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Via Electronic Submission

April 16, 2016

Mr. Brent J. Fields
Secretary
United States Securities and Exchange Commission
100 F Street, N.E. Washington, D.C. 20549-1090

Re: File No. S7-12-15
Release Nos. 33-9861; 34-75342; IC-31702
Listing Standards for Recovery of Erroneously Awarded Compensation

Dear Mr. Fields:

I appreciate the opportunity to submit a comment with respect to the above-referenced Release. I write in my individual capacity; my institutional affiliation is noted for identification purposes only.

My comment consists of the two attached academic papers. The first, "Rationalizing the Dodd-Frank Clawback" is a working paper dated April 12, 2016. [Updated versions will be available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2764409.] The second is "Excess-Pay Clawbacks," 36 J. Corp. L. 722 (2011)(with Nitzan Shilon).

"Excess-Pay Clawbacks" describes the results of an empirical study of recovery policies of S&P 500 firms before Dodd-Frank, and explains why these types of policies are unlikely to deter executives from misreporting to generate excess pay. "Rationalizing the Dodd-Frank Clawback," which builds on "Excess-Pay Clawbacks," analyzes certain features of the SEC's proposed clawback rule. It explains that, while the proposed rule would reduce some executives' incentive to misreport, it sweeps too broadly. In particular, it reaches types of issuers, executives, and compensation arrangements where the costs of the rule are likely to outweigh the benefits.

I hope that these two papers are useful to the SEC in finalizing the Dodd-Frank clawback. If you would like additional information about the findings and analyses in these papers, please contact me at [redacted].

Sincerely,

Jesse Fried

Jesse Fried

Rationalizing the Dodd-Frank Clawback

Jesse M. Fried*

Harvard Law School
April 12, 2016

Abstract

On July 1, 2015, the Securities and Exchange Commission (SEC) proposed an excess-pay clawback rule to implement the provisions of Section 954 of the Dodd-Frank Act. I explain why the SEC's proposed Dodd-Frank clawback, while reducing executives' incentives to misreport, is overbroad. The economy and investors would be better served by a more narrowly targeted "smart" excess-pay clawback that focuses on fewer issuers, executives, and compensation arrangements.

*Dane Professor of Law, Harvard Law School. Thanks to John Cook, Lauren Falkowitz, Craig Ferrere, Dan Gallagher, Rob Jackson, Kobi Kastiel, Ira Kay, Da Lin, Yaron Nili, David Raedler, Nitzan Shilon and others who provided helpful comments. I am especially grateful to John Cannon and Brian Foley for their very detailed feedback on an earlier draft of the paper. Comments are welcome and can be sent to me at jfried@law.harvard.edu.

Rationalizing the Dodd-Frank Clawback

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I. Introduction

Executives of public firms receive a substantial amount of their pay in the form of incentive compensation—compensation that is tied to a performance metric. Much of this incentive compensation is directly tied to financial accounting results, such as revenues or earnings, or to other performance-related measures. While such incentive compensation can beneficially encourage executives to generate value for shareholders, it can also lead them to misreport financial accounting results or other metrics to generate "excess pay"—extra pay received solely because a pay-relevant metric is erroneous. Such misreporting imposes costs on shareholders of the firm and on the market as whole.

Misreporting is difficult to deter directly through case-by-case enforcement of the securities laws against individual executives. To be sure, extreme forms of misreporting, which are relatively easy to detect and prove, can lead to legal action against individual executives for violating the securities laws. Forfeiture of ill-gotten gains,[1] or even more severe punishments, may then follow. However, less extreme forms of misreporting may often go unsanctioned, because of the difficulties of detection and proof, and because the boundaries between good-faith reporting and misreporting are often fuzzy.

The difficulty of deterring misreporting through case-by-case law enforcement has led to a search for alternative regulatory strategies. One

[1] The SEC has long used equitable remedies to force executives found to have personally violated the securities laws to return ill-gotten gains. *See, e.g.,* SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 92–94 (S.D.N.Y. 1970); *aff'd in part and rev'd in part*, 446 F.2d 1301, 1307–08 (2d Cir. 1971) (granting remedy requiring restitution of profits obtained by defendants following Section 10(b) and Rule 10b-5 violations). This remedy has often been used to force individuals to disgorge bonuses that were inflated on the basis of financial misstatements. *See* Securities & Exchange Comm'n, Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002 at 8 (reviewing enforcement actions over the five years preceding the enactment of the Sarbanes-Oxley Act) *available at* https://www.sec.gov/news/studies/sox308creport.pdf; S.E.C. v. Razmilovic, 738 F.3d 14, 32 (C.A.2, 2013) (holding that it was not an abuse of discretion for the district court to order disgorgement of a culpable CEO's bonuses and other compensation earned in relation to an accounting fraud).

such approach is a (no-fault) excess-pay clawback: a mechanism that recovers excess pay without the need to prove misconduct or fault on the part of the executive.[2] If executives knew that they would be required to return excess pay, the thinking goes, they would have much less incentive to misreport.

In 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] ("Dodd-Frank"), one of whose provisions (Section 954) will require issuers with securities on a national exchange to create and enforce an excess-pay clawback meeting certain requirements (the "Dodd-Frank clawback").[4] On July 1, 2015, the SEC proposed a Rule (Rule 10D-1) to implement the Dodd-Frank clawback (the "SEC's proposed Dodd-Frank clawback").[5] A final version of the Rule has yet to be adopted.

In a nutshell, the Dodd-Frank clawback requires an issuer that has restated its financials to recover from a covered executive who had received "incentive-based compensation" the excess (if any) of (a) the incentive-based compensation she *actually* received over (b) the incentive-based compensation she *would have* received under the restated financials.[6] There is no need to prove executive misconduct or fault.

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[2] I will use the term "excess-pay" clawback throughout this paper to refer to *no-fault* excess-pay clawbacks. For a discussion of excess-pay clawbacks, s*ee generally* Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 722 (2011).

[3] Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

[4] *See infra* Part II.A. While most provisions of Dodd-Frank target financial institutions, three provisions apply to executive compensation in both financial and non-financial firms: (1) "say on pay"—requiring a shareholder vote on executives' compensation and any golden-parachute arrangements (Section 951); (2) a provision relating to the composition and functioning of compensation committees (Section 952); and (3) the clawback provision in Section 954.

[5] *Listing Standards for Recovery of Erroneously Awarded Compensation*, Securities Act Release 33-9861, Exchange Act Release No. 34-75342, 80 Fed. Reg. 41144 (proposed July 1, 2015) (to be codified at 17 C.F.R. pts. 229, 240, 249 & 274) (also available at http://www.sec.gov/rules/proposed/2015/33-9861.pdf) [hereinafter, "*Listing Standards*"].

[6] *See infra* Part II.A.

The purpose of this Essay is four-fold:

First, to explain that given the current lack of a "reliable" excess-pay clawback at public firms, the Dodd-Frank clawback can be expected to beneficially reduce (at least some) executives' incentives to misreport financial information to shareholders.

Second, to systematically identify the costs that any reliable excess-pay clawback will inevitably impose.

Third, to argue that the SEC's proposed Dodd-Frank clawback reaches issuers and executives where it cannot be expected to materially improve incentives, and compensation arrangements where it may well reduce the incentive to misreport but where there is a very high risk that the costs will substantially exceed this benefit.

Fourth, to put forward a more narrowly-targeted "smart" version of the Dodd-Frank clawback—aimed at fewer issuers, executives, and types of compensation—that, I argue, would be more desirable than the SEC's proposed Dodd-Frank clawback.

I begin by describing the potential incentive benefits of the Dodd-Frank clawback. I focus on the application of the Dodd-Frank clawback to those executives whose behavior is most likely to be improved by it: top executives at a firm without a controlling shareholder (CS), one with dispersed investors ("a non-CS firm"). At a non-CS firm, directors have small equity stakes and spend relatively little time on firm affairs. For these and other reasons, directors are generally hands-off, turning effective control over to top executives and providing them with high-powered incentives. Given their small equity stakes, directors are unlikely to have a substantial personal interest in taking steps to deter misreporting or, for that matter, pressuring executives to misreport. If misreporting occurs, it is likely to be driven by the executives themselves, who are perhaps seeking to generate excess pay through their high-powered incentives. In this setting, an effective excess-pay clawback is likely to offer the greatest potential incentive benefit.

Before Dodd-Frank, executives of publicly-traded firms (including non-CS firms) were *potentially* subject to two types of clawbacks that could operate as (no-fault) excess-pay clawbacks. First, Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX") gave the SEC the power to force the CEO or CFO to return pay to the firm in certain situations involving a restatement and "misconduct" by the firm itself, even if the SEC could not show that the executive herself engaged in misconduct (hereinafter, the "SOX clawback").[7] Second, directors could choose to seek to recover excess pay, under a firm-adopted recovery policy or otherwise.[8]

However, these potential clawbacks have not been "reliable"; neither the SEC nor directors could be counted on to recover excess pay. During the first decade after SOX was enacted, there were approximately 8,000 financial restatements by U.S. firms.[9] Given the widespread use of incentive compensation keyed to financial accounting results, it is likely that hundreds of executives (if not more) received excess pay, including the kind targeted by Dodd-Frank. But during this 10-year period, the SEC used the SOX clawback to recover pay from only six executives who were not alleged to have personally engaged in misconduct (even though their firms were accused of misconduct).[10]

The frequency of director-initiated recoveries appears to be even lower. The overwhelming majority of public firms (about 75%) lack a disclosed recovery policy; in these firms there do not appear to be any instances of directors recouping excess pay.[11] Among the 25% of firms that have disclosed recovery policies, the statistics are not much different. One study reports that, since firms began voluntarily adopting clawback policies, there have been *only three* reported instances of recovery during the period 2007-2012 among the 242 firms that restated their financials.[12] An important reason why director-initiated recoveries are so rare, even at firms with clawback policies, is that almost all voluntarily-adopted

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[7] *See infra* Part III.B.1.

[8] *See infra* Part III.B.2.

[9] *See infra* Part III.B.1.

[10] *See infra* Part III.B.1.

[11] *See infra* Part III.B.2.a.

[12] *See infra* Part III.B.2.a.

clawback policies give directors discretion to forego recovery of excess pay from executives,[13] and directors of non-CS firms have strong personal reason to use their discretion to avoid recouping pay.[14]

After the SEC's proposed Dodd-Frank clawback is implemented, restating firms will, except in limited circumstances, be required to recover covered excess pay from executives.[15] With a reliable excess-pay clawback in place, the frequency of excess-pay recoveries will increase dramatically. Thus, Dodd-Frank can be expected to beneficially reduce the incentives of top executives at non-CS firms to misreport financial information to shareholders. The reduction in misreporting will, in turn, generate "incentive benefits": among other things, it will reduce the often large costs associated with restatements and improve the quality of financial reporting across the market.[16]

Although Dodd-Frank will generate incentive benefits, it will also impose costs. I thus systematically identify the costs that any reliable excess-pay clawback will inevitably impose.[17] There are two types of costs. The first type—"incentive costs"—includes all of the potential adverse effects on executives' behavior of such a clawback, such as inducing them to shift from value-reducing earnings manipulation to even more destructive real earnings management, or to over-invest in financial reporting. These incentive costs, like the incentive benefits described above, are associated with applying the Dodd-Frank clawback to the executives with the most power: namely, top executives at non-CS firms. With respect to these executives, the clawback will generate *net* incentive benefits (benefits less costs) which, we are hope, are positive. The second type—"non-incentive costs" —includes regulator-diversion, issuer-compliance, and executive-burden costs, all of which would arise even if there are no adverse effects on executives' behavior. These costs, I

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[13] *See infra* Part III.B.2.b.

[14] *See infra* Part III.B.2.a.

[15] See *infra* Part II.B.

[16] *See infra* Part III.C.

[17] *See infra* Part IV.

explain, arise with respect to any executive targeted by the Dodd-Frank clawback.

After sketching out the benefits and costs of a reliable excess-pay clawback such as Dodd-Frank, I identify three dimensions along which the SEC's proposed Dodd-Frank clawback sweeps too broadly from a cost-benefit perspective. First, it reaches two types of issuers that are always controlling shareholder (CS) firms: issuers with no listed equity but with listed debt, and "controlled companies" (a CS firm where the CS has more than 50% of the voting power).[18] Unlike in a non-CS firm, where directors have small equity stakes and do not closely monitor top executives, a CS firm has an 800-pound gorilla in the boardroom: namely, the CS. The CS has a large financial stake in the company, and exercises control through personally appointed directors. If the CS wants to discourage executives from misreporting, the CS has the ability to put in place a reliable excess-pay clawback or threaten more severe measures (pay cut, termination) to deter misreporting; the CS does not need the government's helping hand to do so. By the same token, if because of its large equity stake the CS wants to *encourage* executives to misreport (say, to enable the firm to issue shares at a higher price or the CS to unload some of her shares at a higher price), the CS can easily undo the incentives created by the Dodd-Frank clawback through the use of carrots (extra pay) and sticks (threats of pay cut, termination) whose magnitudes will dwarf that of the clawback. In either of these cases, the Dodd-Frank clawback cannot be expected to generate material net incentive benefits at the CS firm. However, it will still impose all of the non-incentive costs of the clawback (on regulators, issuers, and executives), and thus likely generate costs in excess of the net incentive benefits.

Second, the SEC's proposed Dodd-Frank clawback reaches too many executives.[19] In particular, it can be expected to reach ten or more executives at each firm,[20] including low-level executives (executives below the top 5, whom I call "below-5" executives). Application of the clawback to below-5 executives, even at a non-CS firm, cannot be expected to reduce misreporting. To begin, below-5 executives have much

[18] *See infra* Part V.A.

[19] *See infra* Part V.B.

[20] *See infra* Part V.B.1.

less ability to influence financial reporting results than top-5 executives. In addition, even if below-5 executives have some ability to influence financial reporting, they have very different incentives than top-5 executives. Because their pay packages are much smaller, the personal benefit of generating excess pay is much lower. More importantly, below-5 executives can be expected to focus keenly on pleasing their bosses (top-5 executives), who determine their pay and whether they will stay in their jobs, be promoted, or be terminated. If top-5 executives signal that below-5 executives should *not* use their (limited) discretion to misreport, the below-5 executives won't do so, even absent the Dodd-Frank clawback. If, on the other hand, top-5 executives *want* below-5 executives to misreport, an excess-pay clawback cannot be expected to deter the below-5 executives from misreporting. As with application of the Dodd-Frank clawback to any executive at a CS firm, application of the Dodd-Frank clawback to below-5 executives at any firm cannot be expected to generate significant net incentive benefits. But it still imposes non-incentive costs on regulators, issuers, and executives.

Third, the SEC's proposed Dodd-Frank clawback covers too much compensation.[21] It applies not only to "accounting-based pay" (pay that is granted, earned or vested based on accounting results) but also to "price-based pay" (pay that is granted, earned, or vested based on the stock price).[22] As I explain, an excess-pay clawback is suitable for accounting-based pay because the "but for" amount of compensation (had financial results not been misstated) is knowable, permitting easy calculation of the excess amount.[23] But the clawback is not suited for price-based pay, because the "but for" stock price is *un*knowable. Excess price-based pay thus can only be *guesstimated*. While application of the Dodd-Frank clawback to the price-based pay of top-5 executives at non-CS firms will generate some incentive benefits, the need to guesstimate excess price-based pay (and defend the guesstimated amount to regulators, shareholders, and courts) will lead to large non-incentive costs, such as issuer compliance costs and risk-bearing costs for executives, creating a

[21] *See infra* Part VI.

[22] *See infra* Part II.B.

[23] *See infra* Part VI.A.

large risk that these costs will exceed any net incentive benefits.[24] As a result, there is a very high likelihood that the costs of extending the clawback to price-based pay will exceed any incentive benefits.

After explaining that the SEC's proposed Dodd-Frank clawback goes too far along these three dimensions, I put forward a more narrowly-targeted "smart" version of the Dodd-Frank clawback—aimed at fewer issuers, executives, and types of compensation—that, I argue, would be more desirable than the SEC's proposed Dodd-Frank clawback.[25] This clawback would be targeted solely at the accounting-based pay of top-5 executives at types of issuers that are not exclusively CS firms.

Throughout the Essay, my yardstick for evaluating the SEC's proposed Dodd-Frank clawback is economic-value maximization. That is, I assume that the proper objective of the government in regulating public companies is to increase the size of the total economic pie: the total amount of value flowing to those with residual claims on the value of firms subject to the clawback (as well as taxpayers, to the extent they must fund the regulators enforcing the clawback).

Before proceeding, several caveats are in order. First, my analysis does not extend to two types of issuers that are subject to the SEC's proposed Dodd-Frank clawback: (1) firms whose compensation arrangements are subject to regulation and oversight by the Federal Reserve or any other body that regulates financial institutions; and (2) "foreign private issuers" (firms that are organized under the laws of a foreign country and meet certain other criteria).[26] Although both regulated financial institutions and foreign private issuers are subject to the SEC's proposed Dodd-Frank clawback,[27] their institutional features and regulatory environments are sufficiently distinct from those of the firms that I cover here to warrant separate treatments. However, the analysis I offer—that it is undesirable to apply an excess-pay clawback to CS firms, below-5 executives, and price-based pay—should apply with equal force

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[24] *See infra* Part VI.B.

[25] *See infra* Part VII.

[26] These criteria are described in Exchange Act Rule 3b-4(b) and (c).

[27] *See infra* Part II.B.1.a.

to these two types of issuers.

Second, I do not consider here many of the "nuts-and-bolts" details of the SEC's proposed Dodd-Frank clawback, including (a) the types of required restatements that will trigger activation of the clawback; (b) timing issues (the deemed date of the required restatement, the operation of the look-back window); (c) the precise boundaries of "incentive-based compensation" and the difficulties that arise from the use of bonus pools and compensation that is only partly based on accounting results; (d) the recovery process; (e) disclosure requirements around the clawback; and (f) transition questions. I thus do not express a view, one way or the other, on whether the SEC's proposed Dodd-Frank clawback gets these details "right." Instead, I focus solely on the types of issuers, executives, and compensation covered by the proposed clawback.

Third, I do not seek here to defend the government's decision to impose an excess-pay clawback on issuers of publicly-traded securities. Nor do I seek to show that the benefits of any particular implementation of the Dodd-Frank clawback will exceed the costs. Instead, taking *some* form of the Dodd-Frank clawback as a given, I suggest that the SEC's proposed Dodd-Frank clawback should be trimmed along various margins (issuers, executives, pay arrangements) where, I argue, the costs of going beyond each of these margins likely exceed the benefits.

The remainder of this Essay proceeds as follows: Part II briefly describes the Dodd-Frank clawback, and the features of the SEC's proposed Dodd-Frank clawback that are most relevant for my analysis. Part III highlights the potential incentive benefits of a reliable excess-pay clawback such as Dodd-Frank, given the limitations of the SOX clawback and firm-adopted recovery policies. Part IV turns to the inevitable incentive and non-incentive costs that a reliable excess-pay clawback imposes. Part V explains that the SEC's proposed Dodd-Frank clawback reaches certain issuers and executives where the net incentive benefits are at best marginal (and thus less than the expected costs). Part VI argues that the SEC's proposed Dodd-Frank clawback reaches certain types of compensation arrangements where, even if there are possible net incentive benefits, there is a great risk that the non-incentive costs are likely to be significantly higher. Part VII suggests that the SEC adopt a "smart" targeted excess-pay clawback aimed at fewer issuers, executives, and compensation arrangements—one that, I argue, will generate almost all of the incentive benefits of the SEC's proposed Dodd-Frank clawback at a much lower cost. A conclusion follows.

II. The Dodd-Frank Clawback

This Part briefly describes the Dodd-Frank clawback, and the SEC's proposed Dodd-Frank clawback. Section A focuses on the Congressional statute instructing the SEC to create the clawback. Section B highlights the most important features of the SEC's proposed Dodd-Frank clawback. Section C explains that the Dodd-Frank clawback is a "reliable" but "limited" excess-pay clawback, in that it requires the recovery of *some* but not *all* excess pay.

A. Congressional Mandate to the SEC

Section 954 of Dodd-Frank[28] added a new Section 10D to the Securities Exchange Act of 1934 (the "Exchange Act").[29] Section 10D is divided into two subsections: Section 10D(a) and Section 10D(b).

Section 10D(a) instructs the SEC to adopt rules directing the national securities exchanges[30] (hereinafter, collectively, the "exchanges") to prohibit the listing of any security of an issuer that is not in compliance with the requirements of Section 10D(b).[31]

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[28] Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

[29] 15 U.S.C. 78j-4.

[30] A "national securities exchange" is an exchange registered as such under Section 6 of the Exchange Act [15 U.S.C. 78f]. There are currently eighteen exchanges registered under Section 6(a) of the Exchange Act, most notably the NASDAQ Stock Market and the New York Stock Exchange ("NYSE"). The Dodd-Frank clawback also applies to "national securities associations." A "national securities association" is an association of brokers and dealers registered as such under Section 15A of the Exchange Act [15 U.S.C. 78o-3]. However, the Financial Industry Regulatory Authority ("FINRA") is the only association registered with the SEC under section 15A(a) of the Exchange Act, and it does not list securities. Thus, for now, the Dodd-Frank clawback applies only to national securities exchanges.

[31] 15 U.S.C. 78j-4.

Section 10D(b) requires each issuer to develop and implement a policy providing:

(1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and

(2) that, in the event that the issuer is required to prepare an accounting restatement due to… material noncompliance… with any financial reporting requirement …, the issuer will recover from any… executive officer ….who received incentive-based compensation….during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.[32]

B. The SEC's Proposed Dodd-Frank Clawback

On July 1, 2015, the SEC proposed Rule 10D-1 to set forth the listing requirements that exchanges must establish pursuant to Section 10D of the Exchange Act.[33] The SEC also proposed a variety of related rule and form amendments mostly concerning disclosure.[34] I will use the term "SEC's proposed Dodd-Frank clawback" to refer to Proposed Rule 10D-1 and the accompanying rule and form amendments, collectively.

Under the SEC's proposed Dodd-Frank clawback, an issuer's security would be subject to delisting if the issuer does not adopt a fully compliant compensation recovery policy, disclose the policy, and comply with the policy's recovery provisions.[35]

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[32] 15 U.S.C. 78j-4.

[33] *Listing Standards*, *supra* note x.

[34] *See id*. at 41,146 (proposing rules "for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws").

[35] *Id*.

1. Issuers, Executives, and Compensation Covered

My focus in this Essay is on the types of issuers, executives, and compensation covered by the SEC's proposed Dodd-Frank clawback. Along these dimensions, the SEC's proposed Dodd-Frank clawback applies to a wide range of issuers, executives, and types of compensation.

a. Covered Issuers

Almost all issuers with listed securities are covered.[36] Among the covered firms are issuers with unlisted equity but with listed debt, controlled companies, and foreign private issuers.[37] Only a few types of issuers are exempted.[38] The SEC estimates that 4800 issuers will be covered by their proposed clawback.[39]

b. Covered Executives

At a covered issuer, a covered "executive officer" is defined as:

"the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer."[40]

This definition is modeled on the definition of "executive officer" under Rule 16a-1(f). As I explain in Part V.B., this definition may cover 10 or more executives at a particular issuer, potentially bringing around

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[36] *Listing Standards, supra* note x, at 41,146.

[37] *Id*. at 41,146--41,150.

[38] *See infra* Part V.A.

[39] *Listing Standards*, *supra* note x, at 41,172.

[40] *See* Proposed Rule 10D-1(c)(3); *Listing Standards, supra* note x, at 41,153. For discussion of this definition and the types of executives it includes, s*ee infra* Part V.B.

50,000 executives within the scope of the rule.

c. Covered Compensation

For each covered executive, covered "incentive-based compensation" is defined as:

*"any compensation that is granted, earned or vested based … upon the attainment of a financial reporting measure…[which are] measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures that are derived from ...such measures, and **stock price and total shareholder return"*** (emphasis added).[41]

Note that "incentive-based compensation" excludes stock options, restricted stock, or other equity-based awards that are either time-vested or granted outright. Even though the ultimate value of these instruments is tied to the stock price, these instruments are not within reach of the clawback because they are not *granted, earned or vested* upon the attainment of a financial reporting measure, stock price, or total shareholder return.

For convenience, I will refer to incentive-based compensation that is granted, earned or vested based on *actual* financial reporting results (e.g., earnings, revenues) as "accounting-based pay;" I will refer to both "stock price" and "total shareholder return [TSR]" as "stock price" and denote compensation that is granted, earned or vested based upon the attainment of stock price as "price-based pay."

2. Activation

The Dodd-Frank clawback must be activated only if there is a restatement due to material noncompliance with any financial reporting requirement under the securities laws (hereinafter, "restatement").[42]

[41] Proposed Rule 240.10D-1(c)(4).

[42] Proposed Rule 240.10D-1(b)(1).

In the event of a restatement, a determination must be made whether the erroneous accounting results directly (through accounting-based pay) or indirectly (through price-based pay) impacted the amount of incentive-based compensation that was granted, earned or vested.

If the erroneous accounting results generated excess pay, the issuer is generally required to recover the excess amount: the difference between what the executive actually received (under the original financial results) and what the executive would have received (under the restated financial results).[43] As I will discuss in Part VI, knowing the excess amount of price-based pay is impossible; it can only be "guesstimated."

However, an issuer is permitted to forego recovery in one particular situation. Specifically, the SEC's proposed Dodd-Frank clawback exempts an issuer from recovery if the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered.[44]

C. Dodd-Frank as a Reliable (but Limited) Excess-Pay Clawback

The SEC's proposed Dodd-Frank clawback is a "reliable" excess-pay clawback because it appears to require recovery of covered excess pay in most circumstances. As discussed in Section B, the only situation in which recovery is not required is that where the cost of recovery paid to a third party would exceed the amount recovered. Thus, with respect to the excess pay covered by the clawback, recovery of covered excess pay seems highly likely to occur.

