Statement No. 359

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Because the proposal targets specified groups of managers whether or not the particular manager was in a position to have prevented the accounting misstatement, the provision would claw back compensation from some managers, who were not responsible for the misstatement, while failing to penalize other managers or employees, who were responsible. Thus, the “no-fault” provision potentially leads to a need to provide the executive greater ex ante compensation to compensate for the greater exposure to penalties.

The “no-fault” approach proposed by the SEC could have other adverse incentive effects as well. Rather than affecting the likelihood of firms restating their accounts, the proposal might simply induce companies to alter the form of their bonus compensation. The proposed rule could change the structure of executive compensation by encouraging companies to adopt less transparent compensation practices. Managers’ compensation could be clawed back if their compensation is based on accounting data but could not be altered if the managers are given a discretionary bonus. Thus, the proposal would provide firms an incentive to shift to discretionary bonuses. In the extreme, a company might redesign its compensation structure so that it does not depend on accounting data. Given the potential distortions, the clawback proposal may have dysfunctional consequences.

It is unclear that the form of compensation should be mandated by regulators. However, a more robust approach to optimal compensation than the clawback requirement would provide adequate long-term incentives by tying compensation to the long-term success of the firm. For example, regulators could simply require a certain amount or proportion of the compensation be deferred and invested in restricted stock for a number of years (such as three to five years) rather than micromanaging the specifics of the compensation structure.

It is unfortunate that the Dodd-Frank Act has focused so extensively on executive compensation issues, particularly on facets that do not seem linked to the core of the financial crisis. The Shadow Committee finds itself wondering about the extent to which the generation of this rule making has been captured by political agendas unrelated to systemic risk.

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1 The proposed rules include a definition of an executive that is similar to the definition of “officer” under Section 16 of the Exchange Act. The definition includes the company’s president, principal financial officer, principal accounting officer, and vice presidents in charge of principal business units, divisions or activities as well as those who perform policy-making functions for the firm.