segment, Merrill executives reassured the market that their business was not negatively impacted by subprime lending problems.⁴⁷ By October of 2007, Merrill's losses were estimated at around \$4 billion.⁴⁸ The executives in charge of the fixed-income income division were fired.⁴⁹ Merrill's board of directors had given O'Neal a \$46 million bonus for his performance in 2006 but dismissed him after the CDO related losses were reported.⁵⁰ By the end of October 2007, Merrill Lynch had written off \$8 billion in CDOs.⁵¹ The write-off precipitated rating companies, such as Moody's and Fitch, to downgrade the securities.⁵² After declaring that the company's problems had been addressed, Merrill Lynch reported \$10 billion in write-offs in the fourth quarter of 2007,⁵³ \$9 billion in the first quarter of 2008,⁵⁴ and an additional \$10 billion in the second quarter of 2008.⁵⁵ Despite raising \$15 billion in additional capital, Merrill Lynch was forced to agree to a sale to Bank of America in September of 2008 for \$50.3 billion.⁵⁶

The demise of Lehman Brothers was less transparent and happened more quickly. Even in July of 2007, Lehman continued to deny any subprime lending problems.⁵⁷ In the third quarter of 2007 the company reported a 3.2% decrease in income

46. See Randall Smith & Serena Ng, *Merrill Hints of Credit Woes; Filing Comes as Rivals Prepare to Post Results*, WALL ST. J., Sept. 15, 2007, at B5.

47. This assertion led some analysts to question Merrill Lynch's accounting practices. See *id.*

48. See Landon Thomas Jr., *2 Executives Are Ousted At Merrill*, N.Y. TIMES, Oct. 4, 2007, at C1.

49. *Id.*

50. *Id.*

51. See Aparajita Saha-Bubna & Carrick Mollenkamp, *CDO Ratings Are Whacked By Moody's; AAA to Junk in a Day Raises More Questions About Credit Agencies*, WALL ST. J., Oct. 27, 2007, at B1.

52. *Id.*

53. See Jenny Anderson, *Merrill Posts Huge Loss; Chief Says Firm's Capital is Adequate*, N.Y. TIMES, Jan. 18, 2008, at C6.

54. See Louise Story, *At Merrill, Write-Downs and More Layoffs*, N.Y. TIMES, Apr. 18, 2008, at C6 (reporting a write-down of \$9.7 billion).

55. Susanne Craig & Randall Smith, *Merrill Posts Another Loss; Write-Downs Keep Coming*, WALL ST. J., July 18, 2008, at C1.

56. See Louise Story, *Merrill Sale to Bank of America Is End of an Era Brokerage Firm Founded in 1914, Was First to Bring Wall Street to Main Street*, INT'L HERALD TRIB., Sept. 16, 2008, at 13.

57. See Christopher Faille, *Lehman Fills Risk Post, Denies Subprime Rumors*, HEDGEWORLD NEWS (July 18, 2007), available at 2007 WLNR 13714696.

from the previous quarter,⁵⁸ followed by a 12% decrease in the fourth quarter.⁵⁹ Until October of 2007, however, Lehman had not written off any CDOs.⁶⁰ The CEO, Richard S. Fuld Jr., received a pay package of \$22 million for 2007.⁶¹ Lehman declared losses starting in the first quarter of 2008 until the firm, under the weight of \$60 billion in bad real estate investments, declared bankruptcy in mid-September 2008.⁶² In May of 2008, analysts had expressed concerns about Lehman's accounting methods. CEO Fuld, however, continued to assert that the company was on solid footing and would emerge independently from the crisis.⁶³ By the time Fuld realized that he had to find a buyer for Lehman, it was too late to sell for most stockholders.⁶⁴ In light of accusations about the use of questionable accounting practices to hide the level of risk at Lehman, the New York State Attorney General considered charging Lehman executives with violating securities laws.⁶⁵ Proving those charges, however, could have been extremely difficult and the State Attorney General eventually declined to press charges.⁶⁶

JP Morgan and Goldman Sachs emerged relatively unscathed from the crisis. However, both firms had to pay SEC fines of \$153 million⁶⁷ and \$550 million,⁶⁸ respectively, to settle charges of misleading investors about the values of CDOs.

The anecdotal evidence pertaining to ethically questionable conduct of SIFI leaders is certainly not dispositive or indicative of underlying trends. It does seem to show, however, that some of

58. See Jenny Anderson, *Lehman Profit is Stronger than Expected; Wall St. Relieved*, N.Y. TIMES, Sept. 19, 2007, at C3 (reporting that "[t]hird quarter profit fell 3 percent").

59. See Jenny Anderson, *Lehman's Earnings Fall 12% in a Season that Could Have Been Worse*, N.Y. TIMES, Dec. 14, 2007, at C10.

60. See Jenny Anderson, *The Survivor: Lehman Brothers Speaks Loudly and Avoids Big Risks*, N.Y. TIMES, Oct. 28, 2007, at B1.

61. Dan Wilchins, *Lehman's Fuld Gets \$22 mln in Fiscal '07*, REUTERS (Mar. 5, 2008, 6:16 PM), <http://www.reuters.com/article/2008/03/05/lehman-fuld-idUSN0565219320080305>.

62. See Andrew Ross Sorkin, *Merrill is Sold; Failing to Find Buyer, Lehman Set to File for Bankruptcy*, N.Y. TIMES, Sept. 15, 2008, at A1.

63. See Jenny Anderson, et al., *As Options Fade, Lehman Is Said To Seek a Buyer*, N.Y. TIMES, Sept. 12, 2008, at A1.

64. *Id.*, at A16.

65. See Steve Eder, *Lehman Auditor May Bear The Brunt*, WALL ST. J., Mar. 14, 2011, at C1.

66. *Id.*, at C3.

67. See Dominic Rushe, *JP Morgan Pays SEC \$153M to Settle Charges Over Mortgage Securities*, GUARDIAN, June 21, 2011, at 24.

68. See *Goldman's Record Payout Over Subprime: A Price Worth Paying*, ECONOMIST ONLINE (July 15, 2010), http://www.economist.com/blogs/newsbook/2010/07/goldmans_record_payout_over_subprime.

the most pervasive cases of unethical conduct did involve SIFIs. Legislatures worldwide recognize that avoiding a repeat of the financial crisis of 2008–2009 is an important legislative objective.⁶⁹ The regulation of financial institutions has emerged as a priority.⁷⁰ However, the proposals have not yet focused on mechanisms that specifically address the corporate governance shortcomings pertaining to SIFIs. The mismanagement of SIFIs, management practices, and possible corporate governance shortcomings pertaining to SIFIs could call for an internal SIFI-specific mechanism that addresses corporate governance shortcomings in SIFIs without imposing undue regulatory burdens on these entities.

III. CONTINGENT CAPITAL

The concept of contingent capital securities has been recognized as a promising tool to address core issues in the context of regulating SIFIs.⁷¹ For purposes of this Article, contingent capital is the predefined conversion of a certain percentage of financial institutions' debt securities into equity securities. Contingent capital is an automatic mechanism for increasing capital while reducing debt with the long-term benefit of lowering leverage.⁷² Strained financial institutions may find the automatic conversion of debt into equity an attractive alternative to being forced into restructuring or liquidation.⁷³

69. The Dodd–Frank Act was enacted with the intention of preventing another crisis. See 155 CONG. REC. H14418, H14420 (daily ed. Dec. 9, 2009) (statement of Rep. Kanjorski) (“[T]his body will have the opportunity to . . . fundamentally change the way Wall Street and large financial institutions operate. For roughly two years, we have endured a severe crisis that exposed vulnerabilities in our system for overseeing the financial sector and demonstrated the perils of deregulation.”); HM TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: JUDGMENT, FOCUS, AND STABILITY 62 (2010) (“The policy objective is to reform the regulatory system for financial services to avoid a repeat of the financial crisis.”).

70. For example, see Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank), Pub. L. No. 111-203, § 808, 124 Stat. 1376, 1816 (codified as amended at 12 U.S.C. § 5467 (Supp. IV 2011)), which is entitled “Examination of and Enforcement Actions Against Financial Institutions Subject to Standards for Designated Activities,” and provides that the relevant agency prescribe risk management standards.

71. See *infra* Part III.A.

72. Coffee, *supra* note 12, at 805 (averring that contingent capital can counter leverage debt). For a reading that is critical in the context of automation of financial regulation, see generally AMAR BHIDÉ, A CALL FOR JUDGMENT: SENSIBLE FINANCE FOR A DYNAMIC ECONOMY (2010).

73. See Henkel & Kaal, *supra* note 18; Coffee, *supra* note 12, at 805.

Because contingent capital shows great promise for internalizing bank failure cost,⁷⁴ stabilizing SIFIs, and preparing SIFIs for future financial crises,⁷⁵ policy makers⁷⁶ and academics⁷⁷ support

74. See *id.*; Flannery, *supra* note 11, at 12; Robert L. McDonald, Contingent Capital with a Dual Price Trigger 1, 20 (Apr. 11, 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1553430>. McDonald proposes a model for contingent capital where debt converts to equity if both (1) “the firm’s stock price is at or below a trigger value,” and (2) “the value of a financial institution’s index is also at or below a trigger value.” *Id.* at 1. McDonald concludes that the dual trigger proposal’s strength is its reliance on market prices, and its disadvantage is the index trigger, which could potentially create “a situation where it might be profitable to manipulate the index or try to force bankruptcy.” *Id.* at 12–13; see also Darrell Duffie, Contractual Methods for Out-Of-Court Restructuring of Systemically Important Financial Institutions (Preliminary Draft 2009), available at <http://media.hoover.org/sites/default/files/documents/06EndingGovernmentBailoutsAsWeKnowThemDuffie.pdf> (focusing on possible triggers of Distress-Contingent Convertible Bonds/Debt (essentially CCS)). Duffie explains that if the trigger is an accounting capital ratio, it may not be able to capture the true financial condition of the bank because of accounting failures. *Id.* at 4. The ratio of tangible common equity (TCE) to tangible assets may be more effective because it excludes the relatively “useless assets during a solvency crisis.” *Id.* If the trigger is determined by market value, the impact of a short seller speculative attack could be mitigated by using a trailing average share price e.g. the preceding 20 days. *Id.* at 4–5. To eliminate a bank run, the trigger should be set to convert debt into equity before a liquidity crisis begins. *Id.* at 5. Duffie also discusses mandatory rights offerings. *Id.* at 6–10.

75. See Flannery, *supra* note 11, at 2.

76. See Edmund L. Andrews, *Bernanke, in a Bow to Critics of Fed’s Role, Supports Forming a Regulatory Group*, N.Y. TIMES, Oct. 2, 2009, at B3 (stating that Chairman of the Federal Reserve, Ben Bernanke, opined that giant financial players might be forced to adopt “contingent” capital, and noting that the contingent capital is “gaining popularity within the Fed.”); Daniel K. Tarullo, Federal Reserve Governor, Speech at the Exchequer Club in Washington, D.C. to the Federal Reserve: Confronting Too Big to Fail (Oct. 21, 2009), <http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm> (commenting that contingent capital is an effort “worth pursuing”). For a description of the policy in the European Union, see Press Release, European Comm’n, Commission Wants Stronger and More Responsible Banks in Europe (July 20, 2011), <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/915&format=HTML&aged=0&language=en&guiLanguage=en> (“The proposal will require banks to hold more and better capital to resist future shocks by themselves With its proposal, the Commission translates in Europe international standards on bank capital agreed at the G20 level (most commonly known as the Basel III agreement).”). See also COMM’N OF EXPERTS, FINAL REPORT OF THE COMMISSION OF EXPERTS FOR LIMITING THE ECONOMIC RISKS POSED BY LARGE COMPANIES 59–60 (Sept. 2010) [hereinafter SWISS REPORT], available at <http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en> (proposing the conversion of contingent capital upon certain triggering events).