However, the SEC's proposed Dodd-Frank clawback is not a *complete* excess-pay clawback: it is "limited." Under a *complete* excess-pay clawback, an executive would be required to return any and all excess

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[43] Proposed Rule 10D-1(b)(1)(iii).

[44] Proposed Rule 10D-1(b)(1)(iv). Foreign private issuers, not covered by this Essay, are also exempted from recovering excess pay if recovery would violate home-country law. Throughout this Essay, when referring to "issuers" or "firms," I mean covered entities that are not foreign private issuers.

pay, not just excess pay arising from errors in financial reporting measures that are later corrected in a restatement.[45] In contrast, the SEC's proposed Dodd-Frank clawback permits an executive to keep excess pay for two types of reasons.

First, the SEC's proposed Dodd-Frank clawback can apply only to excess pay that arises out of what is defined as "incentive-based compensation:" pay that is granted, earned or vested based on a "financial reporting measure," which includes accounting measures (e.g., revenues, net income, earnings per share) as well as stock price and TSR.[46] Thus, the clawback does not apply to excess pay generated by the use of non-financial metrics (such as customer satisfaction) that turn out to be erroneous. Even if errors in these metrics substantially inflate an executive's pay, that excess pay need not be returned to the issuer.

Second, because it is restatement-dependent, the Dodd-Frank clawback (and the SEC's proposed Dodd-Frank clawback) cannot reach excess incentive-based compensation when there is no restatement. Excess incentive-based pay can, however, arise absent a restatement in two scenarios. First, a small error in an accounting result (say, earnings) that may be too minor to require a restatement could trigger a large increase in an executive's payout if (a) the executive's payout function is kinked and (b) the error gets the executive over a key threshold. Second, to the extent executives have discretion over whether to restate a firm's financials, they may well be able to avoid a clawback of excess pay by not restating (even if the SEC believes a restatement is required).[47] For these

[45] An example of a complete excess-pay clawback is found in the TARP regulations. In particular, the Interim Final Rules under Section 111(b)(3)(B) of the Emergency Economic Stabilization Act (EESA) provide that executives of financial institutions receiving assistance under TARP are required to repay compensation if awards based on statements of earnings, revenues, gains, or other criteria were later found to be materially inaccurate. TARP Standards for Compensation and Corporate Governance, 31 CFR 30.8. There is no requirement of a restatement, or that the "criteria" that turn out to be materially inaccurate be limited to financial reporting measures corrected in a restatement.

[46] *See infra* Part II.B.

[47] The failure of executives to restate financials has in at least one instance precluded application of the Sarbanes-Oxley clawback (discussed *infra* Part III.A.1), which also

two reasons, an executive may well be free to keep considerable amounts of excess incentive-based compensation in the event there is no restatement.[48]

In sum, the Dodd-Frank is a limited excess-pay clawback because it reaches only "incentive-based compensation," and can only reach that compensation if there is a restatement of results that directly or indirectly impacts pay in the manner described in Section B.

III. Benefits of Introducing a Reliable Excess-Pay Clawback

This Part explains that introduction of a reliable excess-pay clawback such as Dodd-Frank may provide an economic benefit by reducing executives' incentives to deliberately misreport financial accounting results (hereinafter, "misreport") for the purpose of generating excess pay.

Section A describes the setting in which the Dodd-Frank clawback is likely to have the most impact: top executives in non-CS firms. Section B explains why existing clawback rules and arrangements—the SOX clawback and firm-adopted recovery policies—are unlikely to recover excess pay from top executives in non-CS firms and are thus not reliable. Section C describes the benefit of introducing a reliable excess-pay clawback like Dodd-Frank into the compensation environment for top executives of non-CS firms.

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requires that there be a restatement. In *S.E.C. v. Shanahan*, 624 F. Supp. 2d 1072, 1078 (E.D. Mo. 2008), a CFO took part in a scheme to backdate options, which had the effect of overstating firm pretax operating income by 25% and generated $1.9 million in extra bonus for the CFO. The firm never restated its financials, but the SEC argued that the firm should have done so. The district court ruled that the SOX clawback could not be used to recover the CFO's bonus because "an issuer must be compelled or ordered to prepare a financial restatement, and must actually file the restatement" before the SEC can invoke the clawback. *Id*.; *see also* Sarah Johnson, *Sarbox Clawback Ruling Could Keep Pay in Some CFOs' Pockets*, CFO (Dec. 24, 2008), *available at* http://www.cfo.com/article.cfm/12840062 (describing *Shanahan* decision).

[48] *See* Fried & Shilon, *supra* note x, at 748. In our survey of excess-pay clawback policies voluntarily adopted by S&P 500 firms as of 2010, we found that the overwhelming majority required a restatement for activation. *Id*. at 743. For a discussion of these recovery policies, *see infra* Part III.A.2.b.

A. The Sweetspot for a Reliable Excess-Pay Clawback

A reliable excess-pay clawback is likely to have the most positive impact when applied to a particular type of executives: top executives at a firm without a controlling shareholder (CS) but rather with dispersed investors: a non-CS firm. At such a firm, directors have small equity stakes. One frequently cited study estimated that median percentage ownership for independent directors is only about 0.005%.[49] Not surprisingly, directors' time commitment to the firm is extremely limited; they may well sit on other boards, in addition to having a demanding full-time job. Because they have small stakes in the firm and little time to attend to its affairs, non-CS firm directors generally take a hands-off approach, turning control over to the top executives and giving them high-powered incentives. Given their small equity stakes, directors are unlikely to have much personal interest in pressuring executives to misreport, or in discouraging them from doing so. If executives choose to misreport, it is for their own reasons, not because directors are pressuring them to do so. Perhaps they wish to generate excess pay from their high-powered incentives. Of course, whether they decide to misreport may depend, in part, on the existence of a reliable excess-pay clawback.

In Part V, I will explain why a reliable excess-pay clawback is likely to have much less effect on top executives of CS firms, or lower-level executives at any firm, each for slightly different reasons. In brief, these executives have much less power than top executives at non-CS firms; they can be expected to make reporting decisions primarily to satisfy those who have the most power in the firm and control their fates (the CS, in the case of top executives of CS firms; and top executives, in the case lower-level executives at any firm). For these executives, the presence or absence of excess pay cannot be expected to play an important role in their decision-making. Thus, this Part, which focuses on the potential incentive benefit of a reliable excess-pay clawback, will continue to focus on the top executives of non-CS firms.

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[49] John E. Core et al., *Corporate Governance, Chief Executive Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 384 (1999).

B. The Lack of a Reliable Excess-Pay Clawback Before Dodd-Frank

Prior to Dodd-Frank, executives could be forced to return excess pay following a restatement, without the need to demonstrate fault or misconduct on their part, through two mechanisms: (1) the SEC could choose to deploy the Sarbanes-Oxley clawback; or (2) a firm's directors could demand the money back, perhaps under the firm's voluntarily-adopted recovery policy.[50] As this Section explains, the likelihood of recovery under either of these mechanisms has been very low. Thus, neither of these mechanisms has provided a reliable excess-pay clawback.

1. Sarbanes-Oxley Clawback

Section 304 of SOX[51] gave the SEC the power to force certain executives to return pay to the firm in specified situations.[52] In particular, if a firm is required to prepare an accounting restatement due to material noncompliance, as a result of misconduct, with any financial reporting requirement, Section 304 enables the SEC to require the CEO and CFO of the firm to return to the firm any bonus or other incentive- or equity-based compensation received within 12 months of the misleading financial statement, as well as any profits realized from the sale of stock during that period.[53] The SOX clawback can be applied against an executive as long as there is some misconduct associated with the misleading financial statement, even if it cannot be demonstrated that the targeted executive

[50] In some cases, shareholders may have the right to sue derivatively to recover excess pay. But such cases are almost never brought because of the costs involved and the substantial procedural hurdles that must be overcome to maintain such a suit. *See* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 45-48 (2004) [hereinafter, "BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE"] (describing difficulty of bringing derivative suit). Shareholder suits have thus been a viable method for recovering excess pay).

[51] Sarbanes–Oxley Act of 2002 § 304, 15 U.S.C. 7243 (2002)

[52] There is no private right of action under the provision. *See, e.g.*, Neer v. Pelino, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005) (holding that SOX §304 does not provide a private right of action to recover value from executives); *In re* Digimarc Corp. Derivative Litig., 549 F.3d 1223, 1238 (9th Cir. 2008) (same).

[53] *Id.*

was personally at fault.[54]

The SOX clawback is thus not a *pure* excess-pay clawback like Dodd-Frank: one designed to recover only erroneously awarded compensation. Rather, it is potentially *punitive*, enabling not only the recovery of excess pay, but (1) *all* incentive compensation received within the clawback window; as well as (2) profits from stock sales within the clawback window.

For two reasons, however, the SOX clawback is unlikely to be wielded to recover any pay, including excess pay, even if there is a restatement. First, as explained, the SOX clawback can be deployed only if there is "misconduct." Even if the SOX clawback could be perfectly enforced, it would not reach (a) excess pay that is generated without misreporting; and (b) excess pay that is generated by misreporting to the extent that misreporting falls short of "misconduct." It could reach only misreporting that counts as "misconduct." As long as some forms of misreporting are not considered "misconduct" for purposes of the SOX clawback, executives would still be free to misreport and keep excess pay following a restatement.

Second, and more importantly, even if there is restatement and misreporting that counts as "misconduct," the difficulty of enforcing the SOX clawback makes the likelihood of recovery very low. The SEC's resources are limited, given the wide range of tasks it is assigned. Hundreds of issuers restate their financials each year.[55] Investigating restatements to determine whether there might have been misconduct is costly. And litigating a clawback case would be expensive, in part because of the need to prove misconduct. A resource-constrained SEC cannot be expected to detect and litigate every case involving restatement and

[54] *See, e.g.,* SEC v. Jenkins, 718 F. Supp. 2d 1070, 1074–77 (D. Ariz. 2010) (denying defendant CEO's motion to dismiss the case on the ground that he did not commit misconduct, and holding that misconduct by the issuer, acting through any of its officers, agents, or employees, triggers the reimbursement obligation of a CEO or CFO).

[55] Don Whalen et al., *Audit Analytics, 2014 Financial Restatements: A Fourteen Year Comparison __ available a*t https://www.complianceweek.com/sites/default/files/AuditAnalytics_RestatementRpt_4-15.pdf.

misconduct, or even most of them.

Let's look at the statistics. Over SOX's first decade (2003-2012), there were approximately 8,000 restatements.[56] We do not know how many executives received excess pay as a result of incorrect financials that needed to be restated. But given the widespread use of accounting-based pay, there are likely to be at least several hundred (if not more) executives who received excess pay. During this period, the SEC apparently successfully deployed the SOX clawback at 14 firms, recovering pay from approximately 21 executives. Of these 21 executives, 15 were alleged to have personally engaged in misconduct.[57] Thus, during SOX's first decade the SEC recovered pay from only 6 executives not alleged to have personally engaged in misconduct (all of whom were at firms where some misconduct was alleged).[58]

In short, the SOX clawback is punitive when applied, potentially recovering more than the excess pay received by the targeted executive. But the large range of situations in which the clawback cannot be wielded or is unlikely to be wielded means that the SOX clawback is not a reliable excess-pay clawback.[59]

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[56] *Id.*, at 17. Beginning in late 2004, the SEC required certain types of restatements (those that made past financial statements unreliable) to be reported in Item 4.02 of Form 8-K. This 8,000 restatement figure includes almost 1500 Item 4.02 restatements between 2005 and 2012. *Id.* at 20.

[57] For a list of the cases, *see* Appendix A, Table 1. In some of these cases, the SOX clawback was deployed only after the targeted executive had first been convicted of criminal fraud. *See* Fried & Shilon, *supra* note x, at 730-732.

[58] The frequency of recovery appears to have increased during the period 2013-2015. During that period, the SEC targeted 11 executives at 8 firms, 4 of whom were not alleged to have personally engaged in misconduct. *See* Appendix A, Table 2.

[59] The limited ability of the SOX clawback to deter misreporting may well be evidenced by the fact that much of the illegal option backdating occurred after SOX had been enacted in 2002, in blatant violation of SOX's new reporting requirements (as well as longstanding disclosure rules). *See* Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 856-57 (2008).

2. Clawback By Directors

The directors of a non-CS firm could try to create a reliable excess-pay clawback.[60] For example, they could try to make a credible commitment (through a policy, bylaw, or otherwise) to recover excess pay from executives, except perhaps in very limited circumstances. In other words, firms could adopt a clawback policy similar to the one required by Dodd-Frank.

However, as I detail below, directors of non-CS firms do not appear to have created reliable excess-pay clawback policies. The overwhelming majority of firms do not have any disclosed recovery policy, giving directors complete discretion to forego recovery—and there do not appear to be any recoveries of excess pay in these firms. Those firms that have a disclosed clawback policy give directors substantial discretion to forego recovery, which they then almost always exploit to forego recovery. In short, these firms have not created reliable excess-pay clawbacks.

a. Firms Without Disclosed Recovery Policies

According to the SEC's own estimates, more than 75% of the firms that would be covered by the Dodd-Frank clawback have not disclosed any excess-pay recovery policy.61 Unless these issuers have hidden policies that require directors to recoup excess pay, which is extremely unlikely, these issuers leave discretion fully in the hands of directors. Not surprisingly, there does not appear to be any instances of directors of such firms recouping pay.

[60] Because corporate law gives the board of directors ultimate authority over the management of the firm, all clawback decisions by the corporation itself will be made by the board or a subset of its directors.

[61] *Listing Standards*, *supra* note x, at 41,172 (reporting that only 1116 of the 4845 filers that would be covered by Dodd-Frank have a disclosed recovery policy); Ilona Babenko et al., *Clawback Provisions* 9 (April 24, 2015) (unpublished manuscript, *available at* http://ssrn.com/abstract=2023292) (reporting that over 700 of firms in the S&P 1500 did not have a disclosed clawback policy).

There may well be cases where non-CS directors (a) decline to adopt a recovery policy and (b) then forego recovery of excess pay solely for the benefit of the corporation and its shareholders. But their own personal cost-benefit analysis is likely to play a role. As I explain below, for any given director, the personal benefit of recovering excess pay from either a current or departed executive is likely to be miniscule. The costs, on the other hand, are not.

i. The Miniscule Benefit of Recovering Excess-Pay

For a non-CS director considering whether to recover an executive's excess pay, there are two possible benefits. First, to the extent that the director has equity in the firm, the director will share pro rata in any (net) recovery. However, as explained above, independent directors typically own only a tiny fraction of the firm's equity; one study reported that median independent director ownership to be about 0.005%.[62] Even if an independent director held 10 times that percentage (0.05%) of the firm's shares, she would reap a personal benefit through her own equity of only $500 for every $1 million in net recovery. Relative to the median annual pay in 2014 for independent directors at Fortune 500 firms, which exceeds $250,000,[63] this amount is trivial.

Second, the director might be able to maintain her reputation among shareholders as an "independent" director capable of serving shareholders' interests. But the complexity of compensation contracts and the litigation system would make it difficult for outsiders to determine whether a decision to forego recovery is in shareholders' interest or not. Thus, a director foregoing recovery is unlikely to face adverse reputational effects among shareholders, except in rare situations where the firm is already in the public spotlight because of its size or prominence, and the executive's misbehavior is seen as egregious by market participants.

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[62] *See* Core et al., *supra* note x.

[63] Michael Bowie, Towers Watson Executive Compensation Bulletin (August 27, 2015), *available at* https://www.towerswatson.com/en-US/Insights/Newsletters/Global/executive-pay-matters/2015/Executive-Compensation-Bulletin-Equity-Based-Pay-Continues-to-Push-Increases-Outside-Director-Pay.

ii. The Non-Miniscule Cost of Recovering Pay

While benefits to a director of excess-pay recovery will tend to be miniscule, the personal cost of recovering excess pay from an executive is likely to be substantial, whether the executive is still serving at the company or has already departed.

Recovery from Current Executives. In a non-CS firm, directors often have financial, social, and psychological reasons to favor executives in compensation matters.[64] To the extent that directors feel loyal to an executive or otherwise care about their relationships with the executive, who will continue to serve the company and may well be a director on the board with them, it is likely to be personally costly to seek to recover excess pay from that executive.[65]

In addition, there could be a reputational cost to a director (Director X) who decides to recover excess pay from the executive. In particular, Director X would be concerned about her reputation among directors at other firms, who might be less willing to favorably consider Director X for a board position if Director X acquires a reputation for aggressively trying to recover excess pay from executives.

Recovery from Departed Executives. By the time the board learns that an executive has received excess pay, the executive may well have departed the company. One might believe that it would be less costly for directors to recover excess pay from a departed executive. After all, the executive has much less influence over directors once she has left the firm. However, directors will still tend to incur substantial personal costs in seeking to recoup excess pay from departed executives.

To begin, any reputational cost to recovering excess pay from a

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[64] *See, e.g.*, BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note x at 23–27 (describing sources of executives' influence over directors in public companies).

[65] To be sure, directors could indirectly recover excess pay by reducing current compensation. However, if the amount of excess pay is sufficiently large, it may not be feasible or in shareholders' interests to reduce current compensation by enough to fully offset the excess payment. *See* Fried & Shilon, *supra* note x, at 733 n. 53.

current executive would also arise when recovering excess pay from a departed executive. Directors in other firms may be reluctant to bring on board a director who is seen as acting aggressively toward top managers, whether these managers are still in their positions or recently departed.

In addition, an executive will typically resist and may well threaten to litigate rather than turn over any pay sought by the board.[66] Should there be litigation, the directors may be deposed and accused of wrongdoing (even if they are in fact blameless). For directors, the psychological and reputational costs associated with litigation could be considerable.

Finally, directors seeking recovery may forfeit the value of their relationships with the departing executive. Many directors are interested in maintaining good relationships with departing or departed executives because these executives can perform favors for them in the future.[67] A departing CEO is more likely to be a friend if directors do not aggressively pursue the recovery of any excess pay that he received. Directors' desire to ingratiate themselves with departing executives is evidenced by the fact that directors have often provided departing executives with various emoluments not required by the executives' contracts.[68]

Given this pattern, directors are likely to let executives departing the firm keep any excess pay as well as collect other gratuitous goodbye benefits. Indeed, this is precisely what happened at Fannie Mae. During the period 2001–2004, its executives received millions of extra dollars in earnings-based bonuses and earnings-triggered option grants by deliberately overstating firm earnings by at least $10 billion.[69] Franklin

[66] *See* Id., at 734 (describing executives' resistance to returning disputed compensation to the firm).

[67] *See* BEBCHUK AND FRIED, PAY WITHOUT PERFORMANCE, *supra* note x, at 87-89 (explaining why directors treat departing executives favorably).

[68] *See id.* at 87–94 (describing the benefits executives receive when leaving their companies, even if they have performed poorly).

[69] *See* Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807, 807–12 (2005) (explaining how the structure of Fannie Mae's compensation

Raines, Fannie Mae's then-CEO, departed in late 2004, after personally reaping millions of dollars in excess pay from bonuses based on inflated earnings.[70] Fannie Mae's directors not only allowed Raines to keep his excess pay, but also gratuitously boosted his pension on the way out.[71]

b. Firms With Disclosed Recovery Policies

Now let us turn to firms that have publicly disclosed recovery policies. According to the SEC's estimates, slightly over a 1000 of the 4,800 issuers that would be subject to the SEC's proposed Dodd-Frank clawback have voluntarily adopted and disclosed recovery policies.[72] In principle, these policies could constrain director discretion around recovering excess pay. Indeed, these policies (like the SEC's proposed Dodd-Frank clawback) could actually *require* directors to recover excess pay, except in very limited circumstances.

However, what do these recovery policies *actually* do? The SEC and academic researchers have examined clawback policies to determine when they are "triggered."[73] But, as I will explain in more detail, these

arrangements gave executives an incentive to inflate earnings) [hereinafter, "Bebchuk & Fried, *Fannie Mae*"]; Eric Dash, *Fannie Mae to Restate Results by $6.3 Billion Because of Accounting*, N.Y. TIMES (Dec. 7, 2006), *available at* http://www.nytimes.com/2006/12/07/business/07fannie.html?_r=1&em&ex=1165726800&en=ce14eaf69685179d&ei=5087%0A (reporting regulators' conclusion that, of the $90 million paid to Fannie Mae CEO Franklin Raines during the period 1998–2003, at least $52 million—more than half—was tied to bonus targets that were reached by manipulating accounting).

[70] *See* Bebchuk & Fried, *Fannie Mae*, *supra* note x. at 807 (describing Raines' departure from Fannie Mae); Dash, *supra* (explaining that Raines reaped tens of millions of bonus dollars as a result of manipulating earnings).

[71.] *Id*. at 814.

[72] *See Listing Standards*, *supra* note *5*, at 41,172 (reporting that slightly over 1000 issuers of the more than 4,800 issuers that would be subject to the proposed Dodd-Frank clawback have disclosed a recovery policy); Babenko et al., *supra* note x, at 9 (reporting that 791 of firms in the S&P 1500 had a disclosed clawback policy).

[73] *See, e.g., Listing Standards, supra* note 5, at 41,173 ("Many of the issuers that disclose recovery policies do not require misconduct on the part of the executive to trigger

policies are generally written carefully so that there are *no conditions* under which recovery is *automatically* triggered. In almost all firms, there can be recovery only if (a) certain requirements are met and (b) *directors use their discretion to squeeze the trigger*. In other words, almost all firm-adopted clawback policies leave director discretion intact.

The first study to examine director discretion under clawback policies is one that I conducted with Nitzan Shilon several years ago.[74] Our study examined all of the disclosed clawback policies that had been adopted by non-financial S&P 500 firms shortly before Dodd-Frank was enacted.[75] We focused on provisions dealing with the recovery of excess pay.[76] At the time, over half of these firms had no disclosed clawback policy of any kind.[77] A number of firms indicated that they had a clawback policy but failed to disclose enough details to make the plan intelligible.[78] Only 225 of the non-financial S&P firms had a well-disclosed clawback policy concerning the recovery of excess pay.[79] We examined each of these policies carefully.

We found that the overwhelming majority (81%) of the 225 policies give directors *complete discretion to forego* a clawback of excess

recovery."); Babenko et al., *id.* at *9* ("Out of 12 triggers that we identify, the most common trigger is an accounting restatement…").

[74] *See* Fried & Shilon, *supra* note x.

[75] *Id.* at 735-736.

[76] Unlike the Dodd-Frank clawback, which is restatement-dependent, 15% of these policies contemplated the possibility of recovering excess pay even if there is no restatement. *Id.* at 743.

[77] *See id*. at 736-737.

[78] *See id.* at 736.

[79] *See id*. The SEC estimates that, in 2015, fewer than 25% of the issuers covered by the SEC's proposed Dodd-Frank clawback disclose some form of executive compensation recovery policy. *See supra* note x. Consistent with our findings, *see* Fried & Shilon, *supra* note x, at 737, the SEC finds that the frequency of disclosed recovery policy is much lower for smaller firms. *Listing Standards*, *supra* note x, at 41,172.

pay, even if directors determined that the executive committed "misconduct."[80] Another 16% of the 225 policies required directors to recoup excess pay, but if and only if directors first determined that there was "misconduct" on the part of the executive. In these firms, directors wishing to avoid recovery could thus use their discretion to determine that there is insufficient proof of "misconduct."[81] Only 3% of the policies required directors to recover excess pay whether or not there was a determination of misconduct (barring some undefined "impracticability").[82] Thus, 97% of the 225 policies gave directors substantial discretion to avoid recovery if they preferred to let executives keep their excess pay.[83]

Critically, the use of a misconduct condition in firm recovery

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[80] *See* Fried & Shilon, *supra* note x. at 738-39.

[81] As noted above, if the misconduct is egregious and the facts are publicly-known, directors may well feel compelled to seek recovery of at least some of the excess pay. *See supra* Part III.A.2.a.i. But in the large range of cases where the details are murky, directors inclined to avoid recovery may be able to hide behind the misconduct requirement to avoid recovery of any excess pay.

[82] *See* Fried & Shilon, *supra* note x, at 738, 742. Moreover, even in these recovery-requiring firms, the clawback policy lacked the teeth of the Dodd-Frank clawback. Some of these policies did not apply to former executives, or applied only to particular compensation arrangements. *See id.* at 742 n. 89. More importantly, these policies could be amended or eliminated at any time by the directors themselves, without shareholder consent, thus providing a "meta-level" of discretion to directors looking for a way to avoid recovery.

[83] While the policies at these firms may have been revised somewhat since we looked at them, it is unlikely that they were changed to substantially increase clawback risk for executives. Babenko et al. also look at the provisions of clawback policies, and concluded that trigger-pulling discretion can be exercised in 60% of policies. Babenko et al, *supra* note x, at 45. But our study finds that in almost all of the clawback policies where directors do not have explicit discretion to forego recovery if certain conditions are met, one of these conditions is that the directors must determine that there has been misconduct by the executive, a condition that implicitly returns full discretion to the directors. We can presume that, in the 40% of policies where Babenko et al. found no discretion, there was in fact considerable discretion accorded to executives. Otherwise, it would be difficult to explain their study's finding (discussed *infra*) that there were only 3 instances of pay recovery among 242 firms with recovery policies that restated their earnings during the period 2007-2012.

policies not only makes it easy for recovery-averse directors to avoid recouping excess pay, but also creates a high hurdle for any recovery-seeking directors trying to get excess pay back. In our sample, 154 (67%) of the 225 firms with fully disclosed policies barred directors from recovering excess pay unless there was a determination that the executive committed "misconduct."[84] In these firms, even if an executive had engaged in what directors would deem as misconduct (if they knew all the facts), the misconduct may be difficult for directors to detect or prove (if as could be expected, the executive resists recovery). Like the SEC seeking to deploy the SOX clawback, the directors would need to determine that the misconduct occurred and then be prepared to prove it in court.[85] Thus, in only 33% of the firms with disclosed policies could recovery-seeking directors do so without proving misconduct.[86]

All in all, a close reading of disclosed firm recovery policies suggests that directors who wish to forego recovery of excess pay typically have the discretion to do so, while directors who wish to recover

[84] *See* Fried & Shilon, *supra* note x, *at* 742. Similarly, in a sample of 2,326 companies in the Corporate Library database, DeHaan et al. find that 61 percent had compensation recovery policies that could not be activated without a finding of executive misconduct. *See* Ed DeHaan, Frank Hodge & Terry Shevlin, *Does Voluntary Adoption of a Clawback Provision Improve Financial Reporting Quality?*, 30 CONTEMP. ACCT. RES. 1027-1062 (2013).

