STUART R. LOMBARDI

COMMENTARY ON CLAWBACK POLICIES

August 13, 2012

United States Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C. 20549-1090
**Attention: Ms. Elizabeth M. Murphy, Secretary**

Dear Ms. Murphy:

I submit this letter in response to the Commission's invitation for preliminary comments on Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Section 954"). I understand that the Commission will soon adopt preliminary rules under Section 954, concerning the recovery of executive compensation. I write to comment on this issue.

I am a recent graduate of Columbia Law School.[1] While at Columbia, I conducted research on executive compensation under the supervision of Professor Robert J. Jackson, Jr. My research includes analysis of clawback policies, Section 954, Say-on-Pay, and portfolio incentives. Enclosed is a Note I authored, published in the *Columbia Business Law Review*, which presents an original empirical study of the clawback policies of large public companies and uses the study's findings to help interpret Section 954.

In light of the Commission's substantial agenda, I will limit my comments to two recommendations. In short, on the basis of my empirical findings presented in the attached Note and summarized below, I suggest that the Commission's rules:

- **Give issuers discretion** to determine on a case-by-case basis when and how to exercise their clawback powers; and

- **Require each issuer to disclose whether it decided to clawback compensation**, and the reasons justifying its decision.

## Empirical Findings

The study presented in the attached Note examines the clawback policies of all companies in the Dow Jones Industrial Average ("DJIA"). I reviewed the companies' public filings and websites, and contacted each company directly requesting all relevant information regarding each company's clawback policy. Using all available information, I then categorized each company's clawback policy using a number of factors, including: (1) culpability (whether the policy applies only against culpable executives), (2) trigger (what triggers the clawback policy), (3) discretion (whether the company reserves discretion to make clawback decisions on a case-by-case basis), and (4) amount clawed back.

The study's primary finding is that **companies value the discretion to determine when and how to exercise their clawback powers**. Out of the thirty companies in the sample, twenty-four (80%) have policies that give the company complete discretion to determine, on a case-by-case basis, whether to clawback compensation when the clawback policy is triggered. An additional four companies (13%)

[1] I write solely in my individual capacity; my institutional affiliation is for identification purposes only.

have clawback policies that apply only against culpable executives, but allow the company to make the initial and/or final determination of the executive's culpability, meaning each company is effectively able to exercise discretion to determine when to clawback compensation. The remaining two companies (7%) have clawback policies that apply automatically in certain circumstances if the company finds the employee culpable, but each company also reserves discretion to clawback even if it does not find the employee culpable.

In short, the study finds that the vast majority of companies reserve complete discretion to determine on a case-by-case basis when to exercise their clawback powers, and that all companies are able to exercise at least some discretion in applying their clawback provisions. In other words, the clawbacks in the study are generally not binding; the company generally has discretion to determine (1) whether it wants to recoup compensation and (2) what compensation to recoup. I interpret this to show that **companies value the discretion to determine when and how to exercise their clawback powers.**

## The Benefits of Discretion

In light of my finding that companies value discretion, I suggest that the Commission's rules **give issuers discretion to determine on a case-by-case basis when and how to exercise their clawback powers**. This recommendation is rooted in two conclusions. First, board discretion offers a number of benefits. Second, if the Commission denies issuers the discretion they value, issuers will face a powerful incentive to implement compensation arrangements that are not governed by Section 954, and this would be worse than simply giving issuers appropriate discretion.

**Board discretion offers a number of benefits**. First, it allows each issuer's board to exercise its business judgment to determine, on a case-by-case basis, whether the costs of clawing back compensation outweigh the benefits. In other words, discretion enables the board to determine whether clawing back compensation is in the shareholders' best interest. Second, discretion simplifies Commission rule-making and enforcement. Rather than carving out a specific exception (and applicable test) for *de minimis* clawbacks, or giving issuers the opportunity to persuade the Commission that a clawback is unnecessary in a particular case, the Commission could simply allow boards to make such case-by-case determinations. Third, granting issuers discretion appropriately acknowledges that determining whether to clawback compensation is a highly fact-specific inquiry. If companies believed otherwise, they could have implemented binding clawback policies, subject to simple cost-benefit tests, and the Commission could turn to those tests for guidance when implementing Section 954. But issuers did *not* create simple cost-benefit tests; instead, they reserved broad discretion to make case-by-case determinations, which strongly suggests that issuers believe that determining whether to clawback compensation is a highly fact-specific inquiry that must be made on a case-by-case basis. Fourth, even when shareholders ask companies to implement clawback policies, they have never, to my knowledge, asked for a *binding* clawback policy. This indicates that shareholders also recognize that deciding whether to clawback compensation is a highly fact-specific inquiry, and that such an inquiry requires some board discretion.

**If the Commission denies issuers the discretion they clearly value, issuers will face a powerful incentive to implement compensation arrangements that are not governed by Section 954**. There is little reason to believe that the compensation arrangements issuers would use to evade Section 954 would be better for shareholders. To the contrary, there is good reason to believe they would be worse. For example, the alternative compensation arrangements may well weaken the relationship between pay and performance (as issuers abandon accounting-based metrics in an effort to implement compensation arrangements that are not subject to Section 954).

## Enhanced Disclosure

Some academics have argued that board discretion in clawback policies is undesirable.[2] They argue that, due to managerial power (that is, management's influence over the board), boards will abuse their discretion and under-utilize their clawback powers.[3] To address these concerns, the Commission should give boards the discretion they value, but **balance the discretion with enhanced disclosure requirements**.

**Whenever a company issues an accounting restatement that triggers a Section 954 clawback, the Commission should give the issuer's board two options: (1) publicly announce its decision to clawback compensation, or to decline to clawback compensation, and the reasons justifying such a decision, or (2) turn all clawback decision-making authority over to an independent actor**. As the attached Note discusses in more detail, the first option would give shareholders the information necessary to hold the board accountable for its decision, thereby mitigating managerial power concerns. The second option avoids the managerial power problem by placing the decision in the hands of an independent actor (such as a compensation consultant, auditor, or arbitrator). If the board pursues the second option, the Commission could further require the board to disclose the independent actor's decision and its reasoning. This would allow shareholders to hold the board accountable if it chooses an independent actor that has a pro-management bias, and would accordingly encourage boards to choose neutral independent actors. Thus, this disclosure regime effectively reduces managerial power concerns by giving shareholders the information they need to hold boards accountable, while still giving boards the flexibility they need to make clawback decisions that are in the shareholders' best interest.

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I appreciate the opportunity to provide comments regarding Section 954. If further discussion of these comments would be helpful to the Commission or the Staff, please do not hesitate to contact me at srl2134@columbia.edu.

Stuart R. Lombardi

Columbia Law School
Class of 2012

Attachment

cc: Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
Meredith Cross, Director, Division of Corporation Finance
Thomas J. Kim, Chief Counsel and Associate Director, Division of Corporation Finance

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[2] *See, e.g.*, Jesse Fried & Nitzan Shilon, Excess-Pay Clawbacks, 36 J. CORP. L. 721, 739-40 (2011).
[3] *Id.*

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Lombardi, Stuart R. *Interpreting Dodd-Frank Section 954: A Case for Corporate Discretion in Clawback Policies*, 2011 Colum. Bus. L. Rev. 881.