77. See, e.g., Christoph K. Henkel & Wulf A. Kaal, *Contingent Capital in European Bank Restructuring*, 81 NW. J. INT’L. L. & BUS. (forthcoming 2012); see

the concept and have identified several core objectives for using contingent capital securities, including but not limited to: (1) signalling default risk,⁷⁸ (2) providing incentive to increase capital,⁷⁹ (3) preventing bailouts,⁸⁰ (4) decreasing risk taking,⁸¹ (5)

DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (Unintended) Consequences* 84–85 (2011) (arguing that the then-existing channels of bankruptcy would have sufficed to treat failing banks and noting that the Dodd-Frank Act instructs the General Accountability Office to conduct a study on contingent capital and to begin using it when the study is completed). While Skeel refers to contingent capital as a “promising strategy,” he points out some limitations. Contingent capital will not be “especially effective if the bank can easily manipulate its capital, or if capital requirements are low.” *Id.* at 84–85. Skeel also recognizes that “contingent capital will not protect against a sudden collapse, as in the cases of Bear Stearns and AIG—a collapse that occurs so quickly and so pervasively that new capital would come too late to break the fall.” *Id.* at 85; *see also* Coffee, *supra* note 12, at 801–03 (promoting contingent capital as an alternative to bailouts); Henkel & Kaal, *supra* note 18; George Pennacchi et al., *Contingent Capital: The Case for COERCs* 9, 13 (INSEAD, Working Paper No. 2010/89/FIN, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1656994. Pennacchi proposes a Call Option Enhanced Reversed Convertible (COERC) security as a form of contingent capital. A COERC has two significant features: (1) “the conversion price is set significantly below the trigger price,” and (2) shareholders have the option to “buy the shares back from the bondholders after conversion at this same low conversion price.” *Id.* at 9. Pennacchi notes that for conversion to occur at such low stock prices, common stockholders would have to approve the increase in authorized shares. The authors assert that the structure of COERCs would potentially make future financial distress less likely, stating that “the fact that the conversion price is set significantly below the trigger price gives a strong incentive for shareholders to . . . repay the bonds at their par value. This will in turn reduce the risk of the bonds, thereby enhancing their marketability with fixed income investors.” *Id.* The authors also note that contingent capital can prevent bail-outs of banks that are “too big to fail.” *Id.* at 1.

78. *See* Raghuram Rajan, *More Capital Will Not Stop the Next Crisis*, *FIN. TIMES* (London) (Oct. 1, 2009), <http://www.ft.com/intl/cms/s/0/a830fc6-aed1-11de-96d7-00144feabd0.html#axzz1aQNhCNnY> (suggesting that CCS should be used to raise capital “when regulators see a crisis coming”); Dudley, *supra* note 17 (proposing that CCS can be used to adequately capture risk).

79. *See* SQUAM LAKE WORKING GROUP, *supra* note 11 (suggesting that hybrid securities would increase creditors’ confidence in banks, prevent bailouts, and enable banks to raise more private capital). Squam Lake’s suggested trigger mechanism would be dual: (1) “a declaration by regulators that the financial system is suffering from a systemic crisis,” and (2) “a violation by the bank of covenants in the hybrid-security contract.” *Id.* at 4. The bank-specific trigger would likely “be based on the measures used to determine a bank’s capital adequacy, such as the ratio of Tier 1 capital to risk-adjusted assets.” *Id.* Squam Lake also offers alternatives for the rate at which debt will convert to equity, including basing the conversion rate solely on market value of equity or on the market value of equity *and* the hybrid security. *Id.*; *see also* Charles W. Calomiris & Richard J. Herring, *Why and How to Design a Contingent Convertible Debt Requirement* 39 (Apr. 2011) (unpublished manuscript), *available at*

minimizing moral hazard,⁸² (6) avoiding financial contagion,⁸³ and (7) limiting systemic risk.⁸⁴ While legislatures in some jurisdictions have set up contingent capital rules,⁸⁵ the role of contingent capital in international finance and its potential applications remain unclear.⁸⁶

A. Possible Applications

Contingent capital securities have the potential to play a significant role in the efficient restructuring and resolution of failing financial institutions.⁸⁷ Contingent capital could also support and optimize general risk control in financial institu-

<http://ssrn.com/abstract=1815406> (also proposing that a contingent capital requirement would be an incentive to capitalize).

80. See SQUAM LAKE WORKING GROUP, *supra* note 11, at 4 (suggesting that hybrid securities would help prevent bailouts); Coffee, *supra* note 12, at 801–03 (promoting contingent capital as an alternative to bailouts); Calomiris & Herring, *supra* note 79, at 39 (averring that contingent capital could help prevent the “too big to fail” problem).

81. See Pennacchi et al., *supra* note 77, at 9, 13 (suggesting that their COERC proposal would reduce the risks of bonds); Dudley, *supra* note 17 (averring that because bank difficulties would trigger conversion, this dilution of shareholders creates an incentive for bank managers to “manage not only for good outcomes on the upside of the boom, but also against bad outcomes on the downside”).

82. See Flannery, *supra* note 13, at 15.

83. See GOLDMAN SACHS, EFFECTIVE REGULATION, *supra* note 14, at 6 (noting that if the appropriate triggers are in place, it could prevent bank runs—though if the trigger is based on market prices, it could worsen bank runs).

84. See Henkel & Kaal, *supra* note 18; Coffee, *supra* note 12, at 806 (suggesting that contingent capital should be designed to create a standard for systemically important financial institutions).

85. See also discussion *infra* Part III.C (discussing the Swiss, German, and United Kingdom law).

86. See, e.g., SKEEL, *supra* note 77, at 85 (pointing out that contingent capital will not likely be effective if a bank can “easily manipulate its capital,” and that contingent capital “will not protect against a sudden collapse, as in the cases of Bear Stearns and AIG”); Koziol & Lawrenz, *supra* note 16, at 91, 101; see also Oliver Hart & Luigi Zingales, *A New Capital Regulation for Large Financial Institutions* 5 (Institutions and Markets Series, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1533274. In proposing a market-based trigger, Hart and Zingales point out that Flannery’s 2005 proposal has three potential shortcomings: “First, it is too lenient toward management, eliminating one of the disciplinary effects of debt. Second, it can have perverse effects: the manager talking down the stock so as to obtain more slack. Third, it generates multiple equilibria, some of which are inefficient.” *Id.*

87. Henkel & Kaal, *supra* note 18; DG Internal Market and Services, Technical Details of a Possible Framework for Bank Recovery and Resolution, Annex I (Jan. 2011) (unpublished manuscript) [hereinafter DG Market], available at http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

tions.⁸⁸ By internalizing bank failure costs, contingent capital could contribute to minimizing moral hazard. Evaluations of contingent capital triggers could help eliminate moral hazard incentives and could further lower default risk of CCS.⁸⁹ Installing contingent capital could be more efficient than raising capital requirements because the capital injection is available only when it is needed. When triggered, only enough CCS would convert as is necessary to recapitalize the firm.

Contingent capital could also incentivize SIFI management to lower their risk taking on behalf of the financial institution.⁹⁰ The threat of dilution of stock holdings in combination with a threat of loss due to conversion could help reduce shareholder pressure on SIFI management to take higher risks.⁹¹ If conversion should have a negative effect on the stock price,⁹² management could be further incentivized to maintain and manage risk to avoid reputational loss and income reduction due to losses in stock options and other deferred compensation.⁹³ These and

88. See Rajan, *supra* note 16, at 28. *But see* Koziol & Lawrenz, *supra* note 16, at 91.

89. See Flannery, *supra* note 13, at 3. Flannery suggests that Reverse Convertible Debentures (RCD) (essentially CCS) could allow for recapitalization without involving outside parties (e.g., taxpayers). The trigger would be automatic based on market value and convert at the current share price. *Id.* "Issuing RCD as part of a bank's capital structure will then a) protect depositors and taxpayers via a transparent means of automatic re-capitalization, b) cause shareholders to internalize the costs of risk, c) impose no tax penalty on bank shareholders, and d) reduce the incidence of costly failures." *Id.*

90. Coffee, *supra* note 12, at 806. Coffee avers that converting the debt security into preferred stock creates a "countervailing voting constituency," which offsets the voting power of "risk-tolerant common shareholders, thereby reducing the pressure on corporate managers to accept greater risk and leverage." *Id.*; see also Dudley, *supra* note 17 ("If the bank encounters difficulties, triggering conversion, shareholders would be automatically and immediately diluted. This would create strong incentives for bank managements to manage not only for good outcomes on the upside of the boom, but also against bad outcomes on the downside.").

91. Dudley, *supra* note 17.

92. A potential effect of CCS conversion on stock prices will likely be evaluated in future research. See Suresh Sundaresen & Zhenyu Wang, *On the Design of Contingent Capital with Market Trigger* 21 (FRB of New York Staff Report, Working Paper No. 448, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1612894 (suggesting that under their design of contingent capital, where the state-contingent conversion ratio prevents value transfer, the prices would be kept "'smooth' at conversion").

93. Even though there is a trend toward a reduction in stock option compensation, management may still receive a certain percentage of their compensation in stock options. See Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks*, 64 *VAND. L. REV.* 431, 460-61

other observations could contribute to an increasing role of contingent capital in executive compensation.⁹⁴

Contingent capital could also create a regime for providing countercyclical regulatory capital⁹⁵ that further enhances regulatory capital requirements of the Federal Reserve⁹⁶ and under Basel III.⁹⁷

B. *Unresolved Design Issues*

If the proliferation of the market in contingent capital securities should continue, contracting parties and policy makers could eventually be tasked with resolving open design issues and potential flaws in the design of contingent capital in their respective jurisdictions. The optimal design of CCS has been the subject of a long academic debate.⁹⁸ Unresolved questions include: design features of CCS and the calibration of

(2011) (noting that stock option compensation has been curtailed). For example, in France, remuneration requirements ban stock options and limit bonuses. *See id.*

94. *See* Wulf A. Kaal, Contingent Capital in Executive Compensation, (unpublished manuscript) (draft on file with author).

95. *See* Dudley, *supra* note 17.

96. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank), Pub. L. No. 111-203, § 171, 124 Stat. 1376, 1435 (codified as amended at 12 U.S.C. § 5371 (Supp. IV 2011)); John H. Cochrane, Op-Ed., *The More Bank Capital, the Safer the Bank*, WALL ST. J., July 15, 2011, at A15 (stating that “the Federal Reserve wants another 3% for ‘systemically important banks,’” bringing the total regulatory capital requirement to 10% and that the Federal Reserve’s Dan Tarullo even proposed a 14% capital requirement).

97. Press Release, Bank for Int’l Settlements, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards (Sept. 12, 2010) [hereinafter Press Release, BIS], *available at* <http://www.bis.org/press/p100912.pdf>; *see also* Rajan, *supra* note 78 (suggesting that CCS should be used to raise capital “when regulators see a crisis coming”). Raising capital through CCS during “good times” will allow it to be cheap and easier to enforce. *Id.* Also, infusing capital during “bad times” protects the system and the taxpayers with the right contingencies in place. *Id.* CCS has both stick and carrot incentives. *Id.* Automatic conversion of CCS has a disciplinary effect by punishing aggregate bank losses. *Id.* Conversion when a bank’s capital ratio falls below a certain level encourages banks to anticipate losses to raise new capital and to protect the taxpayer and their shareholders. *Id.* But see Cochrane, *supra* note 96, at A15, for an argument that financial engineers will likely find a way to circumvent the new rules on regulatory capital under Basel III and Dodd–Frank, because they did so successfully in the past. As long as the government subsidizes lending and bail-outs, more capital is needed to make banks safer.