[85] While it might seem natural to model voluntary firm recovery policies on the SOX clawback, there is an important difference between the SOX clawback and an excess-pay clawback that makes the use of a misconduct hurdle in an excess-pay clawback inappropriate. SOX allows the recovery of *all* incentive-based compensation within the clawback window, both excess pay and non-excess pay. *See supra* Part III.A.1. If SOX had no misconduct requirement, all of an executive's incentive pay could be recovered in the event of a restatement, many of which could occur for completely innocent reasons. SOX would thus impose a large tax on the use of incentive-based pay and thereby could seriously distort compensation arrangements. However, this over-deterrence concern does not apply where the clawback policy targets only *excess pay.* There is no good reason why the culpability or innocence of an executive should affect an executive's ability to keep money that he or she received only because of an error in a financial reporting measure.

[86] Fried & Shilon, *supra* note *x*, at 743. These policies also appear to have created other impediments to recovery. In particular, any of these policies barred recovery from former executives or permitted recovery only for excess pay arising from part of an executive's compensation arrangement, such as a particular incentive program. *Id.*

excess pay commonly must overcome hurdles to do so. The result is that even when a firm has a disclosed recovery policy there is no reliable excess-pay clawback. Not surprisingly, according to a recent study, the number of reported cases of pay recovery by directors in the 242 firms that adopted a recovery policy and then restated their financials during the period 2007-2012 could be counted on one hand, even if it were missing a finger or two – there have been *three*. [87]

To be sure, an executive in one of the 25% of issuers with a disclosed recovery policy may be more likely than an executive in one of the 75% of issuers without a disclosed recovery policy to perceive a greater risk of recovery. This may account for findings that suggest that investors view adoption of these policies favorably,[88] and that there is a positive association between these policies and higher-quality financial reporting.[89] But the low frequency of recovery resulting from director

[87] *See* Babenko et al, *supra* note x, at 29.

[88] *See, e.g.,* Mai Iskandar-Datta and Yonghong Jia, *Valuation Consequences of Clawback Provisions*, 88 ACCT. REV. 171, 173 (2013) (finding positive stock price reaction to announcement of recovery policy adoption as well as a narrower bid-ask spread). However, because of self-selection effects (the firms adopting recovery policies may differ from those not adopting such policies in ways that cannot be observed and measured), it is exceedingly difficult (if not impossible) to attribute any observed changes in the behavior of executives and firms, or in the market's valuation of firms, to the adoption of recovery provisions. *See, e.g.,* Diane K. Denis, *Mandatory Clawback Provisions, Information Disclosure, and the Regulation of Securities Markets*, __ J. ACCT. & ECON. __ (2012).

[89] See Lilian H. Chan et al., *The Effects of Firm-Initiated Clawback Provisions on Earnings Quality and Auditor Behavior*, 54 J. OF ACCT. & ECON. 180-196 (2012) (finding that after the adoption of a recovery policy, auditors are less likely to report a material weakness in an issuer's internal control over financial reporting) [hereinafter, "Lilian H. Chan et al., *Earnings Quality and Auditor Behavior*"]; Lillian H. Chan, et al., *The Effects of Firm Initiated Clawback Provisions on Bank Loan Contracting,* 110 J. FIN. ECON. 659 (2013) [hereinafter, "Lilian H. Chan et al., *Bank Loan Contracting"*] (finding that voluntary adoption of recovery policies appears to improve lenders' perception of reporting quality); Mark A. Chen, Daniel T. Greene, & James E. Owers, *The Costs and Benefits of Clawback Provisions in CEO Compensation*, ___ REV. CORP. FIN. STUD. ___ (2014) (finding that voluntary adoption of a recovery mechanism reduces aggressiveness in financial reporting, leading to a lower likelihood of restatements and a smaller magnitude of abnormal accruals); Dehaan et al., *supra* note x, at __ (voluntary adoption of recovery policies appears to lead to less aggressive financial reporting and decreased "unexplained" audit fees, as well as fewer restatements, higher earnings response

discretion means that expected likelihood of excess-pay recovery is low. As a result, even the issuers with disclosed policies lack a reliable excess-pay clawback.

C. Incentive Benefits of the Dodd-Frank Clawback

As we saw in Section A, before Dodd-Frank there had not been a reliable excess-pay clawback: excess pay is almost never clawed back by either the SEC wielding the SOX clawback or by directors themselves under firm-adopted recovery policies (or otherwise). Introducing a reliable excess-pay clawback such as Dodd-Frank will reduce the incentives of top executives at non-CS firms to misreport, generating economic benefits.

1. Reduced Incentive to Misreport

When top executives at non-CS firms are given incentive compensation—compensation tied to a performance measure—they have incentive to misreport to generate excess pay. The greater the potential gain from generating and retaining excess pay, the larger the incentive to misreport. Thus, everything else equal, the absence of a reliable excess-pay clawback that would prevent executives from retaining excess pay increases the incentive to misreport.

To be sure, the absence of a reliable excess-pay clawback does not mean that these executives will always misreport. Ethical considerations, reputational concerns, and fear of adverse reactions by directors or shareholders might discourage an executive from misreporting even if misreporting would generate excess pay. An executive may also be afraid that misreporting will be considered fraud, and potentially subject the executive to civil or criminal penalties. However, everything else equal, the absence of a reliable excess-pay clawback can be expected to increase the amount of misreporting.

The introduction of a reliable excess-pay clawback such as in Dodd-Frank will thus, on the margin, reduce these executives' incentives

coefficients, and lower analyst forecast dispersion). All of these findings, however, may be due to a self-selection effect that cannot be controlled for. *See* Denis, *supra* note x.

to misreport. By requiring directors of non-CS firms to do what they would otherwise be inclined to avoid doing, recouping excess pay, executives know that they are less likely to be able to keep excess pay. The expected gain to top executives at non-CS firms from misreporting will thus decline.

Of course, misreporting may generate other benefits for the executive besides excess pay. In particular, by boosting the stock price, misreporting may enable top executives at non-CS firms to unload shares at a higher price or reduce the likelihood of a hostile takeover bid, shareholder-activist intervention, or institutional-investor pressure. Thus, a reliable excess-pay clawback will not necessarily deter an executive from misreporting. It can only reduce the expected benefit of misreporting that arises from excess pay, and therefore the propensity to misreport. [90]

2. Benefits from Reduced Misreporting

The reduction in the incentive to misreport can be expected to reduce the frequency and severity of misreporting, and therefore generate a variety of benefits. I will describe just two of these benefits below: (1) reduced restatement-induced value destruction; and (2) higher quality financial reporting and thus better capital allocation in the wider market.[91]

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[90] Executives may also take steps to reduce the likelihood of inadvertent misreporting. For example, executives may structure transactions to require fewer accounting judgments. Such steps may improve the quality of financial statements, providing a benefit. However, if the steps taken are themselves costly, the costs could outweigh the benefits. For a discussion of this type of incentive-distortion cost, see *infra* Part IV.A.

[91] There are at least three other economic benefits to reducing misreporting. First, reduced misreporting improves corporate governance mechanisms by making it difficult for managers to mask poor performance. When managers are doing poorly, higher quality financial reporting increases the likelihood that directors and/or shareholders will act to replace them.

Second, reduced misreporting may lower firms' cost of capital by reducing *ex post* diversion of value to executives. While *ex post* diversion, by itself, does not generate an *economic* cost that reduces the total economic pie, *see infra* Part IV.B.3, *ex post* diversion may well systematically lower public-investor returns to the extent that it is not fully taken into account *ex ante* by directors in setting executive pay. Reducing *ex post* diversion can thus lower firms' cost of capital and increase the amount of capital available for value-increasing projects.

a. Reduced Restatement-Induced Value Destruction

When executives deliberately generate excess pay through the manipulation of financial results, they can destroy far more value at the firm than the amount of excess pay they ultimately receive. For example, Fannie Mae alone incurred over $1 billion in expenses cleaning up its books after its executives, who had been given high-powered incentives to boost earnings, overstated earnings by $10 billion.[92] Firms that engaged in secret option backdating also spent large amounts dealing with the collateral damage of this misreporting.[93] The destruction in firm value at Fannie Mae and these backdating firms likely far exceeded the excess pay received by the executives themselves. By reducing the frequency and severity of restatements, a reliable excess-pay clawback will lower such costs.

b. Better Quality of Financial Reporting

The prospect of generating excess pay may give executives an incentive to engage in financial misreporting that reduces the real and/or perceived quality of financial information provided to the market. The prospect of such misreporting (or perceived misreporting) can be expected to raise firms' cost of capital by increasing the cost to investors of assessing the performance of their investments, thereby making it difficult

Third, reduced misreporting can, by reducing *ex post* diversion, also improve pay-for-performance sensitivity and thereby strengthen executives' incentives to generate value. *See* Lucian A. Bebchuk and Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 665 (2005).

92 *See* Marcy Gordon, *Wall St. Applauds Fannie Mae Restatement*, CHI. TRIB., Dec. 7, 2006, at 3 (describing the response to Fannie Mae's 2006 earnings restatement); Bebchuk & Fried, *Fannie Mae*, *supra* note x, at 809–12 (explaining how the structure of Fannie Mae's compensation arrangements gave executives an incentive to inflate earnings).

93 *See* Peter Lattman, *Big Law Firms Find Backdating Probes Good for Business*, Wall Street Journal July 19, 2006 (reporting that one firm estimated it spent $70 million in legal, accounting, and other professional fees just to restate its financials because of backdating); Susan Beck, *Companies With Backdating Troubles Are Paying Astronomical Legal Fees*, AM. LAW. (October 27, 2007) (reporting that legal fees for Brocade in connection with backdating could reach $100 million).

for firms to fund certain desirable projects.[94] It also makes it difficult to compare performance across issuers and makes it more difficult for investors to rationally allocate capital across different firms and industry sectors. By reducing such misreporting at particular firms, a reliable excess-pay clawback can improve the quality of financial information at those firms to the benefit of all investors and capital-raisers in the market.

IV. Costs of a Reliable Excess-Pay Clawback

As Part III explained, the SEC's proposed Dodd-Frank clawback, by creating a reliable way to recoup excess pay, can be expected to reduce the incentives of top executives at non-CS firms to misreport, generating benefits.

However, as this Part explains, the SEC's proposed Dodd-Frank clawback or any reliable excess-pay clawback will also impose a variety of costs. Section A describes the incentive-distortion costs that can arise when such the clawback applies to those whose behavior it can most effect: the top executives at non-CS firms. These incentive costs offset (or might even outweigh) the incentive benefits described in Part III.

Section B sketches out the three types of "non-incentive" costs that a reliable excess-pay clawback will impose with respect to *any* firm (CS or non-CS) and any executive (top or non-top, in a CS or non-CS firm) to which it applies. These include: (1) regulator-diversion costs; (2) issuer-compliance costs; and (3) executive-burden costs.

A. Incentive-Distortion Costs

When targeted at executives whose behavior can be meaningfully affected (top executives in non-CS firms), a reliable excess-pay clawback can not only improve incentives (by reducing the payoff from misreporting) but also worsen them in some respects, generating incentive-distortion costs. In particular, it could distort these executives'

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[94] *See, e.g.*, Mary E. Barth, Yaniv Konchitchki & Wayne R. Landsman, *Cost of Capital and Earnings Transparency*, 55 J. ACCT. & ECON. 206 (2013) (finding that firms with more transparent earnings enjoy a lower cost of capital).

incentives either directly or indirectly (by changing their compensation arrangements in a way that undermines incentives).

Potential *direct* distortions include causing executives to (1) substitute from misreporting to "real-earnings management"—transactional decisions that are made to boost short-term financial measures rather than to generate long-term value—that destroys more economic value than misreporting;[95] (2) forego valuable projects that are associated with more accounting judgment and thus a higher risk of restatement; (3) overinvest in financial reporting (relative to the economic optimum) to minimize the chance of a restatement; and (4) avoid or delay a restatement to try to neutralize or minimize the effect of a clawback, reducing the quality of financial reporting.

Turning next to potential *indirect* distortions, issuer-compliance and executive-burden costs (described in Part B) may lead to changes in the structure of compensation arrangements. These changes, in turn, could improve or worsen executives' incentives to generate value. Whether a reliable excess-pay clawback generates any such collateral effects will depend on (a) what, if any changes occur; and (b) how any such changes affect executives' incentives. The net directional impact of these collateral effects cannot be known in advance, and might be positive. However, an adverse change to compensation arrangements is a *potential* cost to any reliable excess-pay clawback. And the larger the issuer-compliance and executive-burden costs associated with the clawback, the more likely it is that there will be a substantial change in compensation arrangements, possibly for the worse.[96]

Going forward, I will use the term "net incentive benefits" to describe the net incentive effects of the clawback, taking into account the

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[95] See Lillian H. Chan, Kevin C.W. Chen, Tai-Yuan Chen, and Yangxin Yu, *Substitution Between Real and Accruals-Based Earnings Management After Voluntary Adoption of Compensation Clawback Provisions*, 90 ACCT. REV. 147-174 (2015) (finding that executives of firms that adopt recovery provisions substitute real transactions management for accruals management).

[96] Incentive-distortion costs, like issuer-compliance costs, will fall largely on the residual claimants of the firm. For a publicly-trade firm, then, these costs will fall mostly on public shareholders.

benefits described in Part III.C. and the distortion costs described here. For ease of exposition, I will assume that these net incentive benefits are generally positive (incentive benefits exceed incentive costs). But the analysis and conclusions do not depend on this assumption.

B. Non-Incentive Costs

The non-incentive costs of applying a reliable excess-pay clawback fall into three categories: (1) regulator-diversion costs; (2) issuer-compliance costs; and (3) executive-burden costs. These costs arise whether or not executive behavior is affected positively or negatively by the clawback. And they arise with respect to any executive targeted by the clawback.

For each of these categories, I divide costs into two types. "*Ex ante* costs" are those non-incentive costs that arise in anticipation of the operation of a reliable excess-pay clawback, whether or not there is misreporting. "*Ex post* costs" are those non-incentive costs that arise when there is a restatement, whether or not the clawback is activated (and whether or not misreporting has occurred).

1. Regulator Diversion

Implementing a reliable excess-pay clawback rule requires "regulators" (self-regulatory organizations such as stock exchanges, government agencies, and courts) to modify, interpret and enforce the clawback. The more issuers and executives are covered by the rule, and the more complicated is the rule, the higher these costs will be. These costs, which are primarily borne *ex post* (after a restatement), reduce the size of the economic pie.[97]

[97] The incidence of these regulator-diversion costs depends, in part, in whether regulators get additional resources to administer the clawback. To the extent regulators are resource-constrained, and spend time and resources on the clawback rather than on other matters, the clawback will reduce the time and resources devoted to other activities that benefit market participants. In this scenario, market participants are likely to bear some or all of the costs associated with regulator diversion. To the extent regulators receive additional resources, the incidence of the regulator-diversion costs will fall on those funding the regulators (taxpayers, etc.).

2. Issuer Compliance

To the extent an issuer is given any responsibility for implementing a reliable excess-pay clawback, the issuer will incur a variety of compliance costs. *Ex ante* costs include the costs of (1) formulating the issuer's clawback policy; (2) revising executive pay arrangements to take account of the clawback policy; (3) modifying the policy over time, in response to "learning" and changing circumstances. *Ex post* costs include the costs of (1) determining whether a clawback is required and calculating the amount of the clawback; (2) seeking recovery if a clawback is required, including the costs of potential litigation by executives and/or shareholders; and (3) any required reporting to regulators and shareholders. [98]

3. Executive Burden

A reliable excess-pay clawback will of course reduce the expected amount of excess pay flowing to executives *ex post*. But this reduction in pay, by itself, does not represent an *economic* cost. That is, it does reduce the size of the total pie; it is offset by an equal increase in value available to the issuer and its shareholders *ex post*. [99]

However, a reliable excess-pay clawback will impose *economic* costs through its effect on executives. For all executives, it creates *ex ante* risk-bearing costs associated with the uncertainty of deployment of a

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[98] Issuer-compliance costs, unlike regulator-diversion costs, are borne (at least in the first instance) entirely by the residual claimants on the value of the issuer. For a publicly-traded firm, this would mean public investors bear almost all of issuer-compliance costs.

[99] Of course, to the extent the executive demands more pay *ex ante* to compensate for the loss of expected excess pay *ex post*, expected pay will not change. That is, the executive simply may demand higher *nominal* pay if there is no excess pay. But *actual* pay should remain the same, everything else equal. As my focus is on the economic costs and benefits of the Dodd-Frank clawback, it does not matter whether there is an *ex ante* adjustment to the expected loss of excess pay. To the extent the tax system does not fully credit the executive for return pay, the executive will be subject to a higher effective tax rate, and may demand higher compensation (even apart from risk-bearing costs). From an economic perspective, however, this extra tax just represents a transfer to other parties and does not represent an economic cost.

clawback (which are exacerbated by the possible failure of the tax system to adequately "credit" the executive for returned pay).[100] For executives who receive excess pay covered by the clawback, the clawback generates *ex post* transaction costs. Unlike the reduction in excess pay *ex post*, these *ex ante* and *ex post* costs do not confer an equal benefit on another party.[101]

V. The SEC's Proposed Dodd-Frank Clawback Reaches Too Many Issuers and Executives

As Part III explained, a reliable excess-pay clawback can potentially generate economic benefits by reducing the incentive of top executives of non-CS firms to misreport. However, a reliable excess-pay clawback is not always necessary or sufficient to prevent misreporting. Misreporting may not occur absent a reliable excess-pay clawback, and may occur even if there is such a clawback in place. And, as we saw in Part IV, a reliable excess-pay clawback may generate incentive-distortion

[100] The SEC's proposed Dodd-Frank clawback prohibits issuers from indemnifying covered executives from the clawback, or reimbursing them for the purchase of insurance to cover clawbacks. Proposed Rule 10D-1(b)(1)(v). Executives could buy their own insurance from a third party. Should such policies be offered, the risk-bearing costs borne by executives may be lower than they would otherwise be. Note also that, in a CS firm, the controlling shareholder can implicitly commit to insulate an executive from the effects of the clawback.

[101] Executive-burden costs fall in the first instance on the executive. The executive, in turn, may demand and receive higher compensation. If that happens, executive-burden costs will be shifted to the firm, and ultimately to shareholders. But whichever party bears these costs, even if it is the executive, these executive-burden costs shrink the size of the pie.

Relatedly, the evidence on the effect of adoption of voluntary firm recovery policies on executive pay is mixed. *See, e.g.*, Iskandar-Datta and Jia, *supra* note x, at 173 (finding no evidence that CEO pay increases at firms adopting recovery policies); Babenko et al, *supra* note x, at 5 (finding that top-5 executive pay increases in aggregate by more than $700,000 upon adoption of a recovery policy); Chen et al., s*upra* note x, __ (reporting higher CEO pay following adoption of recovery policy) Dehaan et al, *supra* note x, at __ (finding that CEO base salary increases following adoption of a recovery policy). Because of a potential self-selection effect, *see* Denis *supra* note x, it is difficult to draw firm conclusions about whether the voluntary adoption of a recovery policy actually *causes* subsequent changes (including compensation levels) at the firm, or whether both the adoption of the policy and subsequent observed changes are caused by another, unobserved change in the firm.

costs when applied to top executives at CS firms, so we must consider *net* incentive benefits (incentive benefits less incentive costs).

As Part IV also explained, a reliable excess-pay clawback will also impose a variety of non-incentive costs with respect to *any* executive to which it applies: (1) regulator-diversion costs; (2) issuer-compliance costs; and (3) executive-burden costs. The non-incentive costs are worth bearing if and only if they are less than any net incentive benefits generated.

It will be difficult to know for certain, even after the Dodd-Frank clawback goes into effect, whether the rule generates net economic benefits or net economic costs. But one thing is clear: it will not be desirable to apply a reliable excess-pay clawback to executives in situations where, *a priori*, one cannot reasonably expect net incentive benefits to be generated. As I explain in this Part, however, the SEC's proposed Dodd-Frank clawback unfortunately does precisely this: it applies to issuers (Section A) and executives (Section B) where it cannot be expected to materially shape behavior for the better. Thus, from an economic perspective, the SEC's proposed Dodd-Frank clawback reaches too many issuers and too many executives.

A. Issuers

The Dodd-Frank Act appears to contemplate application of the Dodd-Frank clawback to the issuers of all publicly-traded securities. Section 10D of the Exchange Act provides that the SEC shall, by rule, direct the exchanges to "prohibit the listing of any security of any issuer that does not comply with the requirements of [Section 10D]."[102]

However, the SEC has general exemptive authority under Section 36(a) of the Exchange Act to exempt specific categories of issuers to the extent such exemptions are in the public interest and consistent with investor protection.[103] And in proposed Rule 10D-1, the SEC appropriately used this authority to exempt several types of securities

[102] 15 U.S.C. 78j-4.

[103] Section 36(a) of the Exchange Act (15 U.S.C. 78mm(a)).

where application of the Dodd-Frank clawback clearly makes no sense: security futures products, standardized options, securities issued by unit investment trusts (UITs), and the securities of registered investment companies that do not themselves pay incentive-based compensation.[104]

Unfortunately, the SEC failed to use this authority to exempt various types of issuers for which the incentive effects (and thus potential net incentive benefits) of the Dodd-Frank clawback are likely to be marginal at best: issuers that always have a controlling shareholder (CS). These firms include (1) issuers that do not have listed common equity, but only listed debt or preferred stock; and (2) controlled companies. As I will explain in more detail, executives of CS firms can be expected to follow the CS' wishes when it comes to misreporting; the Dodd-Frank clawback cannot meaningfully change their incentives or the frequency of misreporting. Because application of the Dodd-Frank clawback to these issuers cannot be expected to generate material net incentive benefits but will still impose regulator-diversion, issuer-compliance, and executive-burden costs, these issuers should be exempted from the rule (or at least permitted to opt out).[105]

1. Firms Without Listed Common Equity

The SEC is proposing to apply the Dodd-Frank clawback to firms that do not have listed common stock ("private firms") but do have listed

[104] *See Listing Standards, supra* note x, at 41,146-47.

[105] The SEC was urged to exempt emerging growth companies (EGCs) and smaller reporting companies (SRCs) on the grounds that the rule would be disproportionately burdensome to these smaller firms. *See Listing Standards*, *supra* note x, at 41,147. The SEC declined to do so. In my view, the SEC's decision to not exempt these categories of issuers is defensible. Smaller firms generally have weaker corporate governance and are subject to less investor and media scrutiny than larger, more established firms. (For example, only 2.4% of EGCs and 4.1% of SRCs have any disclosed recovery policy, vs. over 60% for S&P 500 firms, *see Listing Standards*, supra note x, at 41,172). As a result, they are the firms most likely to experience incentive benefits from a reliable excess-pay clawback. So even if the clawback imposes disproportionate costs on smaller firms, it is likely to yield disproportionate benefits. Importantly, the costs imposed on these smaller firms would be lowered if the SEC narrows the Dodd-Frank to target only top-5 executives and only accounting-based pay, as I propose in Part VII.

non-convertible debt or preferred stock (hereinafter, simply, "listed debt").[106]

A private firm will almost always be a CS firm: it has either a single controlling shareholder or a small group of shareholders that collectively control the firm. In fact, there may well be only a single shareholder of the private firm. As I will now explain, the Dodd-Frank clawback cannot be expected to improve executives' incentives in a private firm.

Obviously, there is no need for a Dodd-Frank clawback to improve executives' incentives vis-a-vis the *shareholders* of a private firm. Unlike a non-CS public firm, a private firm is unlikely to suffer from substantial agency costs in the relationships between shareholders and directors. Indeed, it is likely that the controlling shareholder(s) (or their employees) constitute many, most, or all of the firm's directors. In such a setting, there is no reason to believe that, from s*hareholders' perspective*, pay arrangements will deviate substantially from arm's-length bargaining such that the Dodd-Frank clawback can improve incentives. If the CS believes that a reliable excess-pay clawback is desirable for itself and other shareholders, given the other tools at its disposal, it has the incentive and ability to put one in place, and then enforce it if necessary. If it believes otherwise, we have no reason to second-guess its judgment.

Of course, even if executives' interests are aligned with shareholders' interests in a private firm, these shareholders (and thus the executives they appoint) may have different interests than the direct buyers or holders of the firm's listed debt. Thus we must consider the ability of the Dodd-Frank clawback to improve the incentives of the executives of a private firm vis-à-vis the direct buyers or holders of listed debt. As I will now explain, however, the Dodd-Frank clawback cannot be expected to improve executives' incentives relative to these parties.

a. Direct Buyers of Listed Debt

Consider the parties who buy debt directly from the firm—debt that will subsequently be listed. It might be argued that that the Dodd-

[106] *See Listing Standards, supra* note x, at 41,148.

Frank clawback could increase the quality and reliability of the financial reporting used by purchasers of the debt to assess its value, thereby increasing the firm's ability to raise capital and indirectly benefiting the firm's shareholders. However, as I will explain, the Dodd-Frank clawback cannot be expected to have such a beneficial effect in a private firm.

Imagine, for example, a hypothetical private corporation (ABC) controlled by a CS. ABC will issue listed debt. ABC's executives prepare the financial reports before ABC issues the debt. The CS and the executives know that a rosier financial picture will enable ABC to sell the debt for a higher price, benefiting the CS. Suppose, notwithstanding the expected costs to ABC of a restatement, the CS wants ABC executives to misreport so that ABC can issue debt more cheaply. Will ABC executives be deterred from misreporting because of the possibility of a restatement and the operation of the Dodd-Frank clawback? No. The CS can use carrots (extra pay) or sticks (implicit threats of lower raises, slower promotion, pay cuts, or termination) to overcome the deterrent effect of the clawback. Importantly, if there is a restatement and a clawback, the recovered excess pay will simply be returned to ABC, where it can be used to reward loyal executives. When shareholders directly control the executives, misreporting serves shareholders' interests, and an excess-pay clawback applied to executives simply returns funds to the shareholders, the clawback thus cannot be expected to deter the shareholders from inducing the executives to misreport.

