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DYNAMIC REGULATION TO CURTAIL EXCESSIVE CORPORATE RISK-TAKING—A RESPONSE TO PROFESSOR SCHWARCZ

Wulf A. Kaal*

In his article *Excessive Corporate Risk-Taking and the Decline of Personal Blame*, Professor Steven Schwarcz evaluates “the extent to which corporate risk-taking should be regarded as excessive, and the extent to which personal liability should be used to control that excessive risk-taking.”¹ Professor Schwarcz succinctly identifies the shortcomings of the existing regulatory infrastructure in the context of risk-taking by pointing out that “corporate governance law “already covers, and subjects managers to personal liability for engaging in, certain types of excessive risk-taking. But it does not cover the type of risk-taking that led to the financial crisis and that is becoming ever more common—risk-taking that could have systemic consequences to the financial system.”² Further, he evaluates the adequacy of firm-level liability and concludes that “firm-level liability may well be insufficient—and almost certainly will be inefficient—to deter excessive risk-taking and prevent another financial crisis.”³ Professor Schwarcz’s point is as unmistakable as it is insightful and provocative: “Managers engaging in excessive corporate risk-taking should . . . also be subjected to personal liability.”⁴

While Professor Schwarcz’s main points are of course well taken, and he certainly makes a tremendous contribution to the literature on excessive risk-taking by executives, a key assumption underlying most of the proposals Professor Schwarcz analyzes is that rules could and should be optimally tailored to address a perceived regulatory problem.⁵ In an environment of exponentially increasing disruptive innovation, such assumptions may not be

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¹ Steven L. Schwarcz, *Excessive Corporate Risk-Taking and the Decline of Personal Blame*, 65 EMORY L.J. 533, 533 (2015).

² *Id.* at 578.

³ *Id.*

⁴ *Id.*

⁵ *Id.* at 578–79 (“[C]orporate governance law should require managers to assess the impact of risk-taking on the public as well as on investors This Article also analyzes the extent to which managers performing this public governance duty should be protected by the business judgment rule. . . . This Article also examines how managers who breach their public governance duty by engaging in excessive corporate risk-taking should be sued.”).

justified.⁶ In fact, the assumption that stable and optimal rules are a necessary and adequate remedy in many ways supports and perpetuates excessive risk-taking by executives, financial crises, and financial regulatory cycles. A key role for scholarship in this context could be the evaluation of supplemental governance mechanisms that help the main regulatory framework adapt to constantly changing market environments, disruptive (financial) innovation, and the regulatory environment.

Exponentially increasing disruptive innovation in fintech, among other sectors, calls into question the use of stable and presumptively optimal rules in governance.⁷ Disruptive technological innovation can be characterized by the emergence of completely new technologies, the new combination and application of existing technologies, and the application of new technologies to specific societal problem areas, each precipitating a significant paradigm shift for product technology or creating entirely new paradigms.⁸ The literature on management has studied the implications of disruptive technologies and innovation since the mid-1990s.⁹ Successful disruptive products of the last fifteen years shared core characteristics that were facilitated by growth and advancement in disruptive technologies. Big data is a significant driver of disruptive innovation.¹⁰ Similarly, the exponential development of artificial intelligence and the associated disruptive innovation pose substantial challenges for policy makers in education, financial markets, labor markets, and other areas.¹¹

⁶ See Wulf A. Kaal, *Dynamic Regulation for Innovation*, in PERSPECTIVES IN LAW, BUSINESS & INNOVATION (Mark Fenwick et al. eds., forthcoming 2016).

⁷ *Id.*

⁸ Ronald N. Kostoff, Robert Boylan & Gene R. Simmons, *Disruptive Technology Roadmaps*, 71 TECHNOLOGICAL FORECASTING & SOC. CHANGE 141, 142 (2004); Steven T. Walsh & Jonathan D. Linton, *Infrastructure for Emergent Industries Based on Discontinuous Innovations*, 12 ENGINEERING MGMT. J. 23, 24 exhibit 1 (2000).

⁹ See CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL (1997); see also GEOFFREY A. MOORE, CROSSING THE CHASM (1991).