98. *See supra* notes 11–18; Calomiris & Herring, *supra* note 79; Duffie, *supra* note 74; McDonald, *supra* note 74; Pennacchi et al., *supra* note 77.

design features,⁹⁹ the mandatory or voluntary nature of contingent capital,¹⁰⁰ the objectives of CCS,¹⁰¹ CCS market evolution,¹⁰² and the volume of CCS issuance,¹⁰³ among others.¹⁰⁴

99. See Coffee, *supra* note 12, at 827 (noting that many papers focus on the mechanics of contingent capital); Meera Louis, *Europeans Lose Out to U.S. with Basel Committee's Contingent Capital Vote*, BLOOMBERG (June 27, 2011, 10:38 AM) <http://www.bloomberg.com/news/2011-06-26/basel-committee-decision-on-contingent-capital-backs-u-s-stance.html> (explaining that not all European countries even support the use of contingent capital). Scholars have suggested a variety of different design features. See Duffie, *supra* note 74, at 3 (“There are a number of alternative designs for the distress trigger and for the conversion ratio, the number of shares of equity to be received in exchange for each dollar of bond principal.”); Flannery, *supra* note 11, at 4 (arguing that the conversion trigger must be expressed in terms of equity’s contemporaneous market value); McDonald, *supra* note 74, at 1.

100. Compare Coffee, *supra* note 12, at 808 (discussing ideas for mandatory implementation of contingent capital which “can work even when regulatory oversight fails and a crisis sneaks in under the regulators’ radar screen”), with Letter from Mary F. Monroe, Vice President, Office of Regulatory Policy, Amer. Bankers Assoc., to Basel Committee on Banking Supervision 3 (Oct. 1, 2010) [hereinafter Monroe Letter], available at <http://www.aba.com/NR/rdonlyres/DC65CE12-B1C7-11D4-AB4A-00508B95258D/69072/ABACommentonBCBSContingentCapitalProposal101001.pdf>. Unlike Coffee, Monroe finds that mandatory contingent capital would

hinder unduly the flexibility of banks to create a capital structure that best meets the needs of the bank and its investors Other banks may not be able to, or may find it inefficient to, issue contingent or convertible instruments for a variety of reasons—including, for instance, restrictions under their chartering instruments, tax issues related to the deductibility of payments on the instruments, lack of market access, or insufficient investor interest. These banks should not be harmed by a perception that they are not as well capitalized as others simply because they need to or choose to meet their capital needs through other acceptable channels.

Id.

101. See SQUAM LAKE WORKING GROUP, *supra* note 11, at 4 (noting that contingent capital is intended to increase creditors’ confidence in banks, prevent bailouts, and enable banks to raise more capital).

102. See Letter from the European Ass’n of Public Banks (EAPB) to The European Commission on Internal Market and Services 8–9 (2011) [hereinafter EAPB, Comments], available at <http://www.eapb.eu/file?file=6701> (pointing out burdens including higher costs to the banks for senior debt instruments and the marketability of this type of instrument in regards to the comprehensive approach); EUROPEAN BANKING FEDERATION (EBF), POSITIONING IN RESPECT OF THE EU COMMISSION CONSULTATION ON TECHNICAL DETAILS FOR A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION 56 (2011), [http://www.ebf-fbe.eu/uploads/documents/positions/BankingReg/3%20March%202011-EBF_Response_to_COM_Crisis_Management_Consultation%20\(final\).pdf](http://www.ebf-fbe.eu/uploads/documents/positions/BankingReg/3%20March%202011-EBF_Response_to_COM_Crisis_Management_Consultation%20(final).pdf) (pointing out that predictions examining the market acceptance of such securities simply do not exist with regard to the targeted approach to contingent capital); Monroe Letter, *supra* note 100, at 2 (expressing concern that the Basel Committee’s proposal would make contingent capital indistinguishable from common

The trigger event or events to convert debt into equity are especially contentious.¹⁰⁵ Given their variety and possible combinations, trigger designs may be categorized by their level of uncertainty.¹⁰⁶ While institution-specific triggers would presumably grant most certainty to market participants, regulatory trigger designs could provide lower levels of certainty.¹⁰⁷ CCS could be converted incrementally to soften the negative effect of early or late conversion. Jack Coffee suggests an incremental conversion in a series of steps.¹⁰⁸ Others prefer “carefully designed partial or temporary write-downs within reasonable bounds.”¹⁰⁹

equity and stating that the proposal “would change fundamentally the risk-reward profiles of bank debt and equity investors, ultimately raising concerns about the marketability of these instruments”).

103. See GOLDMAN SACHS, *EFFECTIVE REGULATION*, *supra* note 14, at 4 (suggesting that contingent capital holdings equivalent to 6% of risk-weighted assets would have been sufficient to have the firms recapitalize voluntarily instead of converting the contingent capital); see also Goldman Sachs Global Market Inst., *CONTINGENT CAPITAL: POSSIBILITIES, PROMISES, AND OPPORTUNITIES* 20 (2011), <http://www2.goldmansachs.com/ideas/global-markets-institute/featured-research/contingent-capital-doc-gmi-01-03-2011.pdf> (analyzing the sizing of a potential contingent capital market and estimating that the “potential amount of contingent capital that might be issued starts with the Basel Committee’s requirement that all non-common Tier 1 and 2 securities eventually have a loss-absorption feature”) [hereinafter GOLDMAN SACHS, *CONTINGENT*].

104. Other issues that remain open and debated are the specific trigger mechanisms and whether the trigger is market value or risk-asset based. See, e.g., EAPB, *Comments*, *supra* note 102, at 1, 8–9. The EAPB proposes assurance that when covering for loss, the ranking claim of capital instruments remains intact. *Id.* Regarding the targeted approach, the EAPB questions how the appropriate issuance level and cost will be determined and notes that a very limited group of investors will be interested in these instruments. *Id.*; see also Hart & Zingales, *supra* note 86, at 5–7 (providing an example of a market-based trigger); Stan Maes & Wim Schoutens, *Contingent Capital: An In-Depth Discussion* 17 (2010) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1653877 (pointing out that contingent capital instruments “are very hard to value under a particular model” and suggesting that the “extreme complexity” of CoCos may hamper their success).

105. See *supra* note 104.

106. See Henkel & Kaal, *supra* note 77 (showing in Graph I the difference between institution-specific and systemic triggers).

107. *Id.*

108. See Coffee, *supra* note 12, at 830. Coffee prefers incremental conversion in a series of steps arguing that incremental conversion enables an early trigger for conversion. He uses the following example: “25% of the convertible bonds might convert on a 25% stock price decline from the stock price on the date of the bonds’ issuance; another 25% might convert on a further 25% decline, and the balance would convert if the stock price fell 75% (or more) from the original price.” *Id.*

109. See Monroe Letter, *supra* note 100, at 4.

The consequences of suboptimally designed triggers could be substantial and could be an important reason for the emphasis in the debate on trigger designs and the concern over certainty of triggers. Converting CCS into equity prematurely at a time when the financial institutions can still operate without an equity capital injection could mean that the CCS capital injection would no longer be available when the financial institution will be unable to obtain other funding. In effect, the impact of the equity capital injection would have dissipated and the financial institution would no longer be able to use the CCS capital injection to borrow additional funds from other financial institutions.

On the other hand, converting CCS too late could make the capital injection superfluous. At that stage, the financial institution may have experienced unresolvable financial difficulties that may only marginally be softened with a capital injection. Especially if the financial institution entered the resolution stage, converting CCS may not suffice to turn the entity around.

In addition to problems with possible trigger designs, the issuance of contingent capital may involve other uncertainties. CCS would have fixed returns (as debt security) while displaying risk-bearing properties (similar to equity).¹¹⁰ While a nascent market in CCS evolves, it is unclear in the long-run how desirable investors will find conversion features that turn a debt holder into an equity holder.¹¹¹ Even if a reliable trigger mechanism could be designed, how predictable the circumstances would be in which a conversion from debt into equity would be triggered is unclear.¹¹² The uncertainty involved in buying contingent capital securities could deter investors.¹¹³ Also unclear is if and how

110. See DG Market, *supra* note 87, at 90. (“[The] higher cost of such instruments may simply reflect the view that risk has been transferred from society to the bondholder by the removal of the implicit State guarantee for creditors that may have artificially reduced the costs of debt funding. This may in particular be the case for those institutions that have been considered ‘too big to fail.’”).

111. See *id.* (discussing the benefits “of replacing the original shareholders with converted debt holders, having particular regard of the need to avoid a significant sale of newly-converted equity at a time when it is essential to restore market confidence in the institution”).

112. See *id.* (“[T]he Services of DG Internal Market and Services believe that the resolution trigger is close to the point of failure for an institution, and therefore should be linked to the probability of failure of a bank which is regularly assessed by rating agencies and market participants. However, the Services of DG Internal Market and Services recognize that holders of ‘bail-in debt’ would want the trigger to be as transparent, objective and predictable as possible, and would welcome views on how this might be designed.”).

113. But see *infra* Part V elaborating on the evolution of a market in contingent capital securities.

existing contingent capital design proposals will be able to address information asymmetries and principal agent problems.¹¹⁴

In sum, contingent capital without additional measures and supplemental corporate governance improvements may not prevent firm failure.¹¹⁵ The real potential of contingent capital could unfold if it would be used to supplement other corporate governance improvements.

C. *Application in Europe*

Political pressures demanding adequate remedies to address the perceived shortcomings of regulation increased dramatically after the financial crisis. Constituencies in Europe increasingly demanded that shareholders, management, and creditors share equally in losses resulting from the failure of troubled SIFIs.¹¹⁶ One possible remedy could be the issuance of contingent capital securities. Legislatures in Europe appear to be taking the prospect of contingent capital seriously. The EU Commission, the Basel Committee, as well as the Swiss and German legislatures, have approached contingent capital rules or rule proposals with different degrees of intensity.¹¹⁷ Some of the proposals are very broad and will get narrowed down in the legislative process; others, such as the German approach, merely set up a very basic framework.

In an attempt to improve the restructuring and resolution of financial institutions, the EU Commission proposed a compre-

114. See Henkel & Kaal, *supra* note 18 (discussing how a second trigger that increases voting rights could help minimize information asymmetries and principal agent problems).

115. See Coffee, *supra* note 12, at 833 (“If a firm’s variable costs clearly exceed its revenues, and no turnaround is in sight, the firm will not be saved by converting its bonds into preferred stock . . . [and] resolution authority provides the superior mechanism for its liquidation. Thus, the boundaries within which contingent capital can feasibly work are set by the firm’s ability to recover its variable costs.”).

116. See *The Euro’s Real Trouble: The Crisis of the Single Currency is Political as Much as Financial*, *ECONOMIST* (July 14, 2011), <http://www.economist.com/node/18959279> (noting that Jean-Claude Trichet, president of the European Central Bank, demanded that future bail-outs must include “adequate participation of private creditors”).