Now suppose that the CS does *not* want ABC executives to misreport when ABC is issuing it debt. The executives won't do so, even absent the Dodd-Frank clawback. They will be afraid that the CS will penalize them (through lower raises, pay cuts, slower promotion, or termination) in ways that would dwarf any excess pay they could hope to receive.

Of course, there could be situations where the CS of ABC is *indifferent* to some mild forms of misreporting. In such situations, the Dodd-Frank clawback might well generate net incentive benefits when applied to ABC executives. But if the CS is indifferent to particular forms of misreporting, any net incentive benefits from reducing mild misreporting are likely to be small.

b. Holders of Listed Debt

Next consider the possibility that the Dodd-Frank clawback might improve executives' incentives after the firm issues debt. In particular, after the firm issues debt, the shareholders (and thus executives) may have an incentive to take excessive risks or engage in other forms of "misbehavior" (such as "asset dilution," the distribution of value to shareholders) at the expense of debtholders. Debtholders anticipate this risk and protect themselves from such misbehavior through their extensive contractual arrangements with the firm. These contractual arrangements are typically extremely detailed, and frequently individually tailored and highly negotiated. Can the Dodd-Frank clawback add anything to these contractual protections? The answer is "no." As I explain below, application of the Dodd-Frank clawback to these firms cannot be expected to materially improve incentives of executives vis-à-vis debtholders.

To begin, it is worth noting that the Dodd-Frank clawback does not target excessive-risk taking and asset dilution but rather receipt of excess pay through misreporting. Debtholders are unlikely to be hurt by misreporting itself. First, any losses in firm value due to value-reducing activities used to generate excess pay will be absorbed first by equityholders; the losses hurt debtholders only to the extent they increase the risk of insolvency or the severity of any insolvency. Second, as explained above, the CS of a private firm has the ability to prevent executives from engaging in misreporting and the incentive to do so to the extent it expects to absorb the costs. Executives of a private firm will have an incentive to engage in misreporting only in the presumably unusual situation where this misreporting can somehow transfer value from debtholders to equityholders.

But even in this situation – where misreporting transfers value from debtholders to equityholders – the Dodd-Frank clawback cannot do much good. Why? Because, as the ABC example above illustrated, if the CS wants the executives to engage in misreporting to transfer value from third parties, the CS can use carrots (extra pay) or sticks (threats relating to pay or position) to undo the deterrent effect of the clawback. If there is a restatement and clawback, the recovered funds are simply returned to the firm and the CS (the party that pushed the executives to misreport). Again, the Dodd-Frank clawback cannot affect executive behavior in a private firm; executives will do the shareholders' bidding, for better or for worse, and there is nothing a clawback can do about that.

2. Controlled Companies

The SEC is proposing to apply the Dodd-Frank clawback to controlled companies—those whose stock is publicly-traded but more than 50% of the voting power for election of directors is held by a controlling shareholder (CS), whether it is an individual, a group, or another company.[107] The vast majority of controlled companies are owned, directly or indirectly, by the founder of the company or the founder's family. Application of the Dodd-Frank clawback to these firms cannot be expected to generate meaningful net incentive benefits, for essentially the same reasons that it cannot be expected to generate any net incentive benefit in private firms, including those with listed debt.[108]

In a controlled company, the CS has a large economic stake in the enterprise. If the firm has a single class of common shares, the CS will have more than 50% of the cash-flow rights. Even if the firm has a dual-class structure, the CS will typically have at least 20% of the cash flow rights.[109] By way of contrast, a director of a non-CS firm may own approximately 0.005% of the firm's equity.[110] Even if the non-CS director owns 10 times that percentage (0.05%), a CS' proportional stake will be 400 to 1000 times larger than that of a non-CS director. The CS thus internalizes much of the costs and benefits of misreporting, unlike a

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[107] Under New York Stock Exchange Rule 303A.00 and NASDAQ Stock Market LLC Rule 5615(c) a "controlled compan[y]" is defined as a company of which more than 50% of the voting power for the election of directors is held by an individual, group or another company.

[108] My analysis does not apply to a controlled company whose parent is a non-CS firm and whose executives also serve as executives at the parent. In such a controlled company, power remains in the hands of the executives and a reliable excess-pay clawback such as Dodd-Frank may well improve their incentives.

[109] *See* Paul A. Gompers, Joy Ishii, and Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1053-1057 (2009)(finding that average insider cash-flow ownership in dual-class firms was about 40%).

[110] *See supra* note x.

director of a non-CS firm.

The CS of the controlled company also controls the appointment of every director on the board of the company, who thus can be expected to serve the interests of the CS. The executives, in turn, are chosen either directly by the CS or by its appointed directors. While in a non-CS firm executives often have influence over directors, and are generally given the reins of the firm unless there is a crisis requiring board intervention, in a controlled company top executives can be expected to care deeply about pleasing the CS.

In such a setting, the Dodd-Frank clawback is likely to generate little net incentive benefit. Suppose the CS of a controlled company does not want executives to misreport because, for example, it believes that such misreporting will impose net costs on the firm (much of which the CS will bear indirectly through its large equity stake). It has the power to put in place a reliable excess-pay clawback. Or it can take more powerful steps to deter misreporting, such as making clear that misreporting is likely to lead to termination, a pay cut, or a smaller raise. The CS does not need the government's required clawback to manage executives.

Now suppose that the CS wants executives of the controlled company to boost the stock price, even if this requires misreporting, perhaps so that the firm can issue shares at a higher price or the CS controller can sell some of its own shares at a higher price.[111] Will the Dodd-Frank clawback deter executives from misreporting? No. The CS can deploy a variety of carrots (promises of pay increases, promotions) and sticks (threats of pay cuts, slower pay increases, no promotion, or termination) whose magnitude and incentive effect will dwarf that of an expected clawback. If there is a restatement and recovery from executives, the funds flow back into the firm where they can be used by the CS to reward loyal executives.[112]

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[111] *See* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L. J. 1554, 1566 (2015) (explaining why controlling shareholders with a long-term horizon may wish to manipulate the stock price).

[112] In the situation where the CS of the controlled company is herself the CEO (the CS-CEO), it should be even easier to see that the Dodd-Frank clawback will also have no effect on her incentives. First, she is unlikely to need any of the incentive-based compensation covered by Dodd-Frank to motivate her to perform her job. The purpose of

Of course, there could be situations where the CS of the controlled company (like the CS of a private firm with listed debt) is *indifferent* to some mild forms of misreporting. In such situations, the Dodd-Frank clawback might well generate net incentive benefits when applied to ABC executives. But if the CS is indifferent to particular forms of misreporting, any net incentive benefits from reducing mild misreporting are likely to be small.

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In a non-CS firm, the Dodd-Frank clawback might generate net incentive benefits because misreporting is likely to be driven by the executives themselves, in part to generate excess pay, and the clawback will reduce the expected benefit from generating excess pay. These net incentive benefits might, in turn, be higher than the non-incentive costs, making application of the Dodd-Frank clawback desirable from an economic perspecitve.

But in a CS firm, such as a private firm with listed debt or a controlled company, the CS has a strong economic interest in whether executives misreport and the power to adjust executives' misreporting incentives to serve its economic interest, whether or not the Dodd-Frank clawback is in place. In this setting, the Dodd-Frank clawback cannot be

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incentive compensation is to align an executive's interests with those of shareholders. When the CEO is herself the CS, no such incentive-alignment mechanism is needed. If the Dodd-Frank clawback applies to compensation X but not to compensation Y, the CS-CEO can simply pay herself with compensation Y to avoid the clawback, without any loss of efficient incentives. Second, if the CS-CEO does happen to pay herself with incentive compensation covered by the clawback, she will engage in aggressive reporting not to boost the value of this compensation (which is likely to be trivial relative to her overall wealth) but rather to enable herself or the firm to sell stock at a higher price. If there is a restatement and a clawback, the recovered funds can be used to boost the CS-CEO's pay in the next period. There is nothing that minority shareholders can do to stop this recycling of funds. Moreover, even if the CS does not expect to take the clawed-back compensation and use it to increase her compensation in the next pay period, most of the recovered funds will still flow back to the CS-CEO as the CS. The prospect of having some of her compensation clawed back (most of which will be returned to her) will not deter her from misreporting as long as the extra wealth generated from direct or indirect stock sales at a higher price is greater than the net excess pay recouped from her (excess pay recouped, less amount returned to her as CS of the firm).

expected to generate net incentive benefits. But it will still impose non-incentive costs, including regulator-diversion, issuer-compliance, and executive-burden costs. Applying the Dodd-Frank clawback or any reliable excess-pay clawback to private firms with listed debt or controlled companies is thus unlikely to pass a simple cost-benefit test.[113] Indeed, this analysis suggests that it might well be desirable to exempt not only private firms with listed debt and controlled companies, but also other CS firms where the CS does not have more than 50% of the voting power but still exercises effective control.

B. Executives

In Section A, I explained why application of a reliable excess-pay clawback to *any* executive at a CS firm is unlikely to be economically desirable. I now turn my attention to non-CS firms. As this Section explains, the SEC's proposed Dodd-Frank clawback covers too many

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[113] The SEC proposes to apply the Dodd-Frank clawback to the up to seven registered management companies (RMCs) that are listed issuers (e.g., closed-end funds and exchange-traded funds (ETFs)) and have executive officers who may receive incentive-based compensation. *Listing Standards*, *supra* note x, at 41,148. For the same reasons that the SEC should exempt CS firms from the Dodd-Frank clawback, it should also exempt these RMCs.

Even if the executives of these RMCs might otherwise have an incentive to misreport as a result of their compensation, Dodd-Frank clawback will not generate any incentive benefits. If the asset manager wants to deter financial misreporting by executives, it can be expected to put in place its own clawback (which it has a credible threat to activate) or make it clear that it will fire, demote, or reduce the pay of misreporting executives. Unlike the directors of a non-CS firm, the asset manager has the incentive and ability to discipline misbehaving executives. It does not need Dodd-Frank to do so.

If, on the other hand, the asset manager wants to encourage financial misreporting, the threat of a Dodd-Frank clawback cannot really deter an executive from misreporting. The asset manager will make it clear that the executive will be fired, demoted, or paid less if the executive does not engage in aggressive financial reporting, and that the executive will be compensated for any excess pay that is clawed back. In other words, the asset manager will simply work around the Dodd-Frank clawback to neutralize its incentive effects.

Given that (a) there appears to be no problem that application of the Dodd-Frank clawback to executives of RMCs would address, (b) there are very few such entities, and (c) application of the clawback to these issuers may raise unique issues, generating additional regulator-diversion costs, it is difficult to see how application of the Dodd-Frank clawback to these issuers serves the public interest or the interest of investors.

executives at non-CS firms, reaching executives with respect to which it is unlikely to generate any net incentive benefits. Thus, the non-incentive costs of applying the clawback to these executives are likely to be higher than the incentive benefits.

1. The Wide Net of the SEC's Proposed Dodd-Frank Clawback

Section 10D(b)(2) requires exchanges and associations to adopt listing standards that require issuers to adopt and comply with policies that provide for recovery of excess incentive-based compensation from "any current or former executive officer."[114] Section 10D does not define "executive officer," rather it gives the SEC discretion to define the executive officers covered by the rule.

In its proposed Dodd-Frank clawback, the SEC uses a definition of "executive officer" modeled on the definition of "officer" in Rule 16a-1(f), that includes:

"the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer."[115]

The proposed rule could thus cover a dozen executives at a single issuer. For example, Exxon Mobil has 21 such executives;[116] Procter & Gamble has 20;[117] Ford Motor has 18;[118] General Motors has 15;[119] Tyson

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[114] 15 U.S.C. 78j-4.

[115] 17 C.F.R. 240.16a-1.

[116] Exxon Mobil Corporation Form 10-K Item 4 (2015), *available at* http://www.sec.gov/Archives/edgar/data/34088/000003408816000065/xom10k2015.htm.

[117] The Procter & Gamble Company Form 10-K (2015), *available at* http://www.sec.gov/Archives/edgar/data/80424/000008042415000070/fy141510-kreport.htm.

Foods has 14.[120] Approximately 4,800 issuers would be subject to Rule 10D-1, as proposed, according to SEC estimates.[121] If, on average, the number of senior executives at those issuers subject to the risk of clawback is 10, the SEC's proposed Dodd-Frank clawback would reach around 50,000 executives.

2. The Limited Benefits of Targeting Below-5 Executives

In Section A, I explained that there are categories of issuers—basically, any firm with a controlling shareholder (CS)—for which the Dodd-Frank clawback is likely to generate little net incentive benefit. In those firms, the CS has sufficient power and incentive to deter misreporting if it so desires, or to vitiate the effect of a government-mandated reliable excess-pay clawback, if it so desires. In either case, the Dodd-Frank clawback will do little good. I now turn to an explanation of why application of the Dodd-Frank clawback to lower-level executives in non-CS firms is similarly unlikely to generate material net incentive benefits.

In a non-CS firm, power will be concentrated in the CEO and perhaps one or two other executives, all of whom can be expected to be among the top-5 executives. Other, lower-ranking executives ("below-5 executives") generally do not have a relationship with or influence over directors; they report to, are promoted and paid by, and can be fired by, the top-5 executives. Another way to put it: there is a vast difference in power between the most powerful executives in the top-5 and the most powerful executives in the below-5.

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[118] Ford Motor Company Form 10-K Item 4A (2015), *available at* http://www.sec.gov/Archives/edgar/data/37996/000003799616000092/f1231201510-k.htm.

[119] General Motors Company Form 10-K (2015), *available at* http://www.sec.gov/Archives/edgar/data/1467858/000146785816000255/gm201510k.htm.

[120] Tyson Foods, Inc. Form 10-K Item 4 (2015), *available at* http://www.sec.gov/Archives/edgar/data/100493/000010049315000109/tsn201510kq4.htm.

[121] *Listing Standards*, supra note x, at __.

Given that the below-5 executives lack power, the net incentive benefit of applying the Dodd-Frank clawback to these executives is likely to be marginal at best, because (a) the abilities of below-5 executives to misreport are limited; and (b) their compensation arrangements do not give them as strong an incentive to misreport as those of top-5 executives.

a. Below-5 Executives' Limited Ability to Influence Reporting

In a non-CS firm, below-5 executives' *ability* to influence the firm's reporting decisions are much more limited than, say, that of the CEO or CFO. All major decisions by below-5 executives will generally be reviewed and approved by a top-5 executive. In contrast, top-5 executives (as a group) have considerable power. Even if a top-5 executive such as the CEO must get approval for major decisions from the board, directors of a non-CS firm may not have the incentive, information, or ability to meaningfully constrain decision-making by that top executive. As a result, there is a vast difference in the ability of top-5 and below-5 executives to affect financial reporting.

b. Below-5 Executives' Limited Incentive to Misreport to Generate Excess Pay

Even if below-5 executives in a non-CS firm have some power and discretion over reporting, they have much different *incentives* than top-5 executives, limiting the ability of the Dodd-Frank clawback to improve behavior of these lower-level executives. In particular, they are much less likely to be motivated by the prospect of excess pay to misreport.

First, below-5 executives pay packages are much smaller than top-5 executive pay packages. This means they receive less benefit *directly* through their compensation packages from using whatever discretion they have to engage in misreporting. They simply cannot generate as much excess pay from misreporting as top-5 executives.

Second, because below-5 executives are generally more accountable to top-5 executives than top-5 executives are accountable to directors of non-CS firms, below-5 executives can be expected to place a relatively greater weight on the wishes of top-5 executives than on the prospect of getting (and keeping) excess pay. If they displease top-5 executives, they will be out of a job and not receive any more compensation at that firm. So, even if a below-5 executive has the ability to engage in misreporting that might generate some excess pay for him, he may well be reluctant to do so if it would displease his boss (which may well occur if the misreporting triggers the Dodd-Frank clawback against her).

Of course, under the same logic, if the top-5 boss really wants the below-5 executive to assist in misreporting, notwithstanding the application of the Dodd-Frank clawback to top-5 executives, application of the Dodd-Frank clawback to below-5 executives will not reduce the below-5 executive's incentive to assist in misreporting. The below-5 executive can reasonably expect the top-5 executive to reward him for following her wishes, and punish him for not following them—creating upsides and downsides (promotion or no promotion, raise or no raise, no termination or termination) that dwarf the effect of the Dodd-Frank clawback. In other words, the below-5 executive can be expected to do what the top-5 executive wants him to do, whether or not the Dodd-Frank clawback applies to the below-5 executive. Thus, the relationship between the below-5 executive and a top-5 executive in a non-CS firm is not unlike the relationship between the top-5 executive and the CS in a CS firm. In both cases, the presence or absence of the Dodd-Frank clawback cannot be expected to make much difference to the party seeking to please his boss.

3. Costs of Extending the Clawback to Below-5 Executives

While the benefits of extending the Dodd-Frank clawback to below-5 executives is marginal because it cannot be expected to affect their incentives, it increases the three non-incentive costs: regulator-diversion costs; issuer-compliance costs; and executive-burden costs. Notably, below-5 executives may not be able to shoulder as easily the risk-bearing and other costs as wealthier, top-5 executives, so executive-burden costs may well be higher.

What is more, the SEC's proposed rule does not offer a bright-line test to determine which executives are subject to the clawback, requiring both the issuer and the SEC to expend resources determining which executives are covered and which are not, further increasing costs associated with issuer compliance and regulator diversion.

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The SEC's proposed Dodd-Frank clawback can reach a dozen or more executives per firm. Failure to comply with the clawback's rules means that a firm would be delisted. While such delistings are unlikely to occur, the threat of delisting may well cause firms to spend massive amounts on attorneys and experts to ensure that this outcome is avoided, all of course at shareholders' expense. Is it rational, from an economic perspective, to put a firm at risk of delisting because it did not properly comply with the Dodd-Frank clawback's provisions when seeking to recover excess pay from the 10th most powerful executive in the company? The question answers itself.

The SEC's decision to extend the proposed Dodd-Frank clawback to below-5 executives may well be driven, at least in part, by a misapprehension on the part of the SEC about what limiting the clawback to top-5 executives would mean. In the explanation for its proposed Dodd-Frank clawback, the SEC writes:

"…we do not believe that a listed issuer should be unable to recover unearned compensation from an executive officer simply because he or she was not one of the [top-5 executives]."[122]

However, even if the Dodd-Frank clawback applies only to top-5 executives, *there is nothing preventing the firm from voluntarily creating a clawback policy to cover below-5 executives if it so desires*. And in those cases where the incentives of below-5 executives do matter, top-5 executives would have the incentive and ability to take the necessary steps to ensure that the interests of below-5 executives are aligned with those of top-5 executives, including through the use of specially-tailored excess-pay (or other) clawbacks targeted at the "right" below-5 executives.

In short, the SEC's proposed Dodd-Frank clawback covers far too many executives. There seems to be no good reason for mandating application of the clawback to below-5 executives. If the SEC believes

[122] *Listing Standards*, *supra* note x, at 41,181.

that it is statutorily prevented from limiting the clawback to top-5 executives, it should cover as few executives as possible, and Congress should amend the language of Section 954 to give the SEC discretion to further limit the number of covered executives.[123]

VI. The SEC's Proposed Dodd-Frank Clawback Reaches Too Much Compensation

In Part V, I showed that the SEC's proposed Dodd-Frank clawback reaches types of issuers (CS firms) and executives (below-5 executives) where the net incentive benefits are likely to be marginal at best, and thus lower than the non-incentive costs: regulator-diversion, issuer-compliance, and executive-burden. In this Part, I consider the Dodd-Frank clawback as applied to the top-5 executives of non-CS firms. I show that, with respect to these executives, the SEC's proposed Dodd-Frank clawback reaches too many types of compensation.

As Part II.B explained, the SEC's proposed Dodd-Frank clawback covers not only pay that is accounting-based (granted, earned or vested based on financial results) but also price-based (granted, earned, or vested based on stock price or TSR). Thus, in the event of a restatement, the issuer must return excess price-based pay: pay received by the executives that the issuer believes would not have been received under the restated financials.

Section A explains that, in the event of an accounting restatement, excess price-based pay cannot be known but rather can only be "guesstimated." Section B describes the substantial non-incentive costs of extending the Dodd-Frank clawback to price-based pay because of the need to guesstimate the recovery amount. It also describes the potential net incentive benefits. Given the substantial non-incentive costs, there is a heightened risk that application of the Dodd-Frank clawback to excessprice-based pay will be detrimental. Section C concludes by showing that there are much better tools for the job of addressing price

[123] The SEC might consider permitting firms to decide which of the below-5 executives should be subject to the Dodd-Frank clawback. To the extent top-5 executives and directors believe that they are better off subjecting some below-5 executives to the Dodd-Frank clawback, they can then have the option to do so.

manipulation than an excess-pay clawback (such as Dodd-Frank).

A. Need to "Guesstimate" Excess Price-Based Pay

Calculating excess accounting-based pay is likely to be a relatively straightforward mechanical exercise. One takes the corrected accounting measure, plugs it into an executive's pay formula, calculates the corrected pay amount, and subtracts the corrected pay amount from the pay amount received by the executive. Computation costs should not be too high.

To be sure, executive pay arrangements are complex, and there are likely to be tricky issues requiring some judgment. But the range of possible outcomes over which discretion will need to be exercised is likely to be narrow. Thus, the stakes are likely to be small and the affected parties are unlikely to have an incentive to incur significant costs in calculating the excess amount.

By contrast, it is *impossible* to accurately determine excess price-based pay: that is, how the misreporting of one or more accounting measures affected the stock price of a particular firm over the relevant period or at a given point in time. The effect is simply unknowable. For example, if revenues turn out to be overstated by 2%, we can be fairly confident (although not 100% certain) that this overstatement did not have a *negative* effect on the stock price. But we will have no idea whether the stock price during the relevant period was 0%, 2%, 5%, or 25% higher as a result of this overstatement.

The problem is that a firm's stock price involves the interactions of thousands of buyers and sellers who are making trading decisions based on a variety of inputs, including but not limited to, the particular accounting results that were erroneously reported. Even if stock markets were completely efficient at processing new information, there would always be confounding effects—other information arriving in the market—that make it impossible to tease out the effect of a particular error in the reporting of financial results on a firm's stock price over a particular period or on a given date. Moreover, markets are not completely efficient and might often be quite inefficient. We know there is a considerable amount of movement in stock prices that cannot be explained by the arrival of new value-relevant information to the market but is the result of investor mood swings, errant algorithms,[124] and other "noisy" market drivers. How a particular accounting mis-measurement gets translated into the stock price is not, and cannot be, knowable.

The SEC's proposal appears to recognize the un-knowability of how accounting measures affect the stock price, and permits issuers to make a "reasonable estimate."

"In some cases, issuers may need to engage in complex analyses that require significant technical expertise and specialized knowledge, and may involve substantial exercise of judgment in order to determine the stock price impact of a material restatement…..We recognize these potential challenges and….are proposing that issuers be permitted to use reasonable estimates when determining the impact of a restatement on stock price and [TSR] and to require them to disclose the estimates. We believe that being able to use reasonable estimates to assess the effect of the accounting restatement on these performance measures in determining the amount of erroneously awarded compensation should help to mitigate these potential difficulties."[125]

But a "reasonable estimate" is at best a "guesstimate." It will not (and cannot) reveal whether and how (if at all) a particular error in reported financial results at a particular firm at a particular point in time affected the stock price of that firm during a particular period of time. The estimate generated for purposes of the clawback may well be substantially higher or lower than the actual effect of the error on the stock price.

B. The Marginal Economic Effect of Extending the Clawback to Guesstimated Excess Price-Based Pay

In Part V, I explained why the clawback should be applied only to top executives of non-CS firms. I will thus focus here on that subset of executives. A requirement to recoup guesstimated excess price-based pay

[124] *See, e.g.,* Yesha Yadav, *How Algorithmic Trading Undermines Efficiency in Capital Markets* (Mar. 29, 2015) (unpublished manuscript), *available at* http://ssrn.com/abstract=2586106.

[125] *Listing Standards*, *supra* note x, at 41,155.

from these executives will substantially raise the non-incentive costs of the Dodd-Frank clawback, creating a heightened risk that the marginal costs of extending the clawback to price-based pay will exceed the benefits.

1. Additional Non-Incentive Costs

Unfortunately, the need to guesstimate the amount of excess price-based pay will lead to non-incentive costs that are significantly higher than those that would arise if the Dodd-Frank clawback reached only accounting-based pay.

a. Additional Issuer-Compliance and Regulator-Diversion Costs

As explained in Part IV, any reliable excess-pay clawback will impose issuer-compliance costs, even if the clawback applies only to easy-to-calculate accounting-based excess pay. But applying the clawback to price-based pay would generate large, additional issuer-compliance costs. Issuers would be required to hire highly-paid experts, consultants and advisors to generate “reasonable estimates” of the impact of accounting-measure errors on the stock price. Directors would have an incentive to invest large amounts of shareholders’ money to generate estimates that would be as defensible as possible to the SEC and exchanges (which could delist the issuer if it does not comply with the Dodd-Frank clawback); to proxy advisory services and to shareholders (to the extent that they might believe that the directors were under-enforcing the clawback, and base voting advice or decisions on this issue); to executives (whose money was being clawed back); and to courts (if a clawback becomes the subject of litigation between the firm and any of the parties above—shareholders, executives, or the exchange). The SEC, exchanges, and perhaps courts would all have to grapple with the reasonableness of the estimates of excess price-based pay—something that is essentially unknowable.

b. Additional Executive-Burden Costs

Any reliable excess-pay clawback will generate risk-bearing costs for the executive *ex ante* because of the uncertainty that some of the pay received by the executive will be recovered. But if the claw extends to price-based pay, there would be two sources of uncertainty: (a) whether there is a restatement involving a financial result, and the potential magnitude of the error; and (b) the extent to which that error is guesstimated to affect the stock price. If the clawback is extended to price-based pay, "reasonable estimates" of excess price-based pay produced by issuers may well generally be biased downwards, to reduce or avoid recovery (for the very same reasons that directors now seem averse to recover excess pay under firm clawback policies or otherwise[126]). That, at least, would be my prediction. But a risk-averse executive may worry that, when the claw is applied to her, the estimate will be high. This risk-bearing cost, whether it is borne by executives or passed on to shareholders, reduces the size of the pie.