¹⁰ See VIKTOR MAYER-SCHÖNBERGER & KENNETH CUKIER, BIG DATA: A REVOLUTION THAT WILL TRANSFORM HOW WE LIVE, WORK, AND THINK (2013). The idea of N=All, facilitated by big data, allows researchers to understand correlations that are completely unprecedented and to revolutionize our world. See *id.*

¹¹ See ERIK BRYNJOLFSSON & ANDREW MCAFEE, THE SECOND MACHINE AGE: WORK, PROGRESS, AND PROSPERITY IN A TIME OF BRILLIANT TECHNOLOGIES 205–28 (2014) (discussing policy in face of projected automation of low-skill labor); Tess Townsend, *Peter Diamandis: A.I. Will Lead to Massive Disruption Across Industries*, INC. (Sept. 24, 2015), <http://www.inc.com/tess-townsend/diamandis-artificial-intelligence.html> (“He said self-driving cars will render car insurance and the need for more roads obsolete. He anticipates his children will never drive. He projected that advances in camera technology will lead to cameras woven into clothes, biometric sensing will “massively disrupt” medicine, and satellites will be able to watch raw

In my own work, I have suggested that dynamic elements in regulation can help address many of the shortcomings of the existing regulatory framework associated with disruptive innovation.¹² Dynamic regulation as a supplemental governance mechanism and rule optimization strategy could help address some of the shortcomings of the existing regulatory approach and its reliance on stable and presumptively optimal rules. Through dynamic elements in regulation, rulemaking could become more than a mere reactive process. The increasing utilization of institution specific decentralized information, reflecting preceding events and attempting to anticipate succeeding future contingencies in a dynamic framework, could help heighten the adaptive capabilities of financial regulation.¹³

Through its anticipatory and adaptive features, dynamic regulation could help dampen excessive risk-taking by executives. Dynamic elements in financial regulation could help support regulators in their efforts to continually adapt to financial innovation and new market environments. Dynamic elements in financial regulation may enable regulation to more accurately trace developments that may lead to excessive risk taking and financial crises. By changing the timing, availability and quality of information, and the emphasis of regulation,¹⁴ dynamic elements in financial regulation could help anticipate and preempt excessive risk taking and associated financial crises. A mixture of mandatory rules, market solutions, and private ordering could help increase the adaptive capabilities of rulemaking, curtail the effects of the collective action problem of rulemaking, and dampen financial regulatory cycles.

Dynamic regulation can be more than a mere theoretical concept. If combined with existing stable and presumptively optimal rules in the existing regulatory framework and rulemaking process, dynamic governance mechanisms could become part of a dynamic optimization and supplementation process for rulemaking.¹⁵ More specifically, dynamic

materials entering factories and finished products leaving them, enabling smart AI to extract financial performance data ahead of the markets.”).

¹² See Kaal, *supra* note 6; see also Wulf A. Kaal, *Evolution of Law: Dynamic Regulation in a New Institutional Economics Framework*, in FESTSCHRIFT IN HONOR OF CHRISTIAN KIRCHNER (Wulf Kaal, Matthias Schmidt & Andreas Schwartze eds., 2014) [hereinafter Kaal, *Evolution of Law*]; Wulf A. Kaal, *Dynamic Regulation of the Financial Services Industry*, 48 WAKE FOREST L. REV. 791 (2013); Wulf A. Kaal & Timothy A. Lacine, *The Effect of Deferred and Non-Prosecution Agreements on Corporate Governance: Evidence from 2003–2013*, 70 BUS. LAW. 61 (2015).

¹³ See *supra* note 12 and accompanying sources.

¹⁴ See Kaal, *Evolution of Law*, *supra* note 12.

¹⁵ See Kaal, *supra* note 6.

elements in financial regulation could be facilitated through the increasing use of institution specific information and private ordering. Contingent Capital Securities (CoCos),¹⁶ Corporate Integrity Agreements (CIAs), Deferred Prosecution Agreements (DPAs),¹⁷ venture capitalists' finance allocation,¹⁸ and crowdfunding are among the governance mechanisms that can provide institutions specific information for financial rulemaking.¹⁹

Professor Schwarcz's work is foundational for the literature on remedies for excessive risk-taking and provides much needed guidance for future generations of scholars. He provides important insights into trends in the literature and proposed scholarly solutions for shortcomings in the existing regulatory framework and its role in excessive risk taking by executives. Scholars like myself will be able to use his work and insights to delineate the role of dynamic elements in financial regulation for many years to come.

¹⁶ See Wulf A. Kaal, *Contingent Capital in Executive Compensation*, 69 WASH. & LEE L. REV. 1821 (2012); see also Wulf A. Kaal, *Initial Reflections on the Possible Application of Contingent Capital in Corporate Governance*, 26 NOTRE DAME J.L. ETHICS & PUB. POL'Y 281 (2012).

¹⁷ See Kaal & Lacine, *supra* note 12.

¹⁸ Wulf A. Kaal & Erik P.M. Vermeulen, *Venture Capital as Dynamic Regulation of Disruptive Innovation* (2016) (unpublished manuscript) (on file with author).

¹⁹ See Kaal, *supra* note 6.