117. See Referentenentwurf des Bundesministeriums der Justiz, Gesetz zur Änderung des Aktiengesetzes Feb. 11, 2010 (Ger.) (proposal to amend the Stock Rights Act of 2011, presented by the Federal Ministry of Justice); BANK OF ENGLAND REPORT, *supra* note 3; DG Market, *supra* note 87; SWISS REPORT, *supra* note 76; Press Release, BIS, *supra* note 97. For a summary and critical analysis of European contingent capital proposals, see Henkel & Kaal, *supra* note 18.

hensive and targeted approach.¹¹⁸ Under the comprehensive approach, European resolution authorities can resolve which classes of a financial institutions' debt may be converted to equity or written down.¹¹⁹ The financial situation of the respective financial institution would determine the size of the write-down.¹²⁰

For purposes of assessing the potential of contingent capital as corporate governance reform, the targeted approach of the EU Commission could be more important. In contrast to the comprehensive approach, the targeted approach would enable resolution authorities to require credit institutions to issue a fixed amount of pre-qualified debt that converts into equity upon a statutory trigger.¹²¹ The targeted approach may show that the Commission appreciates the potential use of contingent capital with a conversion feature. Contingent capital as envisioned in the targeted approach (with a conversion feature) could find application in the context of restructuring and resolution¹²² but also as a quasi preparation stage for bankruptcy¹²³ and in going concern as a preventive tool.¹²⁴

Germany's legislature has recognized the potential of contingent capital and proposed a change to the German Corporation Act, allowing the implementation of contingent capital.¹²⁵ German law had previously recognized a debt-equity swap.¹²⁶ Unlike CCS, however, the debt-equity swap requires consent by creditors.¹²⁷ The proposed change to the German Corporation Act would provide a statutory basis for the issuance of CCS in Germany.¹²⁸ The introduction of contingent capital securities in

118. See DG Market, *supra* note 87, at 88.

119. *Id.*

120. *Id.*

121. *Id.* at 89 (“[S]uch debt would need to include a contractual term which would specify that the relevant resolution authority could use a statutory power to write down the debt when the institution meets the trigger conditions for entry into resolution.”).

122. See Henkel & Kaal, *supra* note 77 (discussing the use of contingent capital with in European Union bank restructuring and resolution).

123. See Henkel & Kaal, *supra* note 18.

124. *Id.*

125. See Referentenentwurf des Bundesministeriums der Justiz, *supra* note 117.

126. Gesetz zur Reorganisation von Kreditinstituten (Kreditinstitute-Reorganisationsgesetz) [Act for the Reorganization of Credit Institutions] § 9, ¶ 1. [KredReorG] Dec. 9, 2010, BGBL. I, at 1900 (Ger.).

127. *Id.*

128. The reform of the German Corporation Act is centered around Sections 192, 194, and 221 (AktG). Under prior German Law, the instrument of

Germany would require changes in other areas of German law.¹²⁹ BaFin, the German regulatory agency, may coordinate a possible approach to contingent capital with the Basel Committee. The use and application of contingent capital in Germany could depend on the use of contingent capital in Basel III.¹³⁰

In an attempt to maintain the role of banking in Switzerland, the Swiss legislature may allocate 9.0% of the total core capital for SIFIs to contingent capital securities with predefined triggers.¹³¹ The Swiss approach distinguishes between high and low CCS triggers.¹³² FINMA, the Swiss regulatory agency, recommended a “capital conservation buffer of 8.5% RWA [risk weighted assets] on top of the Basel III minimum capital requirements for all banks of 4.5% RWA.”¹³³ The proposal also includes a 6.0% of RWA surcharge for systemic risk, bringing the capital requirement for Swiss SIFIs to 19.0% of RWA.¹³⁴ In addition:

[T]he Swiss additional capital conservation buffer of 8.5% RWA may consist of CoCos to a maximum of 3% RWA. These CoCos must have a high trigger, forcing conversion when the company’s capital ratio undercuts 7% [Common Equity Tier 1 (CET1)]. The progressive surcharge of 6% RWA is planned to include only CoCos. As part of the resolution scheme, those CoCos conceptually convert at a capital ratio of 5% CET1.¹³⁵

“Mandatory Convertible Bonds” (“Pflichtwandelschuldverschreibung”) had already been recognized.

129. See Steffen Schneider & Markus Söhnchen, *Rescue of Kreditinstituten in der Krise durch Contingent Convertible Bonds – Pflichtwandelschuldverschreibungen für Banken (“CoCo-Bonds”)* [Rescue of Banks in Crisis Through Contingent Capital Bonds – Mandatory Convertible Bonds for Banks], available at http://www.forum-institut.de/fileadmin/data/Bereich_3/Rescue_von_Finanz_instituten_in_der_Krise.pdf (opining that the new Act would require a change of the KWG, the Limited Act, the Corporation Act, the Bankruptcy Act and the Bond Act (“Schuldverschreibungsgesetzes”).

130. See *infra* Part III.D discussing the recognition of contingent capital as Tier 1 capital; see also Schneider & Söhnchen, *supra* note 129.

131. SWISS REPORT, *supra* note 76, at 4; see Emma Thomasson, *Swiss Parliament Committee Backs Tough Bank Rules*, REUTERS (Aug. 31, 2011), <http://uk.finance.yahoo.com/news/Swiss-parliament-committee-targetukfocus-2222124783.html?x=0>. This setup is known in the industry as the “Swiss Finish.” *Id.* Legislation to implement this proposal was approved by the upper house of the Swiss legislature in August of 2011 and is expected to be approved by the lower house and enacted in early 2012. *Id.*

132. *Id.*

133. FINMA, ADDRESSING “TOO BIG TO FAIL”: THE SWISS SIFI POLICY 1, 10 (2011), <http://www.finma.ch/e/finma/publikationen/Documents/be-swiss-sifi-policy-june-2011-summary-20110624-e.pdf>.

134. *Id.* at 11.

135. *Id.* at 12.

It is important to note that only two Swiss SIFIs, United Bank of Switzerland (“UBS”) and Credit Suisse, would be subjected to the Swiss contingent capital regime. Partially because of the size of these entities in comparison with the Swiss economy, the Swiss have prudently adopted capital requirements that are more stringent than the capital requirements under Basel III.¹³⁶ Credit Suisse successfully issued contingent capital securities¹³⁷ whereas UBS raised concerns over contingent capital.¹³⁸

In the United Kingdom, Lloyds Bank,¹³⁹ Rabobank,¹⁴⁰ and Barclays¹⁴¹ already issued or are in the process of issuing CCS.¹⁴² The Bank of England suggested that contingent capital will result in higher loss-absorbency.¹⁴³ As a remedy, the Bank of England proposed precautionary and non-viability contingent capital.¹⁴⁴ While CCS issuances in the United Kingdom seem to have established a nascent market in contingent capital securities, regulatory guidance in the U.K. may have room for improvement.¹⁴⁵

D. *Recognition as Tier 1 Capital*

Recognition of contingent capital as Tier 1 capital could have significant implications for the market in contingent capital securities. The marketing and sales of CCS could benefit if CCS would be recognized as Tier 1 capital. However, the extent of

136. See Coffee, *supra* note 12, at 803 n.23.

137. See *infra* Part V discussing the Credit Suisse issuance.

138. Katharina Bart, *UBS CFO Nixes CoCo Bonds; Mulls Other Loss-Absorbing Capital*, DOW JONES NEWS SERV. (July 26, 2011, 7:28 AM), <http://online.wsj.com/article/BT-CO-20110726-706411.html>.

139. See John Glover & Gavin Finch, *Basel Committee Says Bondholders Should Take Losses*, BLOOMBERG BUSINESSWEEK (Aug. 19, 2010), <http://www.businessweek.com/news/2010-08-19/basel-committee-says-bondholders-should-take-losses.html>.

140. See Dealbook, *A Boost for Contingent-Capital Deals?*, N.Y. TIMES, (Mar. 9, 2010, 4:33 AM), <http://dealbook.nytimes.com/2010/03/09/a-boost-for-contingent-capital-deals>.

141. See Patrick Jenkins, *Barclays Set to Follow Swiss Lead*, FIN. TIMES, Feb. 14, 2011, <http://www.ft.com/cms/s/0/7f3c49ea-386e-11e0-959c-00144feabdc0.html#axzz1SZdsn94g>.

142. See George M. von Furstenberg, *Contingent Capital to Strengthen the Private Safety Net for Financial Institutions: CoCos to the Rescue?*, (Deutsche Bundesbank, Discussion Paper, Series 2: Banking and Financial Studies, No. 01/2011).

143. See BANK OF ENGLAND REPORT, *supra* note 3, at 36.

144. *Id.*

145. See U.K. INDEPENDENT COMMISSION ON BANKING, INTERIM REPORT: CONSULTATION ON REFORM OPTIONS 73 (2011), <http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf>.

recognition of contingent capital as Tier 1 capital is uncertain.¹⁴⁶ The European Banking Authority (“EBA”) is expected to allow national regulators to use their existing Tier 1 definitions.¹⁴⁷ An agreement on EU-wide standards for Tier 1 capital could face many challenges. Germany uses wider definitions for Tier 1 capital,¹⁴⁸ which can result in higher capital ratios. The Financial Services Authority (“FSA”) in the United Kingdom uses a stricter definition of Tier 1 capital¹⁴⁹ and does not allow contingent capital (convertible bonds) to be classified as Tier 1 capital.¹⁵⁰ Spain, on the other hand, allows it.¹⁵¹

Recognizing contingent capital as Tier 1 capital could have beneficial attributes. Financial institutions in countries that use stricter definitions on Tier 1 capital and do not recognize contingent capital as Tier 1 capital could appear to have less capital and thinner capital cushions than financial institutions in countries with broader definitions for Tier 1 capital. Investors may perceive less capital and capital cushions as a negative attribute. Countries that recognize contingent capital as Tier 1 capital could also give their financial institutions additional options for complying with international capital adequacy requirements.

The Basel Committee has already considered contingent capital and bail-in debt instruments for capital adequacy.¹⁵² Basel II and III allow the use of “Enhanced Capital Notes”¹⁵³ and permit the conversion of subordinated debt into equity.¹⁵⁴ However, the Basel Committee rejected requests from EU member states to use CCS to satisfy the new capital buffers under Basel

146. See *supra* notes 117–45 and accompanying text (discussing the tension between the Basel Committee and the European Union in determining if CCS will qualify as convertible instruments as Tier 1 capital).

147. See David Enrich, *Europe Blinks on Bank Test: Regulators Seen Easing ‘Stress’ Gauge, Undercutting Effort to Restore Confidence*, WALL ST. J., Mar. 9, 2011, at A1, A10.

148. For the German definition of the Tier 1 capital, see Gesetz über das Kreditwesen [Kreditwesengesetz – KWG] [German Banking Act] Sept. 9, 1998, BGBL. I, 2776, as amended, §10, ¶2a (providing definitions of Tier 1 capital for various financial institutions, partnerships, and companies; for public savings and private savings banks, Tier 1 capital consists of the reserves).

149. *Id.*; see also Gregory J. Lyons et al., *Basel Bank Resilience and Liquidity Proposals Confirm the Global Paradigm Shift Toward Increased Financial Regulatory Oversight*, 137 BANKING L.J. 226, 239 (“[T]he FSA proposal would permit capital instruments with ‘step ups’ and other incentives to redeem to count as Tier 1 capital to a degree.”).