In addition, should the clawback be applied to excess price-based pay, executives can be expected to spend resources seeking to lower the guesstimated amount, perhaps through litigation. These are deadweight costs.

2. Marginal Incentive Benefits and Incentive-Distortion Costs

While the non-incentive effects of extending the Dodd-Frank clawback to price-based pay would be substantially higher, there would also be additional incentive benefits and incentive-distortion costs. The effect on net incentive benefits is thus unclear.

a. Additional Incentive Benefits

Even though excess price-based pay can only be guesstimated, there is a marginal incentive benefit to recouping the guesstimate amount via a reliable excess-pay clawback. The stock price is driven in large part by reported financial results. Thus, *to the extent firms continue to use price-based pay to compensate executives*, there is a benefit to bringing price-based pay within the sweep of the clawback: it reduces the excess pay that would arise *indirectly* from accounting-measurement errors, and thus decreases executives' incentives to misreport.

b. Additional Incentive-Distortion Costs

[126] *See supra* Part III.A.2.

To the extent the Dodd-Frank clawback extends to price-based pay, there will be more incentive-distortion costs. For example, executives may have stronger incentives to switch from misreporting to real earnings management, or to delay or refrain from a necessary restatement.

In addition, extending the Dodd-Frank clawback to price-based pay is likely to change compensation arrangements, potentially for the worse. In particular, the large issuer-compliance costs and executive-burden costs associated with recovering excess price-based pay are likely to drive issuers and executives away from price-based pay, everything else equal. This, in turn, could cause a shift from price-based pay to accounting-based pay, as the costs associated with applying the clawback to the former will be higher than applying the clawback to the latter. It could cause a shift from price-based pay to types of compensation that are beyond the reach of the clawback, such as equity pay that is time-vested. We don't know what effects any such changes would have on the overall mix of incentives provided to executives, and whether these changes would be good or bad. But the *risk* of large indirect incentive-distortion costs rises substantially if the clawback is extended to guesstimated excess pay, because such guesstimation sharply increases the issuer-compliance and executive-burden costs of the clawback.[127]

C. Better Alternatives for Dealing with Price Manipulation

Executives have a variety of levers to manipulate the stock price to boost their payouts in ways that reduce economic value generated by the firm over time. Accounting manipulation that gives rise to a restatement, the target of the Dodd-Frank clawback, is one such lever. But there are

[127] In the proposed Dodd-Frank clawback rule, the SEC solicits comments as to whether the clawback should be further extended to any type of instrument whose payoff is based on stock price, including time-vested restricted stock or options. *See Listing Standards*, *supra* note x, at 41,159. Extending the clawback further in this manner may create some additional benefits, but would sharply raise issuer-compliance costs and executive-burden costs, and might well lead to additional changes in compensation arrangements, the direction and magnitude of which are unknowable. For the same reason extending the clawback to price-based pay is risky, further extending the clawback to proceeds of equity sales—which are likely to be a more important feature of compensation arrangements —is even more risky.

others, such as real earnings management.[128] Reducing executives' incentive or ability to pull any of these manipulation levers to boost the stock price is certainly a worthwhile objective.

However, as Nitzan Shilon and I have argued, a mandatory excess-pay clawback requiring costly guesstimation of the "but-for" stock price is not the right tool for addressing any form of price manipulation.[129] To deal with problems relating to price manipulation (including but not limited to manipulation of financial results), there are much better tools for the job. Some of these tools must be wielded by directors, but others are already in the hands of the SEC.

1. Directors' Toolkit: Improving Equity Compensation

The most powerful tools for reducing executives' incentive to engage in price manipulation are in the hands of the directors who design and approve executives' compensation arrangements. Directors wishing to reduce price manipulation could seek to limit the extent to which pay from compensation arrangements depend on a single day's price or, indeed, the stock price over a short period of time. For example, as Lucian Bebchuk and I have argued, back-end payoffs from the unwinding of equity grants (or their equivalent) should be based on the average stock price over a significant period of time, perhaps a month, two months, six months or a year.[130] And on the front end, to the extent a firm uses pay that is granted, earned, or vested based on the stock price (i.e., price-based pay), directors should use an average stock price over a reasonably long period of time.[131] By not basing an executive's payoff on the stock price of a particular day or over a short period of time, directors can reduce an executive's incentive to manipulate the short-term stock price to inflate

[128] *See* Lilian H. Chan et al., *Earnings Quality and Auditor Behavior*, *supra* note x.

[129] *See* Fried & Shilon, *supra* note x, at 749.

[130] *See* Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1945-47 (2010) (suggesting that the payoffs from executive stock sales should be based on the average stock price over a reasonably long period).

[131] Similarly, if pay is granted, earned or vested based on TSR, the TSR should be over a sufficiently long period of time.

her compensation.

To be sure, even if compensation arrangements were structured in the manner suggested, executives might still have an incentive to manipulate the short-term stock price. For example, executives might still wish to boost the short-term stock price at the expense of long-term value to reduce the likelihood of a hostile takeover, the intervention of an activist shareholder, or institutional-investor pressure. Moreover, directors will not necessarily adopt compensation arrangements that provide optimal incentives for executives. The point here is only that the compensation-generated incentive to manipulate the stock price is most effectively reduced by improving compensation arrangements to reduce the sensitivity of executive's pay to the stock price on any particular day or over any particular short-term period.

2. The SEC's Toolkit: Improving Disclosure

If the SEC wishes to reduce executives' incentive and ability to engage in stock-price manipulation, there are simple steps it can take to do so—steps that it has already been urged to take. To begin, the SEC could amend its own Rule 10b5-1 so that so-called Rule 10b5-1 plans (which provide an affirmative defense to Rule 10b-5 liability) are less easily gamed by executives.[132] There is long-standing evidence that 10b5-1 plan sales are, on average, preceded by abnormal stock run-ups and followed by abnormal stock declines,[133] suggesting that executives are engaged in a combination of stock-price manipulation and insider trading. Executives' ability to game their 10b5-1 plans and incentive to manipulate the stock price would be reduced if, among other things, the affirmative defense provided by a 10b5-1 plan was not available unless the plan was disclosed and the first trade under the plan did not occur until a month after the plan

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[132] *Cf.* Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 464-466 (2008) (describing some of the flaws of so-called 10b5-1 plans).

[133] *See, e.g.*, Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, 55 MGT. SCI. 224 (2009); Eliezer M. Fich, Robert Parrino, & Anh L. Tran, *Timing stock trade for personal gains: Private information and sales of shares by CEOs* (July 10, 2015) (unpublished manuscript), *available at* http://ssrn.com/abstract=2579047.

was disclosed.[134]

In addition, there is justifiable concern that executives of US firms use open market repurchases (or their announcement) to falsely signal to the market,[135] exert price pressure on the stock,[136] mechanically change earnings per share (EPS), perhaps to boost EPS-based bonus payouts,[137] and buy shares at low prices to boost the value of their long-term equity incentives.[138] Under the SEC's own rules, firms need not disclose open market repurchases until months after they occur, and firms need not disclose each trade but rather monthly aggregates, making it difficult to detect improper activity.[139] There is nothing preventing the SEC from following regulators in other developed markets (such as Hong Kong and the U.K.) and requiring firms to disclose open-market repurchases by the firm within a day or two.[140] Under such a regime, executives would have less incentive and ability to use repurchases to manipulate the stock price and otherwise enrich themselves at the expense of other shareholders.[141] These disclosure requirements would provide considerable benefits to investors, at minimal cost.

In short, there are much better tools than a mandatory excess-pay clawback to deal with the problem of executives manipulating the stock price. Directors and the SEC should seek to employ these tools.

[134] *See, e.g.,* Taylan Mavruk & H. Nejat Seyhun, *Do SEC's 10b5-1 Safe Harbor Rules Need to be Rewritte*n?, __ COLUM. BUS. L. REV. __ (forthcoming).

[135] *See* Jesse M. Fried*, Informed Trading and False Signaling with Open Market Repurchases*, 93 CAL. L. REV. 1323, 1351-57(2005).

[136] *Id*. at 1332.

[137] *See* Heitor Almeida, Vyacheslov Fos & Mathias Kronlun, *The Real Effects of Share Repurchases*, __ J. FIN. ECON. __ (2016).

[138] *See* Jesse M. Fried, *Insider Trading via the Corporation*, 164 U. PENN. L. REV. 801 (2014).

[139] *Id*. at ___.

[140] *Id.* at ___.

[141] I*d.* at___.

Meanwhile, the Dodd-Frank clawback should be focused on the job for which it is the best tool: reducing easily calculated excess *accounting-based* pay.

VII. A "Smart" Dodd-Frank Clawback

The analysis in Parts V and VI suggests that the SEC's proposed Dodd-Frank clawback is overbroad. It reaches issuers and executives where any net incentive benefits are likely to be marginal at best, and applies to types of compensation (price-based pay) for which a clawback is simply not the right tool for the job. Along these margins, there is strong reason to believe that application of the SEC's proposed Dodd-Frank clawback generates or is likely to generate economic costs that substantially exceed the benefits. Most of these net economic costs are likely to be borne, directly or indirectly, by public investors.

Although Dodd-Frank requires the SEC to adopt a rule to implement Section 954's mandatory excess-pay clawback, the SEC has considerable latitude in crafting the rule.[142] It has general exemptive authority under Section 36(a) of the Exchange Act to exempt specific categories of issuers to the extent such exemptions are in the public interest and consistent with investor protection.[143] Similarly, the SEC has at least some rule-making discretion over the types of executives and compensation covered by the rule.

This Part argues that it would be desirable for the SEC to use its discretion to adopt a more narrowly targeted version of the Dodd-Frank clawback, one that is as close as possible to the "smart" clawback described in Section A. Section B describes the advantages of this smart clawback relative to the SEC's proposed Dodd-Frank clawback.

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[142] See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43 (1984) (holding that where Congress has not directly spoken to an issue, "the question for the [reviewing] court is whether the agency's answer is based on a permissible construction of the statute" and requiring only that an agency interpretation, where Congress has not clearly spoken, be one among many permissible readings of the statute).

[143] 15 U.S.C. 78mm(a).

A. CONTOURS OF A "SMART" CLAWBACK

A smart Dodd-Frank clawback would be aimed at top-5 executives at non-CS firms.[144] And it would cover only accounting-based pay, not price-based pay.

The differences between the smart clawback and the SEC's proposed Dodd-Frank clawback are summarized in the Table 1 below.

Table 1: SEC's Proposed Dodd-Frank Clawback vs. "Smart" Clawback

	SEC's Proposed Dodd-Frank Clawback	Smart Clawback
Issuers	Almost all issuers	Excludes issuers with unlisted equity and controlled companies
Executives	Section 16(a) executives	Top-5 executives
Compensation	Accounting-based pay & price-based pay	Accounting-based pay

[144] The top-5 executives would generally correspond to the named executive officers (NEOs) in Item 402(a)(3) of Regulation S-K, whose compensation must be disclosed in elaborate detail in SEC Form DEF 14A each year. In some cases, NEOs would include individuals who served as the CEO or CFO during the year but are no longer serving in those positions. Because individuals other than the CEO and CFO might move in and out of the NEO category from year to year, the clawback could be applied to any individual who was an NEO during any of the last X years. Other possible approaches might be to have the clawback cover (1) the CEO, the CFO, and the next three most powerful executives as designated by the firm; or (2) just the CEO and CFO.

B. Benefits of a Smart Clawback

Relative to the SEC's proposed Dodd-Frank clawback, the smart clawback offers two advantages. By targeting only those issuers and executives that are likely to be positively affected by the clawback, it can achieve all or almost all of any net incentive benefits of the SEC's proposed Dodd-Frank clawback at a much lower cost. And by exempting price-based pay, the smart clawback would eliminate the substantial additional regulator-diversion, issuer-compliance, and executive-burden costs that would otherwise be incurred.

1. Saving Resources by Targeting Fewer Issuers and Executives

As I have explained, applying the Dodd-Frank clawback to private firms with listed debt and controlled companies is unlikely to improve executives' incentives at these firms and the quality of financial reporting. Similarly, applying the clawback to below-5 executives, who have little power or discretion, will not materially improve incentives or financial reporting at any firms. Thus, exempting these issuers and executives will not meaningfully reduce any net incentive benefit of the clawback.

At the same time, there are cost savings to such exemptions. The fewer issuers and executives are covered, the fewer non-incentive costs the clawback will impose on regulators, issuers, and executives. From an economic point of view, these exemptions should generate more economic benefits than costs, and thus be desirable.

Because public investors will enjoy most of the economic benefits and bear most of the economic costs of the Dodd-Frank clawback, they too would benefit from these exemptions. It should go without saying that public investors prefer that firms not spend shareholders' money complying with, or compensating executives for, corporate-governance mandates that do not benefit them. Public investors also do not want regulators to spend their limited time, resources, and attention enforcing relatively pointless rules, at the expense of other activities that could benefit investors.

2. Lowering Costs By Excluding Price-Based Pay

As explained, extending the Dodd-Frank clawback to excess price-based pay may generate additional incentive benefits to the extent it applies to top executives at widely-held firms. But it will also generate much larger non-incentive costs (regulator-burden, issuer-compliance and executive-burden costs) than when the clawback is applied only to accounting-based pay, and potentially larger incentive costs, because the clawback is ill-suited for dealing with price manipulation. The risk of the marginal costs exceeding the marginal benefits thus appears to be quite high.

Focusing the clawback on accounting-based pay will save substantial regulator-diversion, issuer-compliance, and executive-burden costs. While there is a potential failure to achieve net incentive benefits, preserving these potential net incentive benefits does not seem worth it, especially since the SEC has not yet tried to use other, more appropriate and cost-effective tools to deal with the general problem of price manipulation.

Conclusion

The SEC's proposed Dodd-Frank clawback substantially increases the likelihood that executives will return excess pay to their firms following a financial restatement. The clawback can therefore be expected to reduce the incentives of executives to misreport financial results, generating economic benefits. However, as I have explained, this incentive benefit is likely to be generated only with respect to a subset of the firms and executives to which the proposed clawback applies: top executives of widely-held firms. When applied to firms with a controlling shareholder or to the lower-level executives of any firm, the clawback is unlikely to improve behavior. Because the clawback generates a variety of costs (for regulators, issuers, and executives) with respect to any issuer or executive it targets, the costs of applying the Dodd-Frank clawback to firms with a controlling shareholder or lower-level executives of any firm likely outweigh the incentive benefits.

In addition, the SEC's proposed Dodd-Frank clawback applies not only to "accounting-based pay" (pay that is granted, earned or vested based on accounting results) but also to "price-based pay" (pay that is granted, earned, or vested based on the stock price). An excess-pay clawback is suitable for accounting-based pay because the "but for" amount of compensation (had financial results not been misstated) is knowable, permitting easy calculation of the excess amount. But the clawback is not suited for price-based pay, because the "but for" stock price is *un*knowable. Excess price-based pay thus can only be *guesstimated*. The need to guesstimate excess price-based pay (and defend the guesstimated amount to regulators, shareholders, and courts) will lead to large expenditures, most of which will be borne by shareholders. As a result, there is a high risk that the costs of extending the clawback to price-based pay will substantially exceed any incentive benefits.

In short, the SEC's proposed Dodd-Frank clawback, while providing incentive benefits, reaches too many issuers, executives, and types of compensation. It would thus desirable for the SEC to adopt a more narrowly-targeted "smart" clawback focused on fewer firms, executives, and compensation arrangements. In particular, the clawback should be aimed at the accounting-based pay of top-5 executives at issuers that are not exclusively CS firms. Rationalizing the Dodd-Frank clawback in this manner would be consistent with the presumed objectives of the securities laws: strengthening the economy and benefiting public investors.

Appendix A

Table 1. SEC recoveries under the SOX clawback: 2002-2012. "Innocent" denotes executives not personally accused of wrongdoing.

Year	Abbreviated Release Citation	Amount(s) Recovered	Total Executives Reached	"Innocent" Executives Reached
2012	Sec. & Exch. Comm'n v. Don W. Watson, et al., S.E.C. Release No. 3382, 2012 WL 1894182 (Apr. 18, 2012)	$646,404	1	0
2012	SEC v. Koss Corp. & Michael J. Koss., S.E.C. Release No. 3368, , 2012 WL 1894126 (Mar. 9, 2012)	$451,314 + other securities	1	0
2012	SEC v. Richard J. Senior et al., Litigation Release No. 22241, 2012 WL 8700164 (Jan. 30, 2012); In the Matter of Symmetry Medical Inc., S.E.C. Release No. 3358, 2012 WL 1024028 (Jan. 30, 2012)	$450,000 and $185,000	2	1
2011	Former CEO to Return $2.8 Million in Bonuses and Stock Profits Received During CSK Auto Accounting Fruad, S.E.C. 11-243, 2011 WL 5554241 (Nov. 15, 2011)	$2,796,467	1	1
2011	In the Matter of Michael C. Pattison, CPA, S.E.C. Release No. 3407, 2012 WL 4320146 (Sept. 20, 2012) (noting settlement in July 2011)	$300,000	1	0
2011	Sec. & Exch. Comm'n v. James O'Leary, S.E.C. Release No. 3314, 2011 WL 3837289 (Aug. 30, 2011); Sec. & Exch. Comm'n v. Ian J. Mccarthy, S.E.C. Release No. 3250, 2011 WL 761793 (Mar. 4, 2011)	$1,431,022 and $6,479,281 + other securities	2	2
2010	In the Matter of Navistar Int'l Corp., et al., S.E.C. Release No. 33-9132, 2010 WL 3071892 (Aug. 5, 2010)	$1,3200,000 and $1,049,503	2	0
2010	Sec. & Exch. Comm'n v. Carl W. Jasper, Litigation Release No. 21598, 2010 WL 2886400 (July 22, 2010)	$1,869639	1	0
2010	SEC v. Diebold, Inc., S.E.C. Release No. 3137, 2010 WL 2199552 (June 2, 2010)	$470,016 + other securities	1	1
2008	Sec. & Exch. Comm'n v. Sycamore Networks, Inc., et al., S.E.C. Release No. 2843, 2008 WL 2677225 (July 9, 2008)	$190,000	1	0
2007	Sec. & Exch. Comm'n v. William W. Mcguire, M.D., Litigation Release No. 2754, 2007 WL 4270709 (Dec. 6, 2007)	$448M	1	0

Table 2. SEC recoveries under the SOX clawback: 2013-2015. "Innocent" denotes executives not personally accused of wrongdoing.

Year	Abbreviated Release Citation	Amount(s) Recovered	Total Executives Reached	"Innocent" Executives Reached
2015	In the Matter of Computer Sciences Corporation, et al., S.E.C. Release No. 3662, 2015 WL 3526033 (June 5, 2015)	$3,771,00 and $369,100	2	0
2015	In the Matter of William Slater, et al., S.E.C. Release No. 3636, 2015 WL 528128 (Feb. 10, 2015)	$337,375 and $141,992	2	2
2014	In the Matter of Dr. L.S. Smith, S.E.C. Release No. 3596, 2014 WL 5842377 (Nov. 12, 2014)	$106,250	1	1
2014	In the Matter of Babak (Bobby) Yazdani, S.E.C. Release No. 3584, 2014 WL 4726472 (Sept. 24, 2014)	$2,570,596	1	1
2014	Sec. & Exch. Comm'n v. Diamond Foods, Inc., S.E.C. Release No. 3527, , 2014 WL 69462 (Jan. 9, 2014)	>$4,000,000 (voluntary)	1	0
2013	Sec. & Exch. Comm'n v. China Natural Gas, Inc., et al., Litigation Release No. 22719, 2013 WL 2456245 (June 7, 2013)	$77,479	1	0
2013	Sec. & Exch. Comm'n v. Mercury Interactive, LLC, et al., Litigation Release No. 22623, 2013 WL 653016 (Feb. 21, 2013)	$5,064,678 and $2,814,687	2	0
2013	In the Matter of Eric Ashman, S.E.C. Release No. 3440, 2013 WL 139353 (Jan. 11, 2013)	$34,149	1	0

Excess-Pay Clawbacks

Jesse Fried*

Nitzan Shilon**

Abstract: We explain why firms should have a clawback policy requiring directors to recover "excess pay"—extra payouts to executives resulting from errors in performance measures (such as reported earnings). We then analyze the compensation arrangements of S&P 500 firms and find that very few have voluntarily adopted such a policy. Our findings suggest that the Dodd–Frank Act, which requires firms to adopt a policy for clawing back certain types of excess pay, will improve compensation arrangements at most firms. We also suggest how firms should address the types of excess pay not reached by Dodd–Frank.

I. INTRODUCTION

On July 21, 2010, President Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank).[1] Among other things, Dodd–Frank requires publicly-traded firms to adopt policies that compel the recovery of certain payments made to executives on the basis of financial results that turn out to be false and

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

require a restatement.[2] In particular, a firm that is required to restate its financial results must recover certain incentive-based compensation paid to an executive that exceeds the amount he would have received under the restated results.[3] The Securities and Exchange Commission (SEC) is currently developing regulations to implement this new clawback policy requirement.[4]

A number of legal academics have criticized the federal government for imposing this excess-pay clawback requirement on all publicly traded firms.[5] Mandating such clawback policies, they argue, is an unnecessary and undesirable intrusion into these firms' compensation arrangements; private ordering will yield better results.[6] Indeed, over 80% of Fortune 100 firms had voluntarily adopted some form of clawback policy before Dodd–Frank was enacted[7]—a pattern that appears to support these critics' claims.

This Article explains why Dodd–Frank's clawback-policy requirement will likely improve compensation arrangements at public firms, but does not go far enough. Part II discusses why a robust excess-pay clawback policy—one that requires firms to recover extra pay received by executives as a result of errors in performance measures—would be expected to boost "firm value," the value flowing to all of the firm's shareholders over time.[8] We begin by showing that an executive's ability to keep excess pay imposes costs on shareholders, even if the executive has not committed misconduct. We then explain why, absent a robust excess-pay clawback policy, executives will often be able to keep any excess pay that they receive. First, the recovery provision of the Sarbanes–Oxley Act of 2002 (SOX)[9] is unlikely to be used to claw back an executive's excess pay. Second, when given discretion, directors cannot be expected to choose to recoup excess pay from either current or departed executives.

Part III examines excess-pay clawback policies prior to Dodd–Frank: Did firms put in place robust policies—policies requiring boards to recoup excess pay? We find that, before Dodd–Frank, nearly 50% of S&P 500 firms had no excess-pay clawback policy

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2. This requirement is embodied in a new Section 10D to the Securities Exchange Act of 1934. *Id.* § 954.

3. *Id.*

4. *See* Jeffrey S. Klein & Nicholas J. Pappas, *New Clawback Requirements for Listed Public Companies*, N.Y. L.J., Oct. 4, 2010 (reporting that the SEC was planning to propose implementing rules during April–July 2011).

5. *See, e.g.*, Stephen M. Bainbridge, *Dodd–Frank: Quack Federal Corporate Governance Round II* (UCLA Sch. Of Law, Law-Econ. Research Working Paper No. 10–12, 2010), *available at* http://ssrn.com/abstract=1673575 (criticizing the Dodd–Frank clawback as unfairly penalizing executives and describing the clawback, along with the entire Act, as corporate governance quackery); Larry E. Ribstein, *Financial Reform That Isn't*, FORBES.COM (July 8, 2010), http://www.forbes.com/2010/07/08/financial-reform-bill-hedge-funds-opinions-columnists-larry-e-ribstein.html (criticizing the Dodd–Frank clawback for enabling the recovery of payments to "innocent executives" and arguing that the development of such provisions should be left to states competing for corporate charters).

6. *See, e.g.*, Ribstein, *supra* note 5 (claiming that state competition for corporate charters will lead to desirable compensation arrangements).

7. Press Release, Equilar, Clawback Prevalence Continues to Rise in Fortune 100 (Aug. 25, 2010), *available at* http://www.equilar.com/press_20100825.php.

8. In another work, one of us has used the term "aggregate shareholder value" to describe the value flowing to all of the firm's shareholders over time. *See* Jesse M. Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEX. L. REV. 1113, 1114 (2011) (defining "aggregate shareholder value"). We use the term "firm value" here to mean "aggregate shareholder value."

9. Sarbanes–Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2002).

whatsoever. Of those firms with clear policies, 81% did not require directors to recoup excess pay but rather gave directors discretion to allow executives to keep excess pay. Of the remaining firms, 86% did not permit directors to recoup excess pay absent a finding of "misconduct." As a result, less than 2% of S&P 500 firms required directors to recover excess pay from executives whether or not there was misconduct. Thus, on the eve of Dodd–Frank, most S&P 500 executives were not subject to robust excess-pay clawback policies. We conclude Part III by offering two explanations for firms' failure to voluntarily adopt adequate clawback policies before Dodd–Frank.

Part IV turns to Dodd–Frank's clawback requirement, which mandates that publicly-traded firms adopt a policy to recover certain kinds of excess pay received by executives when a restatement is required, regardless of whether there has been misconduct. We explain why, given the inadequacy of the SOX clawback and firms' own weak excess-pay clawback policies, Dodd–Frank is likely to substantially improve the quality of compensation arrangements at most publicly-traded firms. We also consider—and reject—the argument that Dodd–Frank will undesirably reduce the use of incentive pay in public firms.