150. See Enrich, *supra* note 147, at A10.

151. *Id.*

152. See Press Release, BIS, *supra* note 97, at 2.

153. See Glover & Finch, *supra* note 139.

154. *Id.*

III.¹⁵⁵ Instead, the Basel Committee requires SIFIs to use retained earnings and ordinary shares to meet heightened capital requirements.¹⁵⁶ Basel III calls for common equity Tier 1 requirements of at least 4.5% of risk weighted assets (“RWA”), Tier 1 capital levels of at least 6.0% of RWA, and total capital of at least 8.0% of RWA.¹⁵⁷ Under Basel III, however, SIFIs are “required to meet their additional loss absorbency requirement with Common Equity Tier 1 only.”¹⁵⁸ A proposal by the EU Commission would allow contingent capital as an “additional Tier 1 instrument.”¹⁵⁹ The EU Commission proposal defining contingent capital as Tier 1 capital could be a first step towards a basic framework for harmonized contingent capital standards. The implications for the market in CCS could be significant. With a harmonized Tier 1 status for CCS, EU member states would receive guidance to set up rules for contingent capital that comply with EU definitions. Alternatively, they could provide a basic regulatory framework enabling SIFI-specific contingent capital designs via private ordering.¹⁶⁰

155. See Louis, *supra* note 99.

156. *Id.*

157. BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 1, 12 (rev. June 2011), <http://www.bis.org/publ/bcbs189.pdf>; see also *Financial Regulatory Reform: The International Context: Hearing Before the H. Comm. on Financial Services*, 112th Cong. 12 (2011) (statement of Hal S. Scott, Director of the Committee on Capital Markets Regulation and Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School) (“Basel III, when fully implemented by 2019, will require banks to hold 4.5% of common equity and 6% of Tier I capital (up from 4%) of risk-weighted assets (RWAs). Basel III also introduces additional capital buffers, a mandatory capital conservation buffer of 2.5% and a discretionary countercyclical buffer, which allows national regulators to require up to another 2.5% of capital during periods of high credit growth.”), available at <http://financialservices.house.gov/UploadedFiles/061611scott.pdf>.

158. Jung-moh Chang, *Outlook for the Role of Contingent Capital*, KCMi (Aug. 23, 2011), [http://www.kcmi.re.kr/Eng/cmweekly/down1.asp?num=43&seq=1&filename=\(2011-0823\)Weekly_eng.pdf](http://www.kcmi.re.kr/Eng/cmweekly/down1.asp?num=43&seq=1&filename=(2011-0823)Weekly_eng.pdf).

159. See *Commission Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms PART I*, at art. 48a, 49(1)(n), and 51(b), COM (2011) 452 final (July 20, 2011) [hereinafter *EU Commission Proposal*], available at [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0452\(01\):FIN:EN:PDF](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0452(01):FIN:EN:PDF). If this proposal will counterbalance the Basel Committee’s decision to require retained earnings and ordinary shares to meet heightened capital requirements is unclear.

160. A possible model for such a framework could be the Swiss example. See *supra* Part III.C.

IV. ETHICAL DIMENSION OF CONTINGENT CAPITAL

The technical design features of contingent capital, possible ethical implications, and the possible application of contingent capital in corporate governance have not yet been evaluated systematically. Many constituents have an interest in the proper functioning of contingent capital designs. Taxpayers, the respective governments and legislatures, the issuing SIFIs, SIFI management, investment bankers, potential buyers, and actual holders of CCS could have legitimate interests in well functioning and social welfare maximizing designs for contingent capital securities.¹⁶¹

Taxpayers may have an interest in a contingent capital market that facilitates the internalization of future bank failure cost and avoids moral hazard. Similarly, governments could be interested in contingent capital rules to make markets safer, avoid bailouts and moral hazard, curtail banks from taking risks, and minimize systemic risk. While some SIFI issuers already issued CCS to support their financing needs and improve marketing,¹⁶² mandatory issuance of CCS could create new challenges. SIFIs could object to mandatory issuance requirements because of the implicit compliance cost and the potential impact on business strategies, a possible threat of change of control, and a possible increase in overall uncertainty.

Change of control induced by CCS conversion could affect SIFI management if management's employment is at risk. Otherwise, management could embrace CCS as an efficient way of financing with a positive marketing side effect. Investment bankers and other consultants may benefit from the market in contingent capital. They may capitalize on advisory and other fees and may be able to create new or deepen existing consulting relationships. Lastly, buyers of CCS are unlikely to have altruistic motives for their purchase. They buy in sufficient numbers only if CCS are a sound investment or at least appear by their design to be a sound investment.

It is possible that the evolving market in contingent capital securities will, for the most part, be built on private ordering.¹⁶³ If private ordering should not sufficiently protect the public interest, for example, by decreasing the likelihood of future

161. See Henkel & Kaal, *supra* note 18, for a more thorough analysis of constituents' incentives without a discussion of ethical implications.

162. Justin Baer et al., *Credit Suisse Mulls Issuing Up to \$30 Billion in 'CoCo' Bonds*, FINANCIAL TIMES (Dec. 13, 2010, 2:35 AM), http://www.cnbc.com/id/40635253/Credit_Suisse_Mulls_Issuing_Up_to_30_Billion_in_Coco_Bonds.

163. See *supra* Part III.C and *infra* Part V.

bailouts, public ordering could be needed. If public ordering should play a role, it would ideally provide a general framework for contingent capital rules that enables experimentation.¹⁶⁴ As the Swiss experience shows,¹⁶⁵ government authorities in various jurisdictions may wish to make future government bailouts as unlikely as possible to avoid burdening the taxpayer. At the same time, regulators may desire to set up rules for CCS in a way that makes it attractive enough for potential buyers to purchase these securities and enable market proliferation and evolution.

Unintended consequences could result if a government program requiring mandatory issuance of CCS should permit the respective government and its central bank or other SIFs to purchase CCS.¹⁶⁶

A. Adverse Effects

Contingent capital rules could also have unintended adverse effects. Legal rules can have the independent authority to override moral reasoning¹⁶⁷ and may, in certain settings, have the

164. The Swiss government has provided a general framework for the use of contingent capital and capital adequacy. See *supra* Part III.C on the Swiss Banking Act and contingent capital rules. See also *infra* Part VI on the benefits of experimentation in an Institutional Economics framework.

165. See *supra* Part III.C on the Swiss Banking Act and other rules enabling the issuance of contingent capital securities.

166. See *infra* Part VII.D on additional CCS design improvements.

167. Robin Bradley Kar, *The Two Faces of Morality: How Evolutionary Theory Can Both Vindicate and Debunk Morality (with a Special Nod to the Growing Importance of Law)*, in LIII NOMOS: EVOLUTION AND MORALITY 72–75 (forthcoming 2012), available at <http://ssrn.com/abstract=1834965>. In Kar's argument for legal parallelism, he explains:

[I]t is logically possible to have more than one natural sense of obligation, each of which functions in many identical ways, by appearing to us to have precisely the same set of practical implications Morality and law nevertheless engage different classes of obligata, which are better or worse suited to different classes of social contract problems . . . [and] a shared social psychology that naturally inclines us to defer to a smaller group of officials to determine the content of what the law requires, and that allows these officials to learn a shared and technical form of legal judgment Our sense of moral obligation would thus be the product of long-term selective pressures, which have left us with a very powerful and highly evolved perception of moral authority; whereas our sense of legal obligation would have only really come under heavy selective pressure quite recently (*i.e.* after the rise of agriculture and the development of larger-scale civilization).

Id. at 72–75; see also Oliver Goodenough & Monika Gruter Cheney, *Preface: Is Free Enterprise Values in Action?*, in MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY xxiii, xxiii–xxiv (Paul J. Zak ed., 2008).

capacity to actually encourage violations of rules,¹⁶⁸ or undermine the spontaneous workings of values.¹⁶⁹ Paul Zak provides the following example:

In a recent experiment at two day care centers in Israel, both with a rule in place that parents must pick up their children no later than 4:00 PM, one imposed a fine of \$3 for each time the child was picked up late. The other simply depended on the parents' following the rule with no sanction for failing to do so. At the center that imposed a fine, parents' mind-set apparently changed; the fine seemed to remove the implicit social sanction associated with being late, because now one just had to pay a penalty. Over a three-week period, the day care center with the fine saw twice as many parents arriving late, and the proportion of latecomers remained steady thereafter (even after the fines were terminated!). The lesson here is that oversight and penalties may crowd out the good behaviors that most people, most of the time, follow.¹⁷⁰

While contingent capital rules are expected to make financial institutions more resilient, prepare financial institutions for future financial downturns, and minimize moral hazard and systemic risk, they could theoretically give decision makers a false sense of security. If the market in contingent capital securities should evolve with CCS designs that provide sufficient protections and guard against systemic risks and contagion, it seems theoretically possible that decision makers could rely on the design of CCS and neglect their role as monitors.

Operating under the illusion of heightened protections by a possible CCS regime, in combination with the misguided belief in the efficient functioning of a possibly flawed contingent capital design, decision makers could feel encouraged to continue engaging in business practices that result in high social cost. This could mean that contingent capital rules could actually contribute to overriding decision maker's moral reasoning. In that case, contingent capital could actually increase risk incentives for SIFIs that are too big to fail.

While stricter controls, corporate governance constraints, and stronger regulatory pressure can incentivize financial institu-

168. See Goodenough & Cheney, *supra* note 167, at xxiii–xxiv.

169. *Id.*

170. Paul J. Zak, *Values and Value: Moral Economics*, in *MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY*, *supra* note 167, at 259, 265 (citations omitted).

tions to act more prudently and to avoid excessive risk taking,¹⁷¹ the regular corporate governance controls may not work in SIFIs. SIFIs are often considered too big to fail and may be bailed out. If that is the case, SIFI leaders may anticipate a bail-out commitment and may be incentivized to shift their risk preferences upwards. If the SIFI has issued CCS, decision makers in SIFIs could shift their risk preferences towards even higher risk profiles.¹⁷²

In effect, switching to CCS financing could reinforce risk incentives and these distorted risk incentives could create drawbacks for CCS issuances.¹⁷³ Given the nascent state of the market in contingent capital securities,¹⁷⁴ it seems unlikely that these drawbacks could materialize in the near future. Evaluating risk incentives during the drafting process, however, could help address the inherent drawbacks early in the evolution of the market in CCS.

B. Conflicts of Interest

The mandatory issuance of contingent capital securities could result in unintended consequences and conflicts of interest. Given the range of public sector injections into struggling financial institutions during the financial crisis, an EU Commission proposal suggests that a mandatory minimum issuance of contingent capital could range from 8% to 19% of risk weighted assets.¹⁷⁵ Others believe the range of mandatory contingent capital issuance would more likely be between 4% and 8% of risk weighted assets.¹⁷⁶

In a voluntary issuance, SIFIs may buy CCS from other SIFIs if the coupon rate and ratings offer sufficiently attractive features. Under a regime requiring mandatory CCS issuance, however, SIFIs and other financial institutions could desire to

171. See generally Tao-Hsien Dolly King & Min-Ming Wen, *Shareholder Governance, Bondholder Governance, and Managerial Risk-Taking*, 35 J. BANKING & FIN. 512, 512–31 (2011) (showing that strong bondholder governance incentivizes low-risk investments); Bertrand Rime, *Capital Requirements and Bank Behaviour: Empirical Evidence for Switzerland*, 25 J. BANKING & FIN. 789, 789–805 (2001); Ronald E. Shrieves & Drew Dahl, *The Relationship Between Risk and Capital in Commercial Banks*, 16 J. BANKING & FIN. 439, 439–57 (1992).

172. See Koziol & Lawrenz, *supra* note 16, at 98 (explaining that with CoCo bonds, manager-owners face distorted risk incentives since disciplining impact is mitigated). *Contra* Flannery, *supra* note 13, at 12 (finding that shareholders confront undistorted risk-bearing incentives).

173. See Koziol & Lawrenz, *supra* note 16, at 98.

174. See *infra* Part V.

175. See DG Market, *supra* note 87, at 89 n.24.

176. See GOLDMAN SACHS, *CONTINGENT*, *supra* note 103.

purchase the contingent capital securities of their competitors not because of their economic desirability but rather to fulfill their regulatory obligations. A detrimental result of such a practice could be CCS cross holdings among SIFIs. Cross holdings of CCS by SIFIs could undermine the effectiveness of CCS and its ability to limit systemic risk and contagion.

SIFIs have previously used and continue to use similar business strategies to stay competitive. Rules promulgated in the aftermath of the financial crisis in Europe and the United States may not substantially and sustainably change the business strategies and risk profiles of major financial institutions.¹⁷⁷ With similar risk profiles and CCS positions in similarly exposed entities, SIFIs could be hesitant to vote for necessary organizational changes or otherwise exercise their voting rights on a competitor after conversion of CCS into equity. This could especially hold true in the case of CCS cross holdings and if the respective competitor should hold a CCS position with similar voting rights. Without CCS cross holdings, SIFIs could be tempted to exercise their voting rights against the interests of the competitor if a conversion to equity should have been triggered.

V. EVOLVING MARKET IN CONTINGENT CAPITAL

The scope and depth of the market in CCS could depend on many factors, including the level of convergence in CCS designs and issuance volumes.¹⁷⁸ European banks have already recognized the benefits of CCS and are issuing CCS despite lacking regulatory guidance.¹⁷⁹ CCS coupon rates between 7% and 9.5% attracted sufficient investor interest and seem to have established a sustainable market in these securities.¹⁸⁰ The European market in CCS was initially built mostly on hedge fund and retail investor purchases and later included asset managers and pension funds.¹⁸¹ In late 2009, in the first issuance of its kind, Lloyds raised £8.5 billion of contingent core Tier 1 and core Tier 1

177. New capital adequacy rules may have changed the profitability of banks. See Eric Dash, *Profits Falling, Banks Confront a Leaner Future*, N.Y. TIMES, Aug. 29, 2011, at A1, A12.

178. See GOLDMAN SACHS, CONTINGENT, *supra* note 103.

179. See *infra* Part VII.B.

180. Telephone Interview with Barry Donlon, Capital Solutions Desk–CoCo Buy-Side, United Bank of Switzerland (“UBS”) (Sept. 7, 2011) [hereinafter Donlon Interview].

181. *Id.* (noting that hedge funds began to be interested in CoCos at an interest rate of around 15%).

notes through a non-U.S. bond-exchange offer.¹⁸² The bonds Lloyds exchanged for new debt had been trading below face value because of the bank's financial troubles.¹⁸³ Investor demand for the exchange offer exceeded \$2.7 billion, almost three times the amount on offer, which prompted Lloyds to issue the maximum of \$986 million of enhanced capital notes ("ECN").¹⁸⁴ These bonds were designed to convert into equity if Lloyds core Tier 1 capital ratio fell below 5%.¹⁸⁵

In a similarly successful issuance in 2011, Credit Suisse agreed to sell about 6 billion Swiss francs (\$6.17 billion) of contingent convertible bonds to shareholders in Qatar and Saudi Arabia in an exchange offer.¹⁸⁶ Qatar Holding LLC and The Olayan Group hold the notes in exchange for cash or Tier 1 capital notes that the bank sold to a group of investors including Qatar and Olayan in 2008.¹⁸⁷

In addition to the exchange offer, Credit Suisse also issued \$2 billion worth of contingent capital bonds. The bonds, offered to Asian and private investors, among others, were placed with a coupon of 7.875% to 8.125%, less than initially expected.¹⁸⁸ Demand for the offering was robust, attracting orders of around \$22 billion.¹⁸⁹ Asset managers bought about two-thirds of the Credit Suisse CoCo offering, while private banks purchased the

182. See Kathy Sandler & Margot Patrick, *Lloyds Raises \$14 Billion in Bond Exchange*, WALL ST. J. (Nov. 24, 2009), <http://online.wsj.com/article/SB10001424052748704779704574553021875626720.html>.

183. *Id.*

184. See Clara Ferreira-Marques, *UPDATE 1 – Lloyds Gets Strong Demand for U.S. Bond Exchange*, REUTERS (Dec. 8, 2009, 5:23 AM), <http://www.reuters.com/article/2009/12/08/lloyds-idUSGEE5B70QB20091208>.

185. *Id.*

186. See Elena Logutenkova & Matthias Wabl, *Credit Suisse Raises \$6.2 Billion from Qatar Holding, Olayan*, BLOOMBERG (Feb. 14, 2011, 4:22 AM) <http://www.bloomberg.com/news/2011-02-14/credit-suisse-places-sf6-billion-in-tier-1-buffer-capital-notes.html>.

187. *Id.* Qatar Investment Authority, an affiliate of Qatar Holding, has a 6.17% stake in Credit Suisse. Olayan owns 6.61% in Credit Suisse through Crescent Holding GmbH. Qatar and Olayan of Saudi Arabia were among investors that Credit Suisse approached for 10 billion francs in October 2008.

188. See Maria Sheahan, *Credit Suisse Places \$2 bln Worth of CoCos – Paper*, REUTERS (Feb. 17, 2011, 2:08 AM), <http://www.reuters.com/article/2011/02/17/creditsuisse-cocos-idUSLDE71G04H20110217>. These Credit Suisse CoCos were expected to carry a BBB+ rating from Fitch and be listed on the Euro-MTF exchange.

189. See Matthew Attwood & Jane Merriman, *UPDATE 2 – Credit Suisse Steps Up CoCo Pace With \$2 bln Bond*, REUTERS (Feb. 17, 2011, 1:25 PM), <http://www.reuters.com/article/2011/02/17/creditsuisse-cocos-idUSLDE71G0R420110217>.

remaining one-third on behalf of their clients.¹⁹⁰ A total of 550 different investors—an unusually large number—put in orders for the bonds.¹⁹¹ The strong demand from asset managers was particularly important because they were expected to form the backbone of a sustainable market for the products.¹⁹²

In another offering, the Bank of Cyprus, Cyprus's largest bank, had planned to issue up to €1.34 billion in convertible enhanced capital securities to bolster its capital adequacy ratios.¹⁹³ The bank had received subscriptions worth around €890 million (\$1.28 billion) for an enhanced CoCos issue, falling short of its target.¹⁹⁴ Subscriptions totaling €696 million were in the form of exchange of existing eligible securities.¹⁹⁵

These combined offerings suggest that the European market in CCS is sustainable. It is noteworthy, however, that the Credit Suisse offering has so far been the only CCS offering not involving an exchange element. While banks appreciate the benefits of CCS and hope to issue these securities, the lack of regulatory guidance still creates roadblocks for successful issuances.¹⁹⁶ Regulators appear hesitant to give guidance in a market and regulatory environment with a significant number of open issues and uncertainty.¹⁹⁷ Issuing contingent capital is an expensive endeavor and the expense may only seem economically justified if regulatory uncertainties have been adequately addressed. The lack of supply is affecting funds specializing in CCS.

There is some evidence that investors in the United States are interested in contingent capital securities, despite lacking

190. See Jennifer Hughes, *Credit Suisse CoCos Issue Deluged*, FIN. TIMES (Feb. 17, 2011, 18:59), <http://www.ft.com/intl/cms/s/0/31da02a0-3ac6-11e0-9c1a-00144feabd0.html#axzz1Zr1CMncO>.

191. *Id.*

192. *Id.*

193. See Michele Kambas, *Bank of Cyprus CoCos Subscription Misses Target*, REUTERS (May 20, 2011, 10:49 AM), <http://www.reuters.com/article/2011/05/20/bankofcyprus-cocos-idUSLDE74J0CV20110520>.

194. *Id.*

195. *Id.*

196. See Donlon Interview, *supra* note 180; see also Harry Wilson, *Barclays Finalises Plans for Retail Split*, DAILY TELEGRAPH (June 13, 2011), <http://dailytelegraph.newspaperdirect.com/epaper/viewer.aspx?issue=1222201106130000000001001&page=1&article=a2d5ed3e-f1f4-460b-8290-70e8f9981ee8&key=pxlgVfxYtjWArMoeijS2Aw=&feed=rss>. Barclay's Bank is expected to issue a trial bond of about £250 million to assess investor appetite. FSA approval is expected soon.

197. See Donlon Interview, *supra* note 180. For a discussion on open issues relating to contingent capital, see *supra* Part III.B.

regulatory guidance.¹⁹⁸ In comparison with the European CCS offerings, however, contingent capital in the United States could evolve differently. The debt and equity markets in the United States are structurally different from European markets. The experience in the United States with Trust Preferred Securities and High Yield “Junk” bonds could give U.S. market participants a different perspective on contingent capital securities. In comparison with European CCS offerings, the U.S. regulatory environment could result in structurally different CCS offerings in the United States. The eventual depth of the U.S. market in contingent capital could depend on pricing and the coupon rate.¹⁹⁹

The combination of investor interest and an underdeveloped regulatory structure in the United States, pertaining to this market segment, could present a unique opportunity to experiment with contingent capital designs and their possible application in corporate governance of SIFIs.

VI. BENEFITS OF EXPERIMENTATION

The political economy of financial regulation ensures that after the Dodd-Frank-induced expansion of regulatory oversight there will be a subsequent phase of relaxation of regulatory oversight.²⁰⁰ Historical evidence shows that the introduction of regulatory regimes after a crisis,²⁰¹ is often followed by a gradual easing of regulatory strictures.²⁰² The real challenge is to set up a regulatory structure that allows regulators to continually adapt

198. Telephone Conference Interview with Todd Mahoney, CoCo Buy-Side, & John Haas, UBS Capital Solutions Group, United Bank of Switzerland (Sept. 9, 2011).

199. *Id.*

200. Coffee, *supra* note 12, at 795.

201. See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *YALE L.J.* 1521, 1591 (2005) (describing the effects of swiftly-enacted regulations in response to a financial crisis); see Roberta Romano, *Regulating in the Dark I* (Dec. 18, 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1974148> (recommending “automatic subsequent review” and “regulatory exemptive or waiver powers” to remedy possible perverse unintended consequences of foundational financial legislation); Stephen M. Bainbridge, *Dodd-Frank: Quack Corporate Governance Round II*, 95 *MINN. L. REV.* 1779, 1786–88. *Contra* Brett H. McDonnell, *Don't Panic! Defending Cowardly Interventions During and After a Financial Crisis* 36 (Minn. Legal Studies Research Paper No. 11-09, 2011), available at <http://ssrn.com/abstract=1753760>.

202. See Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 *CONN. L. REV.* 393, 395 (2006); see generally Kimberly D. Krawiec, *Don't “Screw Joe the Plummer”: The Sausage-Making of Financial Reform* (Nov. 11, 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1925431>.

to new market environments, financial innovation, and to changes in financial markets as a result of financial regulation. Appropriate capacities to adapt regulation may require the right set of incentives for regulators.

Economic benefits of financial rules are usually described from the vantage point of rational actors who are utility-maximizing. Other core assumptions of this model include: scarcity of resources, methodological individualism, and self-interested rational behavior. Rational actors in this model are designing legal rules and adjudicating disputes over those rules on the supply side. Other rational actors use those legal rules to govern their relationships on the demand side.