Part IV then explains that Dodd–Frank's requirement does not mandate the recovery of all types of excess pay. First, Dodd–Frank does not compel firms to recoup excess pay from executives unless a restatement is required. Second, Dodd–Frank does not appear to require firms to recoup excess pay arising from executives' sale of company stock at prices inflated by errors in earnings or other metrics. We discuss why permitting executives to keep these forms of excess pay is likely to be detrimental to firms and their shareholders. We also suggest how boards seeking to improve executives' incentives should address these two limitations. Part V concludes.

Before proceeding, we wish to emphasize that a publicly–traded firm may need to be subject to other types of clawback policies besides one targeted at excess pay. For example, in a financial firm, it may be desirable for the government to recover payments to executives whose decisions put the firm at risk and necessitated a government bailout, whether or not there were errors in the metrics used to determine those payments.[10] Such insolvency clawbacks would deter executives from taking risks at taxpayers' expense. And should the firm require a bailout, insolvency clawbacks would reduce the cost of the bailout to taxpayers. Similarly, it may be desirable to claw back the pay of executives who engage in certain types of misconduct, such as unethical behavior or violations of the duty of loyalty, even if their pay is properly calculated. Such misconduct clawbacks could deter executives from acting in certain ways that harm the corporation and its shareholders.[11] However, our focus in this Article is only on excess-pay clawback policies: policies designed to recover extra pay that executives receive solely because of

10. *See* Jesse M. Fried, *Uncle Sam Should Claw Back Wall Street Bonuses*, S.F. CHRON., Sept. 30, 2008, at B7, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2008/09/29/ED201385J9.DTL (arguing that the government should seek to claw back bonuses paid to Wall Street executives shortly before their firms were bailed out by the government). *Cf.* KENNETH R. FRENCH ET AL., THE SQUAM LAKE REPORT: FIXING THE FINANCIAL SYSTEM (2010) (proposing collective holdback for senior managers of financial firms that would be forfeited in the event of bankruptcy or extraordinary government assistance).

11. *See* Ben W. Heineman, Jr., *Making Sense of Clawbacks and Holdbacks*, BUS. WK., (Aug. 13, 2010), http://www.businessweek.com/managing/content/aug2010/ca20100813_666706.htm (explaining that acts of malfeasance other than those connected to misstatements of financial results should also trigger a clawback).

errors in earnings or other performance metrics.

II. THE PROBLEM OF EXCESS PAY

This Part describes why excess pay can impose large costs on investors. Part II.A explains that errors in earnings or other compensation-related metrics often inflate executive pay. If such unearned pay were likely to be recovered, it would not impose substantial costs on shareholders. However, as Part II.B discusses, shareholders cannot rely upon the SEC or directors who have discretion over whether to recoup excess pay to recover such pay.

A. Excess Pay and its Costs to Investors

Executive compensation arrangements are likely to give rise to erroneously high payouts to executives. These excess payouts can impose substantial costs on shareholders when they are not recovered.

1. The Likelihood of Executives Receiving Excess Pay

Executives receive a substantial amount of their pay in the form of incentive compensation—equity and bonuses.[12] Much of this incentive compensation is directly or indirectly tied to quantifiable performance measures. For example, bonuses are often directly linked to a company's annual earnings.[13] In addition, the payoff from executives' sale of equity is indirectly tied to current earnings because reported earnings affect the stock price.[14]

The mismeasurement of these performance metrics can lead to erroneously high payouts, or "excess pay."[15] As we explain below, such mismeasurement may arise with or without "misconduct" (however that term is defined) by executives or their firm.[16] Thus, even an executive acting in good faith could end up receiving substantial amounts of excess pay.

Importantly, excess pay is not an inevitable outcome of executive compensation arrangements. Compensation arrangements could be structured to prevent excess pay from arising in the first instance. Firms could address the problem of excess *bonus* pay (and the need for bonus clawbacks) by keeping the bulk of bonuses in "bonus banks" that

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12. *See* Huasheng Gao et al., A Comparison of CEO Pay in Public and Private US Firms 31–33 (Nov., 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1572406 (reporting that equity compensation and bonuses comprised, on average, 73% of CEO pay in all public firms during the period 1999–2008).

13. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 124–25 (2004) (describing the structure of various types of bonus plans).

14. *See* Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 458–59 (2008) (describing evidence on the link between earnings manipulation and insider stock sales).

15. Of course, mismeasurement can also lead to underpayment. However, executives who have been mistakenly underpaid have a strong incentive to seek from the firm any amount they are owed, and directors can be expected to make these executives whole.

16. By "mismeasurement of performance metrics," we mean mismeasurement according to the accounting standards in effect at the time. If accounting standards are subsequently modified so as to change the measurement of a performance metric that was correct at the time it was made, we would not consider that to be a mismeasurement leading to excess pay.

deliver value to executives only after the accuracy of the results driving the bonuses is assured.[17] Alternatively, as Sanjai Bhagat and Roberta Romano have emphasized, the problem of excess pay (and the need for clawbacks) could essentially be eliminated altogether by compensating executives primarily with equity that must be held until after retirement.[18] But until boards adopt such approaches—for which they currently show little appetite[19]—compensation arrangements will continue to generate excess pay.

a. Excess Pay without Misconduct

Excess pay is not always the result of misconduct; it can arise from the accidental mismeasurement of a compensation metric. Suppose, for example, that an executive is to be paid a bonus of $100,000 for each $10 million in reported earnings. The executive and the firm take all reasonable precautions to ensure the accuracy of reported earnings. However, the firm's employees or outside accountants make a book-keeping error or innocently misinterpret the relevant accounting rules, causing the firm to erroneously report an extra $20 million in earnings. As a result, the executive receives a bonus that is $200,000 too high.

The inadvertent receipt of excess pay may well be quite common. For example, it likely occurred in a number of firms that appeared to engage openly and innocently in the backdating of employees' option grants because of a misunderstanding of the relevant accounting rules.[20] Such option-grant backdating erroneously boosted reported earnings[21] and thereby inflated any bonuses based on these earnings. To the extent that the higher reported earnings inflated the stock price, executives were also able to sell their own shares for a higher price. The receipt of both types of excess pay did not appear

17. For example, if earnings errors were always corrected within X years, a board could withhold a bonus for X years to ensure that the executive was properly paid. *See* Nanette Byrnes, *Executive Pay: Bonus Banks*, BUS. WK. (Feb. 4, 2009), http://www.businessweek.com/magazine/content/09_07/b4119000477911.htm (describing several firms' use of bonus banks where "money can be drawn down . . . provided [the firm] meets or exceeds predetermined operating targets and other benchmarks"); Alex Edmans & Xavier Gabaix, *Tractability and Detail-Neutrality in Incentive Contracting* (N.Y.U., Working Paper No. FIN-08-019, 2009), *available at* http://ssrn.com/abstract=1354507 (describing bonus-bank mechanisms for aligning pay with performance).

18. *See* Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-term*, 26 YALE J. ON REG. 359, 367 (2009) (noting that paying executives solely with equity that could not be cashed out until after retirement would create a "natural clawback" and avoid the need for a separate clawback mechanism). *See also* Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1919 (2010) (explaining how long-term holding requirements should be structured to better tie pay to performance).

19. *See, e.g.*, Joann S. Lublin, *Law Sharpens 'Clawback' Rules for Improper Pay*, WALL ST. J. (July 25, 2010), http://online.wsj.com/article/SB10001424052748704249004575385500170389086.html (quoting a compensation expert as estimating that only five percent of publicly–traded firms have bonus deferral arrangements); Nitzan Shilon, Illusory CEO Ownership Policies (2011) (unpublished manuscript) (on file with author) (describing the lack of robust equity holding requirements in publicly–traded firms).

20. *See* Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX REV. 1031, 1038 (2007) (describing firms that openly backdated stock option grants out of ignorance of the accounting rules). Most firms that engaged in option-grant backdating did so secretly. *See* Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 863–64 (2008) (explaining that thousands of firms engaged in the secret backdating of options).

21. *See* Fried, *supra* note 20, at 873–74 (explaining how the backdating of employee option grants boosted reported earnings in some firms by over a billion dollars).

to involve a secret scheme to manipulate earnings or boost other performance metrics. Nevertheless, the executives likely received excess pay.

b. Excess Pay Resulting from Misconduct

Excess pay can also result from wrongdoing; executives may deliberately inflate earnings or other metrics (or pressure others to do so) to boost their own payouts. Unfortunately, it is not difficult to find dramatic examples of executives misreporting financial results to boost their stock-sale profits. For example, Gary Winnick, the CEO of Global Crossing, sold more than $700 million worth of shares in the year before the firm filed for bankruptcy, while the company was allegedly inflating sales revenues.[22] Similarly, Qwest insiders sold more than $2 billion of stock while they were overstating revenues, as the firm's market capitalization dropped from $85 billion to $4 billion.[23]

These are not isolated occurrences. A number of empirical studies have found a link between inflated earnings and executive stock sales. One study found that firms that fraudulently misstate their earnings tend to have more insider selling activity.[24] Another found that executives of firms that experienced accounting irregularities and were subsequently subject to SEC enforcement action were more likely to have exercised their options in the preceding period.[25]

It has also not been difficult to find examples of executives misreporting financial results to boost their bonuses. Consider Fannie Mae. During the period 2001–2004, its executives received millions of extra dollars in earnings-based bonuses and option grants while overstating firm earnings by at least $10 billion.[26] Similarly, during the years 2000–2004, Nortel Networks executives engaged in accounting manipulation that triggered tens of millions of dollars in "return-to-profitability" bonus payments.[27] The

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22. Henny Sender & Rebecca Blumenstein, *Questioning the Books: Global Crossing Creditors Review Sales, Swaps*, WALL ST. J., Feb. 25, 2002, at A6.

23. Roger Martin, *The Fundamental Problem with Stock-Based Compensation*, ROTMAN, Winter 2003, at 9, *available at* www.rotman.utoronto.ca/rogermartin/fundamental_problem.pdf.

24. *See* Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 ACCT. REV. 131, 144 (1998) (reporting that insiders in companies where fraud is found reduce their net position in the entity's stock by engaging in significant selling activity, regardless of whether selling activity is measured by dollars of shares sold, number of shares sold, or number of selling transactions).

25. *See* Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting,* 79 J. FIN. ECON. 35, 63 (2006) (finding that top managers of firms that experienced accounting irregularities and were subsequently subject to SEC enforcement actions had exercised their options in the preceding period at a higher rate than top managers of other firms).

26. *See* Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807, 807–12 (2005) (explaining how the structure of Fannie Mae's compensation arrangements gave executives an incentive to inflate earnings); Eric Dash, *Fannie Mae to Restate Results by $6.3 Billion Because of Accounting*, N.Y. TIMES (Dec. 7, 2006), http://www.nytimes.com/2006/12/07/business/07fannie.html?_r=1&em&ex=1165726800&en=ce14eaf6968517 9d&ei=5087%0A (reporting regulators' conclusion that, of the $90 million paid to Fannie Mae CEO Franklin Raines during the period 1998–2003, at least $52 million—more than half—was tied to bonus targets that were reached by manipulating accounting).

27. *See* Press Release, SEC, SEC Charges Four Former Senior Executives of Nortel Networks Corporation in Wide-Ranging Financial Fraud Scheme (Mar. 12, 2007), *available at* http://www.sec.gov/news/press/2007/2007-39.htm (explaining how Nortel officials misstated revenue by

secret backdating of executive option grants and non-executive employee option grants also boosted reported earnings in affected firms by billions of dollars, thereby increasing executives' bonus payouts.[28]

2. Excess Pay: The Costs to Investors

Executives' receipt of excess pay can impose two types of costs on shareholders if the pay is not expected to be—and in fact is not—subsequently recovered: (1) the systematic diversion of value from shareholders to the executives and (2) the destruction of value that is a byproduct of the manipulation aimed at generating excess payouts.

a. Value Diversion

Whether executives' receipt of excess pay is accidental or results from misconduct, excess pay reduces the amount of value available to shareholders. For example, suppose an executive is paid $1 million based on misstated earnings when he should have been paid $500,000 based on actual earnings. As a result, the executive receives $500,000 that otherwise could have been distributed to shareholders or invested in the firm on their behalf.

To be sure, boards could take into account the potential for receiving excess pay when they negotiate an executive's compensation package. In principle, boards could reduce, dollar-for-dollar, an executive's salary or pension for every expected dollar of excess pay. In such a situation, excess pay would not lead to systematic over-compensation of executives.[29]

But compensation based on misreported metrics would be a peculiar type of pay. Excess pay either is random—in the case of accidental misreporting—or arises from misconduct. It is not, in either case, related to an executive's contribution to firm value. Permitting executives to make such profits is thus an inefficient way to reward them for performance. Indeed, as we explain below, the prospect of receiving excess pay provides executives with incentives to take steps that may reduce firm value.[30]

b. Value Destruction

When executives engage in misconduct to generate excess pay, they can destroy far more value than the amount of excess pay they ultimately receive. In particular, the possibility of over-payment can hurt shareholders by undermining, and in some cases perverting, the desirable effects of incentive-based compensation arrangements.

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several billion dollars).

28. *See* Fried, *supra* note 20, at 858–74 (examining the impact of the secret backdating of executive and non-executive option grants).

29. Some commentators have made a similar claim about insider trading profits. *See, e.g.*, Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 881 n.80 (arguing that shareholders end up paying managers the same compensation whether or not managers are permitted to engage in insider trading).

30. Another reason to be skeptical that excess pay is part of executive compensation arrangements is that there is no evidence that directors or compensation consultants ever calculate expected excess pay when designing compensation arrangements. Absent such a calculation, there is unlikely to be a corresponding reduction in other elements of an executive's pay arrangement to offset expected excess pay.

To begin, large incentive payments are often justified as necessary to motivate managers to generate firm value.[31] But permitting executives to keep pay that is not merited by actual performance reduces the payoff differential between good and poor performance, thereby weakening pay–performance sensitivity and executives' incentive to increase firm value.[32] This problem arises whether or not the excess pay results from misconduct.

Furthermore, the ability to reap excess pay from misconduct can lead executives to take steps that impose direct costs on the firm. In extreme cases, such manipulation can substantially weaken, if not destroy, the firm.[33] For example, Enron executives' manipulation of earnings destroyed a business with an estimated $30 billion of firm value.[34]

Even if a firm is not substantially weakened or destroyed by financial reporting manipulation, the out-of-pocket costs of such manipulation can be substantial. For example, firms that restated their financial statements following SEC allegations of accounting fraud during the period 1996–2002 collectively paid an extra $320 million in taxes while overstating their earnings by $3.36 billion,[35] which may well have enabled managers to sell their shares at higher prices. Fannie Mae alone incurred over $1 billion in expenses cleaning up its books after its executives, who had been given high-powered incentives to boost earnings, overstated earnings by $10 billion.[36] In each of these cases, the amount of firm value lost to the government and outside accountants likely exceeded the excess pay received by the executives themselves.

B. Executives' Ability to Keep Excess Pay

The significant costs to investors associated with excess pay described in Part II.A would not arise if either the SEC or directors could be expected to force executives to return excess pay. However, neither the SEC nor directors exercising their discretion can be depended upon to recoup excess pay.[37]

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31. *See* Michael Jensen & Kevin Murphy, *CEO Incentives: It's Not How Much You Pay, But How*, HARV. BUS. REV. May–June 1990, at 145 (emphasizing the importance to shareholders of giving executives large incentive-based pay packages to encourage performance).

32. *See* Lucian A. Bebchuk and Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 665 (2005) (noting that executives who receive large amounts of compensation even if they perform poorly will have less incentive to perform well).

33. Michael C. Jensen, *Agency Costs of Overvalued Equity*, FIN. MGMT., Spring 2005, at 5, 10–11.

34. *Id.*

35. Merle Erickson et al., *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387, 406 (2004). Some of these taxes may have been subsequently refunded to the firms.

36. *See* Marcy Gordon, *Wall St. Applauds Fannie Mae Restatement*, CHI. TRIB., Dec. 7, 2006, at 3 (describing the response to Fannie Mae's 2006 earnings restatement); Bebchuk & Fried, *supra* note 26, at 809–12 (explaining how the structure of Fannie Mae's compensation arrangements gave executives an incentive to inflate earnings).

37. In some cases, shareholders may sue derivatively to recover excess payments. *See* Phred Dvorak & Serena Ng, *Check Please: Reclaiming Pay From Executives is Tough to Do*, WALL ST. J., Nov. 20, 2006, at A1 (describing shareholder suit against executives of FPL Group Inc. in which executives were forced to return $9.75 million of $92 million in cash bonuses for a merger that was never consummated). But such cases are rarely brought because of the costs involved and the substantial procedural hurdles that must be overcome to maintain such a suit. *See* BEBCHUK & FRIED, *supra* note 13, at 45–48 (describing difficulty of bringing

1. The SEC's Reluctance to Recoup Excess Pay

As we explain in more detail below, the Sarbanes–Oxley Act (SOX) gave the SEC the power to claw back executive pay in certain situations, but the agency has rarely used this power. The likelihood that any given executive would be subject to the SOX clawback has thus been rather small.

a. The SOX Clawback

In 2002, President Bush signed into law the Sarbanes–Oxley Act (SOX).[38] SOX contained a variety of measures aimed at rebuilding investors' confidence in the capital markets, including new rules increasing disclosure requirements, mandating tighter internal controls, and boosting civil and criminal penalties for misreporting.[39] It was widely considered to be the most important federal intervention in corporate governance since the enactment of the securities laws in the 1930s.[40]

SOX also contained a clawback provision that applies to publicly-traded companies: Section 304.[41] If a firm is required to prepare an accounting restatement due to material noncompliance, as a result of misconduct, with any financial reporting requirement, Section 304 enables the SEC to require the CEO and CFO of the firm to return to the firm any bonus or other incentive- or equity-based compensation received within 12 months of the misleading financial statement, as well as any profits realized from the sale of stock during that period.[42]

Notably, in the event of a required restatement and a finding of misconduct, the SEC could recover not only excess pay but *all* of the incentive pay received in the 12-month period following the misleading statement. Relative to an excess-pay clawback of the kind required by Dodd–Frank, the SOX recovery provision appears quite punitive. But, as we explain below, the SOX clawback is very unlikely to be deployed, substantially reducing its ex ante deterrent (and ex post recovery) effects.

b. The Limited Effectiveness of the SOX Clawback

As we explain below, the likelihood that the SEC would deploy the SOX clawback against any given executive has been almost zero. Thus, from an executive's perspective, the expected recovery associated with the SOX clawback is extremely low.

To begin, the SOX clawback can only be deployed if there has been misconduct.

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derivative suit). Shareholder suits are thus not an effective method of recovering excess pay.

38. Sarbanes–Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2002).

39. *See* Fried, *supra* note 14, at 459 (describing SOX).

40. *See, e.g.*, Jonathan R. Macey & Maureen O'Hara, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89, 93 (2009) (citing Roberta Romano's description of SOX as "arguably the most important federal statute in the area of corporate law and corporate governance").

41. SOX § 304.

42. *Id.* The provision does not specify whether the misconduct must be that of the officer targeted or the firm. Recently, however, a court has accepted the SEC's argument that the clawback can be applied as long as there is some misconduct associated with the false financial statement, even if the executive himself did not commit misconduct. *See* SEC v. Jenkins, 718 F. Supp. 2d 1070, 1074–77 (D. Ariz. 2010) (denying defendant CEO's motion to dismiss the case on the ground that he did not commit misconduct, and holding that misconduct by the issuer, acting through any of its officers, agents, or employees, triggers the reimbursement obligation of a CEO or CFO).

However, as we explained earlier, excess pay can impose substantial costs on investors even if there is no misconduct.[43] In particular—whether or not there is misconduct—excess pay diverts value from investors ex post and undermines pay–performance sensitivity (and therefore executives' incentive to generate value) ex ante. The SOX clawback cannot do anything to mitigate these costs.

Moreover, even if there is misconduct, the likelihood that an executive would be forced to return pay under SOX is quite small. Neither boards nor shareholders (derivatively) can use the SOX clawback to sue for a recovery; only the SEC can invoke the provision.[44] Litigating a clawback case is expensive, especially since the SEC must demonstrate misconduct. Because the SEC faces significant resource constraints,[45] it can only be expected to seek recovery in a few cases each year.

Indeed, over the last decade, the SEC deployed the clawback very few times. In most of the cases, the targeted executives had first been convicted of criminal fraud.[46] We cannot precisely determine the number of cases in which the SEC could have deployed the SOX clawback but did not do so. But it is likely to be a significant number, given that thousands of firms restated their earnings during this period.[47] In many of these firms, executives likely received excess pay as a result of some form of misconduct. For example, the deliberate secret backdating of stock option grants improperly boosted

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43. *See supra* Part II.A.2 (discussing the costs of excess pay to investors).

44. *See, e.g.*, Neer v. Pelino, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005) (holding that SOX §304 does not provide a private right of action to recover value from executives); *In re* Digimarc Corp. Derivative Litig., 549 F.3d 1223, 1238 (9th Cir. 2008) (same).

45. *See, e.g.*, *Major Human Capital Challenges at SEC and Key Trade Agencies: Hearing Before the S. Comm. on Governmental Affairs Subcomm. on Oversight of Gov't Mgmt., Restructuring & the Dist. of Columbia*, 107th Cong. (2002), *available at* http://www.gao.gov/new.items/d02662t.pdf (reporting that "limited resources have forced SEC to be selective in its enforcement activities and have lengthened the time required to complete certain enforcement investigations"); Peter J. Henning, *For the SEC, Problems of Time and Money*, DEALBOOK (Feb. 22, 2011), http://dealbook.nytimes.com/2011/02/22/for-the-s-e-c-problems-of-time-and-money/?nl=business&emc=dlbkpma22 (describing how resource constraints compromise SEC enforcement efforts).

46. *See* Jerry W. Markham, *Regulating Excessive Executive Compensation—Why Bother?*, 2 J. BUS. & TECH. L. 277, 299 (2007) (explaining that, as of 2007, the SEC had only sought recovery from executives criminally convicted of fraud); Rachael E. Schwartz, *The Clawback Provisions of Sarbanes–Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1, 2 (2009) (reporting that as of the sixth anniversary of the enactment of SOX, the SEC has only twice sought to claw back bonuses and compensation, despite the thousands of restatements since SOX was signed into law); Robert Khuzami, SEC Director of Enforcement, Speech to the Society of American Business Editors, Securities and Exchange Commission (Mar. 19, 2010), *available at* http://www.sec.gov/news/speech/2010/spch031910rsk.htm (reporting that in the previous two and a half years the SEC has sought Section 304 reimbursements in 11 cases). Two recent cases in which the SEC sought recovery from executives that were not alleged to have committed misconduct themselves include *SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1073 (D. Ariz. 2010) and *SEC v. O'Dell*, No. 1:10-CV-00909 (D.D.C. June 2, 2010). In both of these cases, there was an allegation that the issuer, but not the defendant, had committed misconduct. As of this writing, *Jenkins* is being settled. *See* Joel Rosenblatt et al., *Ex-CSK Auto CEO Jenkins Settles SEC Clawback Lawsuit, Court Records Show*, BLOOMBERG BUSINESSWEEK (Mar. 25, 2011), http://www.businessweek.com/news/2011-03-25/ex-csk-auto-chief-settles-sec-clawback-suit-records-show.html. In *O'Dell,* the defendant CEO agreed to return the compensation requested by the SEC pursuant to a settlement agreement. SEC v. O'Dell Complaint ¶ 8 (June 2, 2010).

47. There were 4609 financial restatements during the years 2006–2009 among the approximately 10,000 publicly-traded firms. *See* MARK CHEFFERS ET AL., *2009 FINANCIAL RESTATEMENTS: A NINE YEAR COMPARISON*, AUDIT ANALYTICS TREND REP. (2010) (reporting on a study of financial restatements).

earnings by billions of dollars at hundreds of affected firms.[48] In short, the likelihood that an executive who had received excess pay would be required to return it via the SOX recovery provision—even if there had been misconduct—has been quite small.[49]

2. Directors' Reluctance to Recoup Excess Pay

The SEC has been unable or unwilling to recover excess pay, except in rare cases. But what about a firm's directors? Assuming that the firm did not structure its compensation arrangement to ensure that an executive could keep excess pay, the firm will have the right to recover any extra pay that the executive received due to a measurement error. Unfortunately, directors who have the right to recover an executive's excess pay cannot be counted on to do so. Indeed, they rarely seek to recover excess pay from executives. As the *New York Times* reported, "[C]ompanies very, very rarely—as in almost never—get that money back."[50]

As we discuss below, the failure of directors to voluntarily recover excess pay can be explained by their personal cost-benefit analyses: for directors, the financial benefit to recovering excess pay from either a current or departed executive is extremely small relative to the cost.

a. Personal Benefit of Recouping Excess Pay

Although directors typically receive some of their compensation in the form of stock or stock options, each director's equity stake as a fraction of outstanding shares is usually insignificant. One study found that median independent director stock ownership is only 0.005% of firm shares.[51] As a result, each director can expect to reap only a tiny amount of the excess pay recovered from a typical executive. Consider, for example, a director who owns 0.005% of the company's shares. Suppose that the director is contemplating whether to seek recovery of $10 million of excess pay. The increase in value of the director's holdings as a result of recovery would be only $500. Such a benefit, or even one several times larger, is highly unlikely to exceed the costs of seeking recovery that we detail below.

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48. Fried, *supra* note 20, at 874.

49. Another limitation of the SOX recovery provision is that it can only be used if there is a restatement. As we explain in Part IV, an executive may receive excess pay—perhaps due to misconduct—in situations where the firm does not restate its earnings. Thus any excess-pay recovery provision that cannot be triggered absent a restatement will necessarily be under-inclusive.

50. Jonathan D. Glater, *Sorry, I'm Keeping the Bonus Anyway*, N.Y. TIMES (Mar. 25, 2005), http://query.nytimes.com/gst/fullpage.html?res=9A00E4DC143CF930A25750C0A9639C8B63; *see* Dvorak & Ng, *supra* note 37, (reporting that most boards do not try to recover excess pay received by executives). In unusual cases, executives may give some of the excess pay back. For example, following the Nortel Network episode described in the text, certain executives "volunteered" to give back $8.6 million in bonuses that they received as a result of inflated earnings. Nonetheless, compensation specialists say that such an event is very rare. *See* Mark Heinzl & Ken Brown, *Nortel Unveils New Accounting Flubs, Company Details Mistakes, Says Executives Will Return Millions in Bonus Payments*, WALL ST. J., Jan. 12, 2005, at A3 (describing compensation experts' reactions to the voluntary return of $8.6 million in unearned bonuses by Nortel executives).

51. John E. Core et al., *Corporate Governance, Chief Executive Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 384 (1999).

b. Personal Cost of Recouping Excess Pay

The cost of recouping excess pay from an executive will depend on whether the executive is still at the firm or has departed. We consider both scenarios.

(1) Recovering from Current Executives

As Lucian Bebchuk and one of us have argued, executives have power and influence over directors in publicly–traded U.S. companies that make it personally costly and difficult for directors to make compensation decisions that executives oppose.[52] For example, a director who was put on the board by a particular executive might feel disloyal in subsequently suggesting that the executive's pay should be reduced or tied more closely to performance. In general, there are a variety of financial, social, and psychological reasons why directors cannot always be counted on to make shareholder-serving compensation decisions.

Forcing a current executive to return excess pay would obviously impose a financial cost on the executive. It could also embarrass the executive, especially if the executive was in some way responsible for the error that gave rise to the excess pay. To the extent that directors feel loyal to the executive or otherwise care about their relationships with the executive, they are likely to find it personally costly to seek to recover excess pay.[53] These costs to directors are likely to exceed the small personal financial benefit of recovering excess pay.

Consider the board of Las Vegas Sands Corporation. It accidentally gave chairman and CEO Sheldon Adelson an extra $1 million in 2005 as a result of what the company termed an "improper interpretation" of his employment contract.[54] But the compensation committee of the board voted 3–1 to allow Adelson to keep the $1 million.[55] Although Sands' stock declined 18% during the year, the committee justified its decision based on the "outstanding performance of the company in 2005."[56] Of the three compensation committee members voting to allow Adelson to keep the excess pay, two were or had been affiliated with another of Adelson's businesses. Yet they were still considered "independent" directors according to the New York Stock Exchange's listing standards, and thus eligible to serve on Sands' compensation committee.[57]

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52. *See, e.g.*, BEBCHUK & FRIED, *supra* note 13, at 23–27 (describing sources of executives' influence over directors in public companies).

53. To be sure, directors could indirectly recover excess pay by reducing current compensation. However, if the amount of excess pay is sufficiently large, it may not be feasible to reduce current compensation by enough to fully offset the excess payment. Suppose, for example, that the overpayment is $2 million and the executive's current compensation package is $3 million. The board thus could in principle reduce current compensation by $2 million to $1 million. However, the executive may refuse to work for only $1 million. And if the executive refuses to work for only $1 million, ex post settling up will be impossible. Moreover, even if the executive were willing to work for $1 million, the $1 million pay package may not provide optimal incentives for the executive to maximize firm value going forward. Thus, even if it were possible to settle up in this manner, it may well be undesirable from shareholders' perspective to recoup previously received excess pay by reducing current compensation.

54. *See* Gretchen Morgenson, *Big Bonuses Still Flow, Even if Bosses Miss Goals*, N.Y. TIMES, June 1, 2006, at A1, *available at* http://www.nytimes.com/2006/06/01/business/01bonus.html.

55. *Id.*

56. *Id.*

57. *Id.*

(2) Recovering from Departed Executives

By the time the board learns that an executive has received excess pay, the executive may well have departed the company. In S&P 500 firms, median CEO tenure is now under six years.[58] There is thus a reasonable likelihood that an executive will be gone—or on his way out—when the board discovers that the executive has received excess pay.

One might believe that it would be less costly for directors to recover excess pay from a departed executive. After all, the executive has much less influence over directors once he has left the firm. However, directors will still incur substantial personal costs in seeking to recoup excess pay from departed executives—at least relative to the trivial financial benefit to them from such a recovery.

First, an executive will typically litigate rather than turn over the money sought by the board.[59] Litigation imposes costs on directors. The executive's lawyers will aggressively question the directors in depositions to put them on the defensive and expose any wrongdoing on their part. This process is not merely unpleasant for directors; it could also reveal potentially embarrassing facts about the directors' service on the board. For individual directors, the psychological and opportunity costs associated with litigation could be considerable.

More importantly, directors seeking recovery will forfeit the value of their relationships with the executive. Directors tend to be interested in maintaining good relationships with departing or departed executives because these executives can perform favors for them in the future. As one corporate lawyer put it, "It's quite normal for a board to want the departing CEO to be a friend, not an adversary."[60] A departing CEO is more likely to be a friend if directors do not aggressively pursue the recovery of any excess pay that she received.

Directors' desire to ingratiate themselves with departing executives is evidenced by the fact that directors often provide departing executives with all sorts of emoluments not required by the executives' contracts.[61] Such "gratuitous goodbye" benefits take a number of forms, including accelerated vesting of options and restricted stock, increases in pension benefits (e.g., by "crediting" CEOs with additional years of service), and promises of consulting contracts that will provide the departing CEO with generous annual compensation for little or no work.[62]

Given this pattern, directors are likely to let executives departing the firm keep any

58. *See* John C. Coates, IV & Reinier H. Kraakman, *CEO Tenure, Performance and Turnover in S&P 500 Companies* (Harv. L. and Econ. Discussion Paper No. 595, 2007), *available at* http://ssrn.com/abstract=925532 (reporting an average and a median CEO tenure in companies listed on the S&P 500 from 1992 to 2004 to be fewer than 7 years and 5.5 years, respectively). *See also* Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed?* (Aug. 2008) (unpublished manuscript), *available at* http://faculty.chicagobooth.edu/steven.kaplan/research/km.pdf (suggesting that average CEO tenure in large companies since 2000 has been less than six years).

59. *See* Dvorak & Ng, *supra* note 37 (describing executives' resistance to returning disputed compensation to the firm).

60. *See* Suzanne Koudsi, *Why CEOs are Paid so Much to Beat it*, FORTUNE, May 29, 2000, at 34–35, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/200/05/29/280626/index.htm (explaining why directors treat departing executives favorably).

61. *See* BEBCHUK & FRIED, *supra* note 13, at 87–94 (describing the benefits executives receive when leaving their companies, even if they have performed poorly).

62. *Id.*

excess pay as well as collect other gratuitous goodbye benefits. Indeed, this is precisely what happened at Fannie Mae. Franklin Raines, Fannie Mae's CEO, departed in late 2004 following an earnings-manipulation scandal after reaping millions of dollars in excess pay from bonuses based on inflated earnings.[63] Fannie Mae's directors not only allowed the departing CEO to keep his excess pay, but also gratuitously boosted his pension on the way out.[64]

III. Excess-Pay Clawback Policies Before Dodd–Frank

As we explained in Part II, executives' ability to receive and retain excess pay can impose substantial costs on shareholders. These costs would not arise if the SEC or directors consistently recovered excess pay from either current or departed executives. However, neither directors nor the SEC can be relied upon to recoup such payments.

Firms could substantially reduce the costs associated with excess pay if they adopted what we call a "robust" clawback policy—one *requiring* the recovery of any excess pay received by executives, whether or not there was misconduct. Such a robust clawback policy would eliminate the diversion of value to executives via excess pay and improve pay–performance sensitivity. It would also reduce executives' incentive to manipulate performance metrics, thereby avoiding the value destruction that is often a byproduct of such manipulation.

Part III.A examines the excess-pay clawback policies that had been voluntarily adopted by S&P 500 firms on the eve of Dodd–Frank. Did firms in fact adopt robust clawback policies? The short answer is "no." We find that nearly 50% of S&P 500 firms had no excess-pay clawback whatsoever. Of the remaining firms, 81% gave directors discretion not to recoup excess pay. And among those firms that had committed to recoup excess pay in at least some circumstances, 86% indicated that they would not recoup excess pay unless the board first found that the executive had committed misconduct. Fewer than 2% of S&P 500 firms had policies requiring executives to return excess pay whether or not there was misconduct.

In Part III.B, we offer two explanations for why most firms did not adopt a robust excess-pay clawback policy. First, directors are reluctant to adopt arrangements that executives oppose, and executives will understandably oppose a robust clawback policy. Second, the directors themselves may not favor a clawback if they seek to maximize their firm's short-term stock price and believe a clawback policy will inhibit an executive from aggressively boosting short-term results.

A. Excess-Pay Clawback Policies in the S&P 500

Over the last decade, many publicly–traded firms voluntarily adopted clawback provisions. For example, Equilar reports that, while fewer than 18% of Fortune 100 firms had a publicly disclosed clawback policy in 2006, over 80% of Fortune 100 firms had

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63. *See* Bebchuk & Fried, *supra* note 26, at 807 (describing Raines' departure from Fannie Mae); Dash, *supra* note 26 (explaining that Raines reaped tens of millions of bonus dollars as a result of manipulating earnings).

64. Bebchuk & Fried, *supra* note 26, at 814.

such a policy on the eve of Dodd–Frank in mid-2010.[65] But how many firms actually had robust excess-pay clawback policies requiring executives to return unearned pay?

To answer that question we examined the actual policies that S&P 500 firms had adopted prior to Dodd–Frank.[66] The securities laws require firms to provide information on their clawback policies in their proxy statements.[67] We reviewed each S&P 500 firm's last annual proxy statement before Dodd–Frank and recorded a description of any clawback policy.

Firms covered by the Troubled Asset Relief Program (TARP) were subject to a special clawback provision.[68] We thus exclude the 15 S&P 500 firms covered by TARP on the eve of Dodd–Frank, leaving us with a sample of 485 S&P 500 firms (denoted hereafter as "S&P 500 firms").[69]

Of these 485 S&P 500 firms, 234 (48%) did not report the existence of an excess-pay clawback policy.[70] The remaining 251 (52%) had some form of excess-pay clawback policy. Of these 251 firms, 26 provided insufficient information for us to fully determine how their policies worked. This left 225 S&P 500 companies with excess-pay clawback policies that we could analyze (denoted hereafter as "S&P 500 firms with policies").

1. No Excess-Pay Clawback Policy in Almost 50% of Firms

We begin by noting the most striking result of our study: nearly 50% of S&P 500 firms did not have an excess-pay clawback policy. Firms that lacked such a clawback policy ranged from companies like Apple and AT&T with market capitalizations in the hundreds of billions of dollars to smaller, less well-known firms.

Importantly, the likelihood of finding an excess-pay clawback policy was substantially lower in smaller companies within the S&P 500.[71] To examine the effect of

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65. Press Release, *supra* note 7.

66. *Cf.* Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 389 (2009) (explaining that the actual effectiveness of a clawback mechanism depends on its terms).

67. Regulation S-K requires that publicly–traded firms disclose in their annual proxy statement "policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment." Executive Compensation Disclosure, 71 Fed. Reg. 78, 338 (Dec. 29, 2006) (altering Section 402 (b)(2)(viii) of Regulation S-K).

68. Section 111(b)(3)(B) of the Emergency Economic Stabilization Act of 2008 (EESA) required all financial institutions selling troubled assets to the government pursuant to the TARP to adopt a clawback that would recover any bonus, retention award, or incentive compensation paid to certain executives and any of the next 20 most highly compensated employees of the TARP recipient if the compensation was based on materially inaccurate statements of earnings, revenues, gains, or other criteria. 31 C.F.R. § 30.8 (2008).

69. We used data from the U.S. Treasury to identify those firms covered by TARP as of June 2, 2010. *See Troubled Asset Relief Program, Transactions Report for Period Ending June 2, 2010*, U.S. Treasury Dept. Office of Financial Stability, *available at* http://www.financialstability.gov/docs/transaction-reports/6-4-10%20Transactions%20Report%20as%20of%206-2-10.pdf. The 15 firms thereby excluded were AIG, Bank of America, Citigroup, Fifth Third Bancorp, First Horizon National Corp., Hartford Financial Services Group, Inc., Hudson City Bancorp, Huntington Bancshares Inc., KeyCorp, Lincoln National Corp., Marshall & Ilsley Corp., M&T Bank Corp., Regions Financial Corp., SunTrust Banks, and Zions Bancorp.

70. Some of these firms may have had clawbacks aimed at something other than excess pay, such as clawbacks that could be triggered if an executive engaged in "unethical" behavior.

71. Market capitalizations were determined as of August 4, 2010.

firm size on the use of excess-pay clawback policies, we divided the S&P 500 into three categories based on market capitalization: (1) Mega Cap firms (market capitalization over $100 billion); (2) Large Cap firms (market capitalization between $10 and $100 billion); and (3) Mid Cap firms (market capitalization between $1 and $10 billion). The results are summarized in Table 1 below.

Table 1: Excess-Pay Clawback Policies in S&P 500 Firms (Mid 2010)

Market Capitalization	*# Firms with Policy*	*% Firms with Policy*
Mega Cap (21 firms)	**16**	**76%**
Large Cap (214 firms)	**126**	**59%**
Mid Cap (250 firms)	**109**	**44%**

While 76% of Mega Cap firms had excess-pay clawback policies, only 59% of Large Cap and 44% of Mid Cap firms had such policies. The strong correlation between size and excess-pay clawback prevalence suggests that the frequency of excess-pay clawbacks among firms too small to be included in the S&P 500 is no higher than 50% and likely to be considerably lower. Indeed, in 2010 only 17% of the 3680 publicly traded firms covered by Institutional Shareholder Services had any type of clawback policy.[72]

2. The Non-robustness of Excess-Pay Clawback Policies

We now turn our attention to those firms that had excess-pay clawback policies, focusing on those 225 S&P 500 firms that had fully disclosed excess-pay clawback policies on the eve of Dodd–Frank. A close reading of the details of these policies revealed that they generally did not require directors to recover excess pay. Of these 225 firms, 81% gave boards discretion to forego clawbacks of excess pay. Of the remaining firms—those that required a clawback in at least some circumstances—86% indicated they would not recoup excess pay unless the board made a finding of misconduct.

a. No Recovery Required

The overwhelming majority of excess-pay clawback policies gave boards discretion not to recoup excess pay, even if the executive had engaged in misconduct. We discuss the lack of a recoupment requirement and explain why it is extremely problematic.

(1) Discretionary Clawbacks

In 81% of the S&P 500 firms with policies (182/225), boards had discretion to forego recovering excess pay, even if the board found that the executive receiving the

72. *See* Lublin, *supra* note 19 (discussing the prevalence of clawback policies and Dodd–Frank's new clawback rule).

excess pay had committed misconduct.[73] Consider, for example, Procter & Gamble's 2010 clawback policy: "The Committee has adopted the Senior Executive Officer Recoupment Policy that *permits the Company to recoup or 'claw back'* [certain bonus and incentive] payments made to executives in the event of a significant restatement of financial results for any reason."[74] Thus, Procter & Gamble fails to require the board to seek recovery of excess pay; instead, it merely gives directors the ability to seek recovery, allowing the board to decline to recover all or any excess pay.

In fact, fewer than 20% of S&P 500 firms with policies required directors to recover excess pay in at least some circumstances. Dell is an example of a firm that commits to recover excess pay, at least to the extent practicable. According to Dell's 2010 proxy:

> If Dell restates its reported financial results, the Board will review the bonus and other awards made to the executive officers based on financial results during the period subject to the restatement, and, to the extent practicable under applicable law, Dell *will seek to recover or cancel* any such awards which were awarded as a result of achieving performance targets that would not have been met under the restated financial results.[75]

One might argue that we are placing too much weight on the difference between phrases such as "will seek to recover" and "permits the company to recoup." In either case, the argument might go, boards can be expected to recoup excess pay if all other conditions of the clawback are satisfied. However, the choice of words matters, and the lawyers drafting these clawback policies—and the directors reviewing them—presumably paid careful attention to the language used.

GE's policy illustrates how a single firm uses both "may" and "will" in the same policy to indicate that recovery will always be triggered in some cases but not in others. According to GE's 2010 proxy:

> If the Board determines that an executive officer has engaged in conduct detrimental to the company, the Board *may* take a range of actions to remedy the misconduct, prevent its recurrence, and impose such discipline as would be appropriate. Discipline would vary depending on the facts and circumstances, and may include, without limit, (1) termination of employment, (2) initiating an action for breach of fiduciary duty, and (3) if the conduct resulted in a material inaccuracy in the company's financial statements or performance metrics which affect the executive officer's compensation, seeking reimbursement of any

73. As we will discuss shortly, a clawback policy that bars recovery unless the board determines that there has been misconduct allows directors to avoid a clawback by wrongly determining that there has been no misconduct. Here we focus on a different problem: directors who have discretion over whether to recoup excess pay may decline to recoup that pay even if they have determined that all other requirements for an excess-pay clawback (such as misconduct) have been satisfied.

74. Procter & Gamble, Notice of Annual Meeting and Proxy Statement (Schedule 14A) at 42 (Aug. 27, 2010), *available at* http://www.sec.gov/Archives/edgar/data/80424/000119312510198880/ddef14a.htm (emphasis added).

75. Dell, Notice of Annual Meeting and Proxy Statement 2010 (Schedule 14A) at 39 (May 27, 2010), *available at* http://www.sec.gov/Archives/edgar/data/826083/000095012310053687/d72405ddef14a.htm (emphasis added) [hereinafter Dell Proxy Statement]. If Dell's directors were likely to use the "to the extent practicable" limitation to avoid recovering excess pay when it is in fact possible to recover such pay, Dell's clawback policy should be considered discretionary.

> portion of performance-based or incentive compensation paid or awarded to the executive that is greater than would have been paid or awarded if calculated based on the accurate financial statements or performance metrics; *provided that if the board determines that an executive engaged in fraudulent misconduct, it will seek such reimbursement*.[76]

GE makes it quite clear that, as long as the board determines that the "detrimental conduct" falls short of "fraudulent misconduct," directors can choose to allow an executive to keep excess pay. By contrast, if the board determines that the executive has engaged in fraudulent misconduct, directors are required to seek recovery.[77]

(2) The Problem with Giving Boards Discretion

In a world where directors could be counted on to use their discretion to recover excess pay from executives, there would be no need for a clawback policy that requires the return of excess pay. When an executive received pay in error, directors would simply force the executive to return it. In such a world, a robust excess-pay clawback policy would be entirely superfluous.

However, as we explained in Part II, directors cannot be relied on to claw back excess pay; for them, the personal cost of seeking recovery dwarfs the personal benefit.[78] A robust excess-pay clawback policy—one that requires directors to seek recovery—is the only way to ensure that such recovery occurs. A clawback policy that does not require directors to recoup excess pay, but rather merely gives them the option to effect a clawback, may be little better than no clawback policy at all.

One might argue that giving directors discretion not to recoup excess pay could benefit shareholders by allowing boards to forego recovery in those cases where the costs of a clawback are greater than the amount of excess pay. But there are two problems with this argument. First, giving boards discretion is itself likely to drive up the cost of recovery. If an executive knows that the firm will pursue him until the excess pay is recovered, he has little incentive to resist recoupment; thus, the cost of recovery will be low. If, on the other hand, the executive knows that directors have discretion over the recovery of excess pay, she has a strong incentive to drive up the cost of the process to deter recoupment. A policy requiring directors to recoup excess pay should therefore lower the cost of recovery.

Second, even if the cost of recovery always exceeds the excess pay recouped, there are likely to be desirable deterrent effects associated with requiring recoupment. Suppose, for example, that by manipulating a compensation metric Executive A will generate excess pay of $5 million. Suppose further that the cost of recovering that excess pay is $10 million. If Executive A knows that the firm will not seek to recover the $5 million because it will cost the firm $10 million, Executive A has an incentive to manipulate the compensation metric and reap an extra $5 million at shareholders' expense. If, on the

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76. Gen. Electric, Notice of Annual Meeting and Proxy Statement 2010 (Schedule 14A) at 26 (Mar. 5, 2010), *available at* http://www.sec.gov/Archives/edgar/data/40545/000119312510048722/ddef14a.htm (emphasis added).

77. Because GE's policy can be expected to give the board discretion in most cases, we classified it as one that gives the board discretion.

78. *See supra* Part II.B.2 (explaining directors' reluctance to recoup excess pay).

other hand, the firm commits in advance to recover the money (even though it will impose a net cost on the firm of $5 million), Executive A has no incentive to manipulate the compensation metric ex ante, and the firm will not be required to incur any recovery costs ex post. The firm's shareholders are $5 million better off by having committed to spend $10 million to recover $5 million of excess pay. Requiring boards to recover excess pay, even if it is costly to do so, is thus likely to lower recovery costs by reducing both executives' resistance to returning unearned pay and the likelihood that such unearned pay will arise in the first instance.

b. No Misconduct, No Clawback

The overwhelming majority of S&P 500 firms with policies do not require a clawback if the board determines that there has been no misconduct by the executive. We discuss this misconduct requirement below and explain why it is also problematic.

(1) The Misconduct Hurdle to Recovery

Sixty-seven percent of S&P 500 firms with policies indicate that boards will not recoup excess pay unless there is a finding of executive misconduct.[79] In other words, an executive can keep excess pay—no matter how large an amount—unless the company determines that the executive has committed misconduct.[80] Among the approximately 20% of S&P 500 firms with policies requiring the recovery of excess pay in at least some circumstances, a full 86% prevent the board from recovering pay absent a determination that the executive has committed misconduct. Companies that have a misconduct requirement include such well-known firms as GE and IBM. Consider IBM's 2010 clawback policy:

> To the extent permitted by governing law, the Company will seek to recoup any bonus or incentive paid to any executive officer if (i) the amount of such payment was based on the achievement of certain financial results that were subsequently the subject of a restatement, (ii) *the Board determines that such officer engaged in misconduct that resulted in the obligation to restate*, and (iii) a lower payment would have been made to the officer based upon the restated financial results.[81]

Thus, IBM commits itself to recouping an inflated bonus from an executive only if the misstated financial results giving rise to the excess pay were due to the executive's misconduct. IBM does not commit itself to recoup an inflated bonus payment if there is no misconduct; the executive would be free to pocket the excess pay.

79. Some clawback policies permit or require a clawback of excess pay if either misconduct or some other event (such as a restatement) occurs. We consider such policies as not requiring misconduct for recovery of excess pay.

80. Note that this approach is much more lenient than the SOX clawback, which (a) permits recovery if there is misconduct by *either* the executive *or* others at the firm and (b) permits recovery of all the executive's incentive compensation (not just excess pay) in the wake of a restatement. *See supra* Part II.B.1 (describing the scope of the SOX clawback).

81. IBM, Notice of Annual Meeting and Proxy Statement 2010 (Schedule 14A) at 36 (Mar. 8, 2010), *available at* http://www.sec.gov/Archives/edgar/data/51143/000110465910012758/a09-36376_1def14a.htm (emphasis added).

3M and many other firms make it even harder to claw back excess pay. According to 3M's proxy, "The Company's Board of Directors has adopted a policy requiring the reimbursement of excess payments made to an executive in the event that 3M is required to make a material restatement of its financial statements and that executive's *intentional misconduct* caused the need for the restatement."[82]

An IBM executive may be subject to an excess-pay clawback if she engages in misconduct. By contrast, a 3M executive cannot be subject to an excess-pay clawback unless she engages in *intentional* misconduct. In other words, if a 3M executive engages in misconduct that is *unintentional*, she can keep her excess pay.[83]

Only 32% of S&P 500 firms with polices did not impose any misconduct hurdle in their clawback policies. Consider again Dell's 2010 proxy:

> If Dell restates its reported financial results, the Board will review the bonus and other awards made to the executive officers based on financial results during the period subject to the restatement, and, to the extent practicable under applicable law, Dell will seek to recover or cancel any such awards which were awarded as a result of achieving performance targets that would not have been met under the restated financial results.[84]

Thus, in the event of a restatement, a Dell executive (unlike an IBM executive) must return excess pay whether or not he has committed misconduct.

(2) Costs of a Misconduct Hurdle

The costs of permitting an executive to keep excess pay absent misconduct are substantial. To begin, allowing an executive to pocket excess pay even in the absence of misconduct confers an undeserved windfall on the executive. This windfall, of course, comes at shareholders' expense ex post. It also reduces the performance sensitivity of the executive's compensation ex ante, thereby undermining his incentive to increase firm value. There is no good reason why the culpability or innocence of an executive should affect an executive's ability to keep money that he did not earn.[85] Indeed, the executive should not be permitted to keep excess pay even if he took all reasonable steps to avoid the error that gave rise to that pay.

In addition, a misconduct hurdle reduces the likelihood of recovery even if there was, in fact, misconduct. Directors may use their discretion to wrongly determine that there has not been "misconduct" for the same reasons that they are reluctant to recoup excess pay absent any policy: the personal costs of recouping pay from an executive far exceed the benefits. In other words, a "misconduct" requirement may give boards an excuse not to demand repayment. In addition, when misconduct has in fact occurred, even directors acting in good faith may have difficulty detecting it. In either case, the

82. 3M, Notice of Annual Meeting and Proxy Statement 2010 (Schedule 14A) at 52 (Mar. 24, 2010), *available at* http://www.sec.gov/Archives/edgar/data/66740/000104746910002668/a2196987zdef14a.htm (describing 3M's clawback policy) (emphasis added).

83. *Id.* About half the firms with a "misconduct" requirement required something more than mere misconduct to trigger a clawback.

84. Dell Proxy Statement, *supra* note 75, at 39 (disclosing Dell's clawback policy).

85. *See* Bebchuk & Fried, *supra* note 26, at 811–12 (explaining that an executive receiving unearned pay should be required to return it to the firm regardless of the executive's culpability).

executive will be permitted to keep excess pay despite having committed misconduct. This, in turn, will systematically transfer additional value from shareholders to executives ex post and further undermine the deterrent effect of the clawback policy ex ante.

In short, a "misconduct" requirement enriches undeserving executives, undermines pay–performance sensitivity, and reduces deterrence against misconduct. Although there are many costs to the use of a "misconduct" requirement, there appear to be no significant offsetting benefits.[86] We certainly cannot think of any.