While the core assumptions of the neoclassical model are shared, New Institutional Economics (“NIE”) replaces the assumption of full rationality with bounded rationality,²⁰³ complemented by the assumption of opportunistic behavior.²⁰⁴ Many of NIE’s modified assumptions have found their way into modern economic analysis of financial markets and financial rules.²⁰⁵ NIE is a relatively young offspring of economic theory focusing on the functioning and development of institutions (positive analysis), suggesting proposals for improving existing institutions (normative analysis), and supporting impact analysis and comparative impact analysis of present regulatory structures and *de lege ferenda* solutions.²⁰⁶

Institutional economics stresses that information is systematically incomplete.²⁰⁷ Institutions are defined as general rules or

203. See STEFAN VOIGT, INSTITUTIONENÖKONOMIK [INSTITUTIONAL ECONOMICS] 22–23 (2d ed. 2009).

204. *Id.* at 88–89; EIRIK G. FURUBOTN & RUDOLF RICHTER, INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTION OF THE NEW INSTITUTIONAL ECONOMICS 5 (2d ed. 2005).

205. HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 9–10 (2002); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 10 (2000).

206. See Furubotn & Richter, *supra* note 204, at 35–37; DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 3 (1990); RUDOLF RICHTER & EIRIK G. FURUBOTN, NEUE INSTITUTIONENÖKONOMIK [NEW INSTITUTIONAL ECONOMICS] (3d ed. 2003); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 15–16 (1985); VOIGT, *supra* note 203; Christian Kirchner, *Public Choice and New Institutional Economics: A Comparative Analysis in Search of Co-operation Potentials*, in PUBLIC ECONOMICS AND PUBLIC CHOICE 19, 32 (Pio Baake & Rainald Borck eds., 2007); Ronald Coase, *The New Institutional Economics*, 88 AM. ECON. REV. 72, 72–74 (1998); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 233 (1979).

207. See Voigt, *supra* note 203, at 237–38.

sets of general rules, together with their enforcement mechanisms.²⁰⁸ Regardless of whether they are created by a legislature or by a private standard setter, legal rules and standards are regarded as institutions if they are enforced.²⁰⁹ NIE recognizes that limiting the analysis to a subset of formal institutions would ignore important problems and therefore emphasizes the importance of informal institutions, such as social norms.²¹⁰

Corporate governance issues often involve formal and informal institutions. NIE's approach, including formal and informal institutions in the analysis, is particularly helpful in this context. Experimentation, observation, and rule revision are seen as part of an ongoing process that may never end with a stable "optimal" rule.²¹¹ Experimentation can result in a learning process that can improve the quality of legal rules. Harmonization and coordination can help facilitate experimentation and a learning process, but experimentation is probably most effective when several different approaches can be tried simultaneously in different jurisdictions. In this process, jurisdictions experiment with different rules and discover which rules do or do not work. If underlying economic circumstances change, suggesting that a different rule might be optimal, it is more likely that some jurisdiction will try a different rule, and will do so more quickly, than if all jurisdictions felt compelled to agree upon the same rule.

Contingent capital rules and privately negotiated contingent capital offerings, as a potential subset of corporate governance rules for SIFIs, could benefit from a process of experimentation and learning. It is likely that the underlying economic conditions will change. The experimentation with different CCS rules and a mixture of market solutions, private ordering, and mandatory rules in different jurisdictions could help avoid a "stable rule" and permit dynamic regulation.²¹² Contingent capital could help facilitate an incentive structure that allows regulators to rely partially on private ordering for the design of CCS.

208. See FURUBOTN & RICHTER, *supra* note 204, at 7; VOIGT, *supra* note 203.

209. See VOIGT, *supra* note 203.

210. *Id.*

211. For background on experimentation with legal rules in the context of jurisdictional competition, see Christian Kirchner, Richard W. Painter & Wulf A. Kaal, *Regulatory Competition in EU Corporate Law After Inspire Art: Unbundling Delaware's Product for Europe*, 2 EUR. COMPANY & FIN. L. REV. 159 (2009) (discussing this phenomenon in the evolution of European corporate law).

212. See *infra* Part VII.C on Dynamic SIFI regulation.

VII. CONTINGENT CAPITAL IN CORPORATE GOVERNANCE

Corporate governance constraints and stronger regulatory pressure can incentivize financial institutions to act more prudently.²¹³ Because the regular corporate governance controls may not work in SIFIs²¹⁴ changing the existing corporate governance structures pertaining to SIFIs could be desirable.²¹⁵ Such an undertaking could be faced with significant path dependencies. Half a century of financial innovation and basic precepts of the capitalist legal system, such as limited liability²¹⁶ and the business judgment rule,²¹⁷ may not be easily circumnavigated. But, political and financial systems could be more amenable to changes in corporate governance when systemically significant financial institutions are involved.²¹⁸ Especially in the vicinity of bankruptcy, the threat of systemic implications could suffice for the respective constituents to support a change in the corporate governance structure.

A. *A Quasi-Public Good*

CCS could have the potential to approximate quasi-public good characteristics. Similar to the difficulty of excluding ships from using the services of a lighthouse,²¹⁹ SIFIs may benefit from the issuance of CCS by other SIFIs if the CCS design minimizes systemic risk and contagion. Increased use of these securities could have the potential to maximize social welfare by decreasing the likelihood of future bailouts, minimizing systemic risk, and avoiding contagion.

CCS's potential for welfare maximization could depend on how much leeway possible future contingent capital rules in the United States will give to industry groups and private parties in designing CCS features. If European developments are at all a

213. See *supra* note 171.

214. See *supra* Part IV.A.

215. See Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1175 (2010) [hereinafter Hill & Painter, *Personal Liability*]; see also Claire Hill & Richard Painter, *Compromised Fiduciaries: Conflicts of Interest in Government and Business*, 95 MINN. L. REV. 1637 (2011).

216. See Hill & Painter, *Personal Liability*, *supra* note 215 (elaborating on the prospect of reintroducing personal liability of investment bankers).

217. See Kaal & Painter, *supra* note 3 (describing changes in the context of the business judgment rule and comparing German and U.S. rules).

218. Christian Kirchner, *Corporate Governance und Ordnungsökonomik [and Order Economics]* (providing general information on the economic dimensions of corporate governance) (on file with author).

219. See R. H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357, 357-76 (1974).

guide for the United States, the larger part of the design features may be left to private ordering. The benefits of private ordering could include increased flexibility, increased placements, and a higher volume of CCS issuances. Market participants may better assess their own needs than regulators. Private parties and their advisors may have the adequate and relevant level of information to contribute to the evolution of a sustainable U.S. market in CCS.

A downside of private ordering could be that private parties may not necessarily structure CCS design features with a view towards: the common good, ethical behavior of SIFI leaders, avoiding future bailouts, limiting systemic risk, and contagion. The social welfare maximization potential of CCS could be lower if the design features are entirely left to private ordering. There is a risk that the discretion implied in private ordering could eventually make mandatory rules necessary. Too much involvement by regulators, on the other hand, could result in overreaching with the associated negative effects. The study on the feasibility of contingent capital as required by section 115(c) of the Dodd-Frank Act²²⁰ could be an opportunity for assessing the optimal level of government involvement.

B. *Reform from Within*

Ethically questionable conduct of SIFI management could be attributable to different factors. Factors such as cultural forces,²²¹ industry pressure, institutional pressure, and peer pressure could influence the decision making process of SIFI management. Influenced by strong institutional and cultural forces, decision makers may have a tendency to compartmentalize their lives and disconnect their moral reasoning from their actions in the workplace.²²² It is possible that even a SIFI leader with strong personal values and moral precepts could engage in ques-

220. See Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, § 115(c), 124 Stat. 1376, 1404-05 (codified as amended at 12 U.S.C. § 5325 (Supp. IV 2011)).

221. See generally Neil Hamilton & Verna Monson, *The Positive Empirical Relationship of Professionalism to Effectiveness in the Practice of Law*, 24 GEO. J. LEGAL ETHICS 137 (2011) (providing empirical analysis as to how professionalism enhances moral decision making).

222. See Richard Painter, *The Moral Responsibilities of Investment Bankers*, 8 U. ST. THOMAS L.J. 5 (2010); see also Lyman Johnson, *Beyond the Inevitable and Inadequate Regulation of Bankers: A Comment on Painter*, 8 U. ST. THOMAS L.J. 29 (2011); Johan J. Graafland & Bert W. van de Ven, *The Credit Crisis and the Moral Responsibility of Professionals in Finance* (European Banking Center Discussion Paper No. 2011-012, 2011), available at <http://ssrn.com/abstract=1809752> (“[A] return to the core virtues in the financial sector will therefore only suc-

tionable conduct. As a result of this compartmentalization, SIFI leaders may engage in business practices that they would not apply to their personal lives. Knowingly taking risks they cannot control,²²³ and ultimately burdening the general public,²²⁴ could be a result of a combination of these factors.

To remedy the ethically questionable conduct resulting from compartmentalization, Richard Painter proposes self-restraint by bankers through self-interest and an open dialogue about morality: “Bankers . . . need to talk with each other and with the rest of society about morality [T]here needs to be a conversation about one’s personal sense of right and wrong.”²²⁵ Lyman Johnson suggests: “[M]eaningful reform of banking must come from within banks themselves and from those who counsel and educate bankers.”²²⁶ Others argue for remodeling professionalism in business and law,²²⁷ and greater participation by civil society.²²⁸ Another approach could be for a banking entity to signal to its relevant market that it will adhere to stricter standards—ethical or otherwise.²²⁹

The issuance of contingent capital securities with a conversion feature could signal adherence to stricter standards. Credit Suisse, the Swiss bank, has already issued \$2 billion worth of convertible contingent capital bonds.²³⁰ An unusually large number of 550 different investors put in orders for the bonds.²³¹ The issuance attracted orders of around \$22 billion, more than eleven times oversubscription.²³² It is difficult to ascertain the possible signaling effect or reform potential of this issuance.²³³

ceed if a renewed sense of responsibility in the sector is supported by institutional changes that allow banks to put their mission into practice.”).

223. See *supra* notes 27–66 and accompanying text.

224. See *supra* notes 6–10 and accompanying text.

225. Painter, *supra* note 222, at 15, 17.

226. Johnson, *supra* note 222, at 35.

227. See generally Rob Atkinson, *Assessing the Foundations of Neo-Classical Professionalism in Law and Business: Remodeling the Temple, Phase I* (Fla. St. U. Coll. of Law, Public Law Research Paper No. 537, 2011), available at <http://ssrn.com/abstract=1924400>.

228. See Claire R. Kelly, *Financial Crises and Civil Society*, 11 CHI. J. INT’L L. 505, 537 (2011).

229. See Michael Spence, *Signaling in Retrospect and the Informational Structure of Markets*, 92 AM. ECON. REV. 434 (2002).

230. See *supra* notes 189–192.

231. See Hughes, *supra* note 190.

232. See Attwood & Merriman, *supra* note 189.

233. At the time of publication of this Article, the author had not been able to obtain internal documents from Credit Suisse that could have helped with an evaluation and assessment of motives for the issuance, internal governance reform, or potential for ethical leadership.

While the issuance may largely be a response to regulatory changes in Switzerland,²³⁴ at a minimum, Credit Suisse seems to be signaling to its customers and market participants that it recognizes a future role of contingent capital securities.²³⁵ Credit Suisse has opted to provide capital ratio triggers and supervisory-based triggers in its CCS issuance.²³⁶ Both triggers are intended to avoid public sector support²³⁷ and could help maximize social welfare. Whether contingent capital securities will also have a role in the governance of financial institutions might depend on the choices of legislatures and regulatory authorities, as well as private ordering.