3. The Big Picture

To summarize the findings discussed above, before Dodd–Frank nearly 50% of S&P 500 firms had no excess-pay clawback policy whatsoever.[87] The remaining firms had extremely weak policies. Of the firms with policies, 81% (182/225) gave directors discretion to waive the clawback, and 68% (154/225) did not permit directors to recoup excess pay if the board determined that there was no misconduct on the part of the executive.[88] Fewer than 9% of S&P 500 firms (43/485) required recovery if the board determined that there was misconduct. Fewer than 2% of S&P 500 firms (6/485) required the recovery of excess pay whether or not there was misconduct.[89] A breakdown of S&P 500 excess-pay clawback polices is illustrated in Figure 1 below.

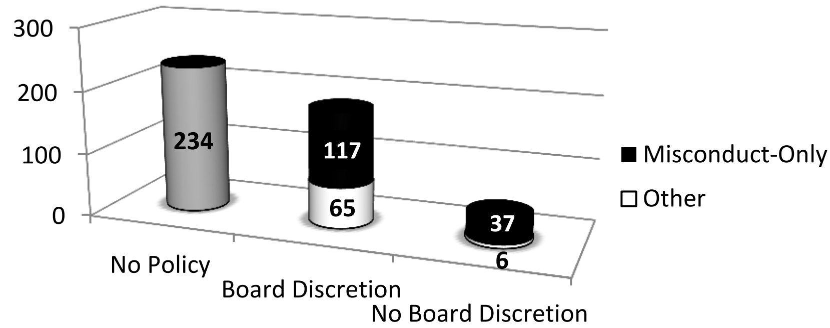
86. Although a misconduct hurdle for excess-pay clawbacks is undesirable, we are not arguing that the misconduct requirement for the SOX recovery provision should be eliminated. SOX allows the clawback of *all* incentive-based compensation, both excess pay and properly earned pay. *See supra* Part II.B.1.a (describing SOX clawback). If SOX had no misconduct requirement, all of an executive's incentive pay could be recovered in the event of a restatement, many of which occur for innocent reasons. Absent a misconduct requirement, SOX would thus impose a large tax on the use of incentive-based pay and thereby distort compensation arrangements. For the SOX clawback, a misconduct requirement might thus be desirable. However, this over-deterrence concern does not apply where the clawback policy targets only *excess pay* that the executive should not have received in any event.

87. *See supra* Part III.A.1 (describing the widespread lack of excess-pay clawback policies in S&P 500 firms).

88. *See supra* Part III.A.2 (describing the deficiencies of excess-pay clawback policies that had been voluntarily adopted by S&P 500 firms).

89. Even among these six firms, clawback policies were far from comprehensive. Some of the policies did not apply to all of an executive's compensation, and others were not triggered unless there was a restatement. We discuss the problem with conditioning clawbacks on a restatement *infra* Part IV.C.

Figure 1: Excess-Pay Clawback Policies in S&P 500 Firms (Mid 2010)



In this Part, we have focused on what we see as the two main problems with voluntarily adopted excess-pay clawback policies on the eve of Dodd–Frank. First, they generally did not require directors to recoup excess pay. Second, the clawback policies typically did not permit recovery absent a finding of misconduct.

Before we offer two explanations for the lack of robust excess-pay clawback policies, we pause to mention several other problems with these policies that are worth noting. First, many policies did not permit recovery from former executives. Second, almost 40% of the policies did not cover all elements of an executive's compensation arrangement. They were instead limited to one or two elements of the arrangement, such as a particular incentive plan. Third and finally, 85% of the clawbacks could only be triggered in the event of a restatement, even though (as we explain in more detail in Part IV) an executive could receive excess pay even absent a restatement.[90] Thus, the excess-pay clawbacks that had been voluntarily adopted by firms prior to Dodd–Frank were even weaker than they might otherwise appear.

B. Explaining the Lack of Robust Clawback Policies

We offer two explanations for why boards have generally failed to adopt robust excess-pay clawback policies. First, executives can be expected to oppose adoption of such a clawback policy, and directors are generally reluctant to adopt arrangements opposed by executives. Second, directors themselves may oppose a clawback policy if they seek to boost their firm's short-term stock price and believe that a clawback would discourage executives from aggressively boosting short-term results.

1. Managerial Power

The first explanation for the widespread lack of robust excess-pay policies is that executives will naturally oppose such a clawback policy, and many directors will be

90. *See infra* Part IV.C.1 (discussing the problems with permitting executives to keep excess pay when there is no restatement).

reluctant to adopt such a policy against executives' wishes. As we discussed earlier, executives in publicly-traded U.S. companies exert substantial influence over directors.[91] For a variety of financial, social, and psychological reasons, directors generally have an interest in supporting, or at least going along with, the firm's top executives. Directors can thus be expected to acquiesce to compensation decisions that do not benefit shareholders and to refrain from decisions that are inconvenient for—and therefore opposed by—executives. Thus, directors with discretion over whether to recoup excess pay from an executive are likely to use that discretion to permit the executive to keep the pay.

Managerial power can also explain why directors are unlikely to adopt a policy that may require them to recover excess pay from an executive in the future. Executives will oppose adoption of a robust excess-pay clawback policy for obvious reasons. Having compensation clawed back would not only impose a financial cost on the executive but would also be embarrassing, especially if the executive was in some way responsible for the error giving rise to the excess pay. Directors will be reluctant to put in place such an arrangement over executives' objections. Indeed, there is evidence that a publicly traded firm is less likely to adopt any type of clawback policy if the firm's governance arrangements give executives relatively more power.[92]

2. Short-Termism

Even if directors were open to adopting an arrangement opposed by executives, they may have their own reasons for declining to adopt a robust excess-pay clawback policy. In particular, directors who are seeking to maximize a firm's short-term stock price may avoid adopting an adequate clawback so as not to discourage executives from aggressively boosting short-term results.

Consider a board that is concerned that a low short-term stock price will expose it to shareholder pressure and perhaps attract the attention of activist investors or a hostile acquirer. The board will not want to discourage executives from taking steps to boost short-term results, even if those steps would reduce long-term value. On the contrary, the board may want to incentivize executives to do everything possible to boost the short-term stock price.[93]

Suppose that the board must consider whether to adopt a robust excess-pay clawback policy. Such a policy would reduce executives' incentive to manipulate earnings to boost the short-term stock price. To the extent that the board is concerned about the short-term stock price, it may thus decline to adopt the clawback policy, even if the firm's executives were not opposed to it.[94]

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91. *See supra* Part II.B.2.b(1) (discussing the extent of managerial power in publicly-traded firms).

92. *See* Noel Addy et al., Recovering Bonuses after Restated Financials: Adopting Clawback Provisions (Aug. 29, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1463992 (finding that public firms are less likely to adopt clawbacks when shareholder rights are weaker).

93. *See* Jesse M. Fried, Current-Shareholder Bias (2011) (unpublished manuscript) (on file with author) (explaining why the firm's current shareholders may want managers to boost the current stock price even if doing so destroys economic value).

94. *Cf.* Patrick Bolton et al., *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 730–34 (2005) (explaining how, in speculative markets, boards seeking to maximize the short-term stock price may put in place compensation arrangements that encourage executives to

IV. THE DODD–FRANK CLAWBACK AND ITS IMPLICATIONS

This Part describes and considers the implications of Dodd–Frank's clawback requirement. Part IV.A describes the requirement and explains how it is likely to improve clawback arrangements at most publicly traded firms. Part IV.B explains why, contrary to critics' claims, Dodd–Frank's clawback requirement is unlikely to undesirably reduce the use of incentive pay. Part IV.C points out two possible limitations of the Dodd–Frank requirement that allow executives to keep some forms of excess pay; it then suggests how boards should structure their clawbacks and other pay arrangements to address these limitations.

A. The Dodd–Frank Clawback Requirement and its Benefits

We now turn to describe the Dodd–Frank clawback requirement and identify its likely benefits.

1. The Dodd–Frank Clawback Requirement

Section 954 of Dodd–Frank adds a new Section 10D to the Securities Exchange Act of 1934.[95] The new provision instructs the SEC to issue rules directing each national securities exchange to require every listed company to put in place a clawback policy to recover certain incentive compensation paid to executives when the firm is required to prepare an accounting restatement.[96] The clawback policy must provide that if a firm is required to restate its financial statements due to "material noncompliance" with financial reporting requirements under the securities laws, the company will recover from current and former "executive officers" any "incentive-based compensation" (including any stock option award) that is (i) based on "erroneous data," (ii) received during the "three-year period preceding the date on which the company becomes required to prepare an accounting restatement," and (iii) in excess of what would have been paid if calculated under the restatement.[97]

Section 954 of Dodd–Frank differs from the SOX recovery provision in a number of important ways. First, Dodd–Frank requires each firm to recover excess pay; the SOX clawback can only be invoked by the SEC which, we have seen, rarely does so.[98] Second, the SOX clawback can be triggered only if the restatement is the result of

manipulate earnings). Of course, if the market were completely rational and the presence or absence of a robust clawback policy were transparent to investors, investors pricing the firm's shares would pay a lower price for the firm's stock in the short run, everything else equal, if there were no clawback policy to discount for the reduced expected accuracy of the firm's results. In such a market, adoption of an excess-pay clawback could increase the short-term stock price. But as Bolton and his co-authors emphasize, the market is not always completely rational. It can often be "noisy" or speculative, and in such conditions we can expect to see pay arrangements that encourage executives to manipulate earnings. *Id.* at 726–29 (discussing existence of speculative markets).

95. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §954, 124 Stat. 1376, 1904 (2010) (codified at 15 U.S.C. 78j–4).

96. *Id.*

97. *Id.*

98. *See supra* Part II.B.1 (describing SOX clawback).

"misconduct;"[99] Dodd–Frank, on the other hand, can require recovery of excess pay even absent misconduct. Third, SOX allows the recovery of all incentive pay,[100] while Dodd–Frank requires only the clawing back of certain types of excess pay.

2. Benefits of the Dodd–Frank Clawback Requirement

The SEC is currently developing regulations for implementing Dodd–Frank's clawback policy requirement.[101] The exact contours of this clawback requirement have not yet been determined. As is always the case, the devil will be in the details.

Nevertheless, it appears that Dodd–Frank will have significant effects on compensation arrangements. As we discussed earlier, prior to Dodd–Frank fewer than 2% of S&P 500 firms had policies requiring the clawback of excess pay whether or not there had been misconduct on the part of the targeted executive.[102] After Dodd–Frank, all publicly-traded firms must have such a clawback policy, substantially increasing the likelihood that excess pay will be recouped.

Requiring publicly-traded firms to put in place robust clawbacks will generate three important benefits for their shareholders. First, it will reduce the ex post diversion of value from shareholders to executives via excess pay. Second, it will improve the performance sensitivity of executives' compensation arrangements by more closely tying payouts to actual performance. This, in turn, will increase executives' incentive to generate value for shareholders. Third, it will reduce executives' ex ante incentive to manipulate earnings and other compensation-affecting metrics.

B. Will Dodd–Frank Undesirably Reduce Incentive Pay?

A number of academics, including Professors Stephen Bainbridge, Sanjai Bhagat, and Roberta Romano, have argued that government-mandated clawbacks can cause firms to undesirably reduce their use of incentive pay.[103] They cite an unpublished study by several economists that seeks to examine the effect of SOX on the amount and level of incentive compensation given to executives.[104] The study finds that the average ratio of incentive compensation to fixed salary declines after SOX.[105] According to Bainbridge,

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99. *Id.*

100. *Id.* Two other differences are worth noting. First, the SOX clawback applies only to CEOs and CFOs. *Id.* By contrast, the Dodd–Frank clawback requirement applies to all current, and even former, executive officers. Second, the look-back period under SOX is the year following the first improper filing. *Id.* Dodd–Frank requires a clawback of erroneously awarded compensation received during the three-year period before a company is required to restate.

101. *See* Klein and Pappas, *supra* note 4 (reporting on the SEC's schedule for implementing the Dodd–Frank clawback rules).

102. *See supra* Part III.A.3 (summarizing prevalence of excess-pay clawback policies in S&P 500 firms).

103. *See* Bainbridge, *supra* note 5, at 27 (arguing that the Dodd–Frank clawback provision is likely to undesirably reduce the use of incentive compensation); Bhagat & Romano, *supra note* 18, at 366 (claiming that the clawbacks required by the Sarbanes–Oxley Act of 2002 decreased incentive compensation, which led to the "perverse consequences" of "providing insurance to managers for increased risk").

104. *See* Daniel A. Cohen et al., The Sarbanes Oxley Act of 2002: Implications for Compensation Contracts and Managerial Risk Taking (Nov. 9, 2007), (unpublished manuscript), *available at* http://ssrn.com/abstract=1027448 (examining the effects of SOX on CEO compensation contracts and firm performance).

105. *Id.* at 28.

Bhagat, and Romano, the study shows that the SOX clawback undesirably affected executive pay arrangements.[106] Bainbridge argues that this finding suggests the Dodd–Frank clawback will do so as well.[107]

However, the study's findings do not mean that an excess-pay clawback like the one required by Dodd–Frank would have undesirable effects. First, the ratio of incentive compensation to salary is a rather crude measure of pay–performance sensitivity, which depends in large part on the specific features of the incentive compensation arrangements, such as the use of performance-conditioned vesting and equity-holding requirements. If the features of incentive compensation arrangements are improved, pay–performance sensitivity could increase even if the ratio of incentive compensation to salary declines. The economists who performed this study make no claim that the compensation changes supposedly caused by SOX were bad for shareholders. Indeed, they specifically look at the effect on firms' operating performance and find that their performance was not hurt by SOX.[108] Thus, the study fails to show that SOX's clawback provision adversely impacted compensation arrangements and hurt shareholders.

Second, and more importantly, even if the study showed that SOX's clawback adversely impacted compensation arrangements and hurt shareholders, the study would at most indicate that the *SOX clawback* was undesirable. But recall that the SOX clawback is quite different from an excess-pay clawback. It allows the SEC to recover *all* incentive compensation if there has been misconduct and a restatement, not just excess pay.[109] Even if the potentially punitive effect of the SOX clawback undesirably reduced the use of incentive compensation, Dodd–Frank's requirement that executives return unearned pay—a quite reasonable obligation—should not distort pay arrangements.

C. Two Limitations of Dodd–Frank's Requirements

Although Dodd–Frank's clawback requirement will substantially improve clawback arrangements at public firms, it does have two limitations: (1) Dodd–Frank does not mandate the return of excess pay if a restatement is not required; and (2) Dodd–Frank does not seem to require a policy to claw back the excess proceeds from sales of stock made while the firm was inflating earnings or other metrics. We discuss each limitation in turn, and explain what firms should do about them.

1. No Restatement, No Clawback

Neither the SOX clawback nor the excess-pay clawback required by Dodd–Frank will be triggered unless the firm is required to restate its financials.[110] A financial

106. Bainbridge, *supra* note 5, at 29; Bhagat & Romano, *supra* note 18, at 366.

107. Bainbridge, *supra* note 5, at 29.

108. Cohen et al., *supra* note 104, at 4–5 (finding that SOX does not negatively impact firms' operating performance).

109. *See supra* Part II.B.1 (describing the SOX clawback).

110. *See* S.E.C. v. Shanahan, 624 F. Supp. 2d 1072, 1078 (E.D. Mo. 2008) (holding that "an issuer must be compelled or ordered to prepare a financial restatement, and must actually file the restatement" before the SEC can invoke the SOX clawback); Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §954, 124 Stat. 1376, 1904 (2010) (codified at 15 U.S.C. 78j–4) (mandating recovery of certain types of excess pay if a restatement is required and other conditions are met).

restatement is generally required upon discovery of an error or accounting irregularity that makes an earlier earnings statement materially false.[111] If an earlier financial statement is not materially false, there will be no financial restatement. A restatement requirement is problematic because an executive could receive excess pay even if a restatement is not considered to be required.

First, there could be a small error in the firm's earnings or other reported financial results that leads to a large increase in payout for the executive but is not considered "material" and thus does not necessitate a restatement. For example, suppose a CEO's contract indicates that he will receive a $1 million bonus if earnings increase by $10 million. Suppose that earnings are reported as having increased by $10 million, even though they increased by only $9.9 million. The CEO receives a large bonus because earnings appear to have increased by $10 million. However, the firm may not be required to restate its earnings, because actual earnings were only $100,000 less than reported earnings. The absence of a restatement may prevent recovery under a Dodd–Frank-compliant clawback policy.

Second, a firm may use non-financial metrics (such as customer satisfaction) in calculating an executive's bonus. Even if these metrics turn out to be highly erroneous and substantially inflate the executive's bonus, they need not be corrected by a financial restatement. Because a restatement is not required, a firm with a Dodd–Frank-compliant clawback policy need not recover the excess bonus pay. There is, however, no good reason to bar recoupment of excess pay resulting from an error in a metric whose correction does not require a restatement.

Third, a firm may take the position that a restatement is not "required" even though most neutral observers would believe otherwise.[112] This is not just a theoretical possibility. Consider the case of Michael Shanahan, the founder and former CEO of Engineered Support Systems.[113] Shanahan had pleaded guilty to falsifying records by stock option backdating.[114] The SEC alleged that Shanahan profited by $8.9 million by approving misdated stock-option grants.[115] The CFO was also involved in the scheme and pocketed an extra $1.9 million.[116] The SEC charged that the company overstated its

111. *See* Ronald E. Marden et. al., *The CEO/CFO Certification Requirement*, THE CPA J. (July 3, 2003), http://www.nysscpa.org/cpajournal/2003/0703/features/f073603.htm (reporting that a restatement indicates that the original financial statements were materially false when issued). *See also* Jap Efendi et al., Can Short Sellers Anticipate Accounting Restatements? 11 (July 20, 2005) (unpublished manuscript) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=591361 (describing different types of restatements, including restatements caused by unintentional misstatements and restatements caused by fraudulent misstatements).

112. *See* Ya Fang Wang & Hung-Chao Yu, Do Restatements Really Increase Substantially after the Sox? How Does the Stock Market React to Them? 9 (Jan. 23, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1087083) (reporting that often "the decision as to whether a restatement is necessary may be a judgment call on the company's behalf, driven by interpretation of accounting principles rather than a mandate or clear-cut requirement").

113. *See Shanahan*, 624 F. Supp. 2d at 1072 (ruling that SOX clawback could not be invoked against executive because firm had failed to file a restatement); Sarah Johnson, *Sarbox Clawback Ruling Could Keep Pay in Some CFOs' Pockets*, CFO (Dec. 24, 2008), http://www.cfo.com/article.cfm/12840062 (describing *Shanahan* decision).

114. Johnson, *supra* note 113.

115. *Id.*

116. *Id.*

pretax operating income by 25% by backdating the measurement dates of stock-option grants on at least ten occasions during the period 1997–2002.[117] According to the SEC, that error warranted a restatement under generally accepted accounting principles. However, no restatement was filed.[118] Consequently, the court did not permit the SEC to deploy the SOX clawback against Shanahan and the CFO.[119]

As we have seen, Dodd–Frank's "required restatement" condition is likely to enable executives to keep excess pay in a number of situations. Boards seeking to put in place shareholder-friendly clawback policies should thus require executives to give back excess pay even if a restatement is not required. Our research indicates that as of mid-2010, approximately 7% of S&P 500 firms already had clawback policies in place that allowed for recovery even absent a restatement. All firms should have such a provision.[120]

2. No Clawback of Excess Stock-Sale Proceeds

Dodd–Frank requires firms to adopt a policy that will recover from an executive "who received incentive-based compensation" the "excess [over] what would have been paid to the executive" in the event that certain conditions are met.[121] Because the proceeds of a stock sale are not "paid" by the firm, the SEC may interpret Dodd–Frank as not requiring firms to adopt a policy to recover the extra proceeds an executive receives when he unwinds equity incentives at a stock price inflated by errors in performance metrics. This omission is problematic even if other elements of an executive's compensation arrangement are subject to recovery under a Dodd–Frank-compliant clawback policy. Executives will still have an incentive to manipulate earnings before they dispose of large amounts of stock. Indeed, earnings manipulation prior to stock sales has been quite common.[122]

We do not suggest trying to remedy this problem by expanding clawbacks to reach excess stock-sale proceeds (the difference between what the executive actually received selling stock and the amount that he would have received absent the metric errors). The reason is simple: it would be complicated for firms to calculate what the stock price would have been absent the errors and thereby determine the amount of excess stock-sale proceeds.

Instead, we suggest structuring executives' equity arrangements to make it difficult for executives to profit heavily from selling stock when the price is inflated by erroneous earnings or other metrics. To begin, firms should limit the extent to which the payoff

117. *Id.*

118. *Id.*

119. *See Shanahan*, 624 F. Supp. at 1078.

120. Although clawbacks should apply to all forms of incentive compensation and not depend on an executive's culpability, there could of course be a carveout for "de minimis" amounts of excess pay. We see no real cost to such a carveout. Refraining from clawing back small amounts of excess pay will not substantially affect shareholders' returns nor meaningfully reduce the deterrent effect of the clawback. At the same time, such a carveout will confer a benefit on shareholders by avoiding the transaction costs associated with effecting a clawback.

121. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §954, 124 Stat. 1376, 1904 (2010) (codified at 15 U.S.C. 78j–4).

122. *See supra* Part II.A.1.b (describing the link between earnings manipulation and executives' stock sales). For an explanation as to why insider trading law is not effective at deterring this type of misbehavior, see Fried, *supra* note 14, at 460–62.

from stock sales depends on a single day's price. Rather, as Lucian Bebchuk and one of us have argued, an executive's equity payoff should be based on the average stock price over a significant period of time, perhaps six months or a year.[123] If the executive's payoff were not based on the stock price over a short period, the executive's incentive to manipulate the short-term stock price prior to unwinding his equity would be substantially diminished.

One or two additional steps should also be taken. First, executives could be subject to a "hands-off" arrangement that leaves them no discretion over when their equity is cashed out.[124] Under this arrangement, restricted stock and stock options would be cashed out according to a fixed, gradual, and pre-announced schedule set when the equity is granted. Because each sale would involve only a small amount of stock and the executive would have no control over the timing of the sale, the executive would have much less incentive to manipulate the stock price around the sale.[125]

Second, to the extent that executives have any discretion over when they cash out their equity, they should be required to disclose their intended unwinding in advance, a proposal one of us made some time ago.[126] Such advance disclosure would notify the market that executives might be manipulating the short-term stock price or aware of bad news, thereby intensifying scrutiny of the firm's accounting results and prospects. This would lead to a downward adjustment in the stock price to the extent that investors believe the firm is "hiding something." Coupled with average-price payoffs, advance disclosure would further reduce executives' ability to profit from manipulating a firm's stock price.

In short, Dodd–Frank appears to allow executives to keep windfalls from stock sales made when earnings or other price-affecting metrics are erroneous, even if these deviations result from deliberate manipulation. This deficiency cannot easily be fixed through an excess-pay clawback policy because of the difficulty of determining the extent of excess stock-sale proceeds reaped by an executive. Instead, it can be mitigated by structuring executives' equity incentives so as to reduce their motivation and ability to manipulate earnings and other metrics before they unload shares.

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123. *See* Bebchuk & Fried, *supra* note 18, at 1945–47 (suggesting that the payoffs from executive stock sales should be based on the average stock price over a reasonably long period).

124. *See* Fried, *supra* note 14, at 468–70 (proposing that executives' equity be cashed out on a pre-arranged schedule as a means of reducing the costs to shareholders that arise when executives have the freedom to choose when to sell their stock).

125. At least one firm, Level 3 Communications, has adopted the "hands-off" approach to its option compensation. *See* Level 3 Commc'ns, 2009 ANNUAL REPORT 28 (2010), *available at* http://files.shareholder.com/downloads/LVLT/1197635810x0x363608/2ABB6CC9-B76E-4529-BFFF-B41A5F76B3AB/2009_Annual_Report-Proxy.pdf ("[R]ecipients of these [stock-indexed securities] will not be able to voluntarily exercise [them] as they will settle automatically with value on the third anniversary of the date of the award or expire without value on that date.").

126. *See* Jesse M. Fried, *Reducing Corporate Insider Trading Profits with Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 349–53 (1998) (arguing that executives should be required to announce their buy and sell orders before transacting in the shares of their firms). For a more condensed version of the proposal, see Jesse M. Fried, *Advance Disclosure of Managers' Stock Trades: A Proposal to Improve Executive Compensation*, ECONOMISTS' VOICE, Nov. 2006, at 3–4, *available at* http://www.bepress.com/ev/vol3/iss8/art7.

V. CONCLUSION

Academic commentators have criticized the Dodd–Frank Act for mandating that public firms adopt a policy requiring the clawback of certain types of "excess pay"—pay that executives receive as a result of errors in the firm's earnings or other compensation-related metrics. These commentators have argued that firms can be counted on to adopt optimal compensation policies and that there is no need for government intervention in this area.

After systematically analyzing the costs that excess pay imposes on shareholders, we have explained why such costs are unlikely to be reduced unless directors are obligated to recover excess pay from executives. Analyzing the clawback policies voluntarily adopted by S&P 500 firms prior to Dodd–Frank, we find that almost 50% of S&P 500 firms had no excess-pay clawback policy whatsoever. Among the remaining firms, clawback policies almost always either gave directors discretion not to recoup excess pay or permitted executives to keep excess pay absent a finding of misconduct. Only 2% of S&P 500 firms required the clawback of excess pay even if there was no finding of misconduct. Our findings suggest that private ordering failed to yield adequate clawback arrangements before Dodd–Frank, and that Dodd–Frank will improve these arrangements.

We also explained that Dodd–Frank still allows executives to keep some forms of excess pay. In particular, it does not mandate that firms claw back excess pay when no restatement is required, and it appears to permit executives to keep excess pay arising from the sale of equity incentives at inflated prices. We suggested how each of these limitations could best be addressed by boards seeking to improve executive pay arrangements. We hope that our work will be useful to regulators, investors, and directors seeking to improve pay arrangements at publicly-traded firms.