Financial institutions seem to be following Credit Suisse's example.²³⁸ There is some evidence that contingent capital could play a role in the governance of financial institutions. Most notably, Barclays has issued contingent capital securities to its executives as deferred incentive awards.²³⁹ While commercial motives are certain to have played a major role in the CCS issuance by Credit Suisse and Barclays, the use of contingent capital to avoid public sector support and to compensate executives

234. See *supra* Part III.C on Swiss rules. See also Press Release, Credit Suisse, Credit Suisse Group Executes Agreement to Put in Place CHF 6 Billion of Tier 1 Buffer Capital Notes, a Form of Contingent Capital (Feb. 14, 2011), available at https://www.credit-suisse.com/news/en/media_release.jsp?ns=41709 (stating that “[t]his form of contingent capital will satisfy an estimated 50% of the high trigger contingent capital requirement under FINMA rules as part of the proposed Swiss TBTF-regime” and that contingent convertible bonds will be used exclusively to strengthen the bank’s equity capital base in compliance with regulatory requirements).

235. *Id.* (statement of Brady W. Dougan, Chief Executive Officer of Credit Suisse Group: “We see this transaction as a significant development for Credit Suisse Group and our industry as we believe that it will put to rest concerns about the attractiveness of these instruments to investors. This is one of a number of steps we have taken to ensure that we are at the forefront of industry developments and it underscores our commitment to creating a sustainable business model for the new environment.”).

236. See Gregg Rozansky, *The Loss Absorbency Requirement and “Contingent Capital” Under Basel III*, 23 EUROWATCH 1, 5 (2011).

237. *Id.*

238. See *supra* Part III.C discussing the pipeline of possible issuances and interest from other banks in the United Kingdom.

239. See Rob Cox, *A Pay System That May Please*, N.Y. TIMES, Dec. 6, 2010, at B2 (“CoCos would not merely constitute a compensation fig leaf. Throwing the securities into bankers’ stockings better aligns their interests with those of regulators hoping to avoid a repeat of the taxpayer bailouts of the last financial crisis.”); see also BARCLAYS, BARCLAYS PLC ANNUAL REPORT 2010, 167 (stating that “deferred incentive awards for 2010 are made under the Share Value Plan (SVP) in the form of Barclays share and under the Contingent Capital Plan (CCP) in the form of contingent capital awards.”), available at http://www.barclaysannualreports.com/ar2010/files/Annual_Report_2010.pdf.

could be a first step towards corporate governance reform from within, with potentially larger implications. Contingent capital in executive compensation could play a role in corporate governance.²⁴⁰ Additional research may be needed to ascertain the reform potential.

C. *Increased Voting Rights*

Issuing contingent capital securities with a conversion feature could provide SIFIs with an opportunity to introduce institution-specific (privately negotiated) reform without regulatory interference.²⁴¹ At the core of a possible application of contingent capital as corporate governance reform from within the respective institution could be a contingent capital design with a voting rights increase.

Voting rights increases after conversion of contingent capital into equity have many applications. It could create a quasi preparation stage for bankruptcy²⁴² but could also have larger applications for corporate governance. The possible application of a voting rights increase could become clearer as the market for contingent capital securities evolves.

By issuing CCS with increased voting rights, SIFIs could signal to their respective markets and investors the adherence to stricter ethical standards. If SIFIs issue CCS, either voluntarily or by way of a mandatory issuance,²⁴³ they would be issuing financial instruments that would have the capacity to internalize bank failure costs. With a design that increases voting rights, SIFIs could implicitly lower risk-taking and allow for a form of indirect and institution-specific corporate governance reform, i.e., increased checks and balances.²⁴⁴ The increase of institution-specific checks and balances could signal to the respective market that the SIFI is adhering to stricter ethical standards.

A voting rights increase could have the potential to change and improve the incentive structure for the constituents of SIFIs.

240. See Kaal, *supra* note 94.

241. As noted earlier, leaving the CCS design features entirely to private ordering could result in increased social cost.

242. Henkel & Kaal, *supra* note 18 (expounding on the use of a voting rights increase to create a quasi preparation stage before bankruptcy).

243. For a prior discussion on the benefits of a mandatory issuance of subordinated debt instruments see CHARLES W. CALOMIRIS, *THE POSTMODERN BANK SAFETY NET: LESSONS FROM DEVELOPED AND DEVELOPING ECONOMIES* (1997) (suggesting that subordinated debt holders should ideally be unrelated foreign financial institutions); Douglas D. Evanoff, *Preferred Sources of Market Discipline*, 10 YALE J. ON REG. 347 (1993).

244. See *supra* Part VII.B.

Under a contingent capital regime with a voting rights increase, management, shareholders, and creditors are similarly affected because the conversion feature can change the power, dependency, and perhaps even the control dynamic in the SIFI. With its impact on control dynamics and incentives for the respective constituents in SIFIs, CCS could help fill a void left by regulators' insufficiencies in monitoring and supervising financial institutions.

The possibility of increased dilution that comes with increased voting rights could lower incentives for SIFI leaders to take risks. Increased dilution could also result in a change of control or at least the threat thereof. This could change the corporate governance dynamic in the SIFI. The threat of change of control through CCS holders could provide SIFI leaders with a higher level of independence from shareholder demands. It could allow SIFI leaders to increasingly act in accordance with their moral convictions and conscience because the threat of change of control may influence SIFI leaders to take fewer risks to avoid triggering the conversion of CCS and a possible change of control. To avoid the trigger, shareholders may allow SIFI leaders more discretion with regard to risk taking and the expected returns on equity.

Corporate governance improvements for SIFIs via a CCS design with a voting rights increase could also increase the threat of loss of employment and career opportunities for SIFI leadership. CCS holders combined with other interested (institutional) shareholders could be in a position to demand corrective action by SIFI leadership if their actions should have taken the SIFI into a market segment that turned out to be excessively risky and endangered the future of the organization.²⁴⁵

The threat of loss of employment and reputational harm could influence management decision making before conversion of CCS and thereafter. More importantly, management incentives for risk control could be heightened upon conversion, especially if management knows that CCS holders would have a majority vote upon conversion (with or without institutional shareholders). The level of influence of CCS holders and their control over management could largely depend on the volume of CCS issuance. However, the potential shift in the power structure within a SIFI, alone, could increase management accountability and improve decisions by SIFI leadership.

Given these possible corporate governance improvements for SIFIs, perhaps the market in CCS could one day be under-

245. See examples *supra* Part II.

stood, in the words of Lyman Johnson, as a “moral institution[], not just an economic phenom[on].”²⁴⁶ Moreover, through the supply and demand of CCS, pricing of CCS could be understood as an implicit indicator to determine how much people care about market integrity and moral hazard. This would imply, however, altruistic motives of CCS purchasers. It is unclear if altruism in CCS purchases would be realistic. The nascent market in CCS seems to have been built on investors’ expectation of above-average returns.²⁴⁷

D. *Additional Considerations*

A contingent capital design with voting rights could help improve corporate governance in SIFIs. Nevertheless, additional design improvements could be warranted and may be accomplished with minimal additional costs. While the details of the design of the respective CCS should be left to industry groups and individual parties to negotiate, additional disclosures could be an integral part of the design.

Depending on the proposed CCS design, concerns over SIFIs or central banks buying CCS issued by systemically significant financial institutions could be raised. If SIFIs were to hold CCS issued by competitors, it is possible they would not act in the best interest of their competitors as equity holders after conversion. Similarly, if SIFIs should be allowed to purchase the CCS of their competitors, the management accountability and risk control incentives of CCS,²⁴⁸ before and after conversion, could be distorted.

An outright ban of SIFI CCS purchases, or at least purchases in other SIFI CCS issuances, could be detrimental for CCS market evolution. Perhaps a mechanism that requires disclosure of the identity of the purchaser for SIFIs and approval by the issuer could address these concerns. Disclosure of CCS purchasers would allow the issuing SIFI to decide if it would be in their interest to give a competitor a substantial CCS position that could give the competitor voting rights as equity holders upon conversion. It is unclear if CCS could be part of investment strategies that would require minimal disclosure to other market participants.

If the U.S. Federal Reserve Bank, the European Central Bank, and other central banks, as part of their monetary policy, were to purchase CCS issued by SIFIs in the primary or secondary market, the prospect of internalizing bank failure costs could be

246. Johnson, *supra* note 222, at 38–39.

247. *See supra* Part V.

248. *See supra* Part IV.

undermined. Central bank purchases in the primary market could also undermine market participants' confidence in these instruments. Central bank purchases in the primary and secondary market could mean the total loss of the investment in these securities if conversion should be unsuccessful and the SIFI defaults. Central banks, in this potential scenario, could be providing two instances of bailout funding, one through CCS purchases, and another through their implied commitment to provide liquidity if the CCS proved unsuccessful and the SIFI remains in financial difficulty. This could multiply the negative effects of government bailouts for SIFIs.

The implicit guarantees in a bailout in combination with central bank purchases of CCS could incentivize SIFIs' increase of leverage. Increased leverage of SIFIs has the potential to increase the overall supply of money and could increase asset price distortions while hiding the mispricing of risk. Governments already prioritize SIFI bailouts over other entities because of potential systemic implications. Combining bailout prioritization with central bank CCS purchases in a given jurisdiction could further incentivize SIFIs to adopt similar risk profiles and correlate risks. From this perspective, banning central bank purchases of CCS could be a policy option. An outright ban on central bank CCS purchases, however, could also inappropriately limit the regulatory tools available to central banks. Given the systemic importance of SIFIs, legislators in the United States and abroad could be hesitant to curtail central banks' discretion in this context.

If the government subsidizes SIFIs through the implied availability of bailout funds and through potential CCS purchases, it could be critical for the government to use counter-subsidies. Without counter-subsidies, the potential negative economic effects of government bailouts could result in significant social cost. One way to counter-subsidize government funding could be to charge banks for actions taken by the regulator.²⁴⁹ Another possibility for a counter-subsidy could be a retroactive charge for government bailout funding received by SIFIs. On the other hand, an outright retroactive charge for government subsidies or actions taken by regulators could actually legitimize the bailout and perpetuate its socially suboptimal consequences.

The issuance of CCS to private parties could make counter-subsidy considerations unnecessary if the internalization of bank

249. For a discussion on the subject of paying regulators, see Frederick Tung & M. Todd Henderson, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 Nw. U. L. Rev. (forthcoming 2012).

failure cost should be accomplished with these securities. Whether the potential of CCS can be fulfilled could depend on the design features and their convergence across jurisdictions.

VIII. CONCLUSION

The design of contingent capital securities in various jurisdictions could have a substantial effect on financial markets, moral hazard, future bailouts, risk taking by SIFI managers, and the perception of systemic and operational risk in SIFIs. Most of the design features of CCS are still underdeveloped. The nascent market in contingent capital securities, in combination with the regulatory evaluation of CCS in various jurisdictions, could be an opportunity to consider contingent capital designs that help reform the corporate governance structure of SIFIs. Because technical features of contingent capital designs are underdeveloped, experimentation with contingent capital designs could include parameters that have the potential to maximize social welfare. The experimentation with different CCS rules and a mixture of market solutions, private ordering, and mandatory rules in different jurisdictions could allow for dynamic regulation. As the design features become more pronounced and their scope and impact become clearer, so may their potential to help reform corporate governance in SIFIs. Contingent capital could help facilitate an incentive structure that allows regulators to rely partially on private party contracting for the design of CCS to account for systemic risk. The preliminary evaluation of contingent capital as corporate governance reform in this Article suggests that additional research is